PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD & AGRICULTURE

DAIRY MARKETING BRANCH

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

THURSDAY, OCTOBER 30, 2008

10:04 A.M.

KATHRYN S. SWANK, CSR
CERTIFIED SHORTHAND REPORTER
LICENSE NUMBER 13061

APPEARANCES

HEARING OFFICER

Mr. Michael Cleary

PANEL MEMBERS

Mr. Hyrum Eastman, Senior Agricultural Economist

Ms. Candace Gates, Research Manager II

Mr. David Ikari, Chief, Dairy Marketing Branch

Ms. Annie Pelletier, Assistant Agricultural Economist

STAFF

Mr. Thomas W. Gossard, Agricultural Economist

ALSO PRESENT

Mr. Dennis Brimhall, Super Store Industries

Mr. Randall Dei, Safeway Inc.

Mr. Eric Erba, California Dairies, Inc.

Mr. James W. Gruebele, Land O'Lakes, Inc.

Mr. John Hitchell, The Kroger Company

Mr. Evan Kinser, Dean Foods Company, Inc.

Ms. Tiffany LaMendola, Western United Dairymen

Ms. Linda Lopes, California Dairy Women Association

Mr. Michael McCully, Kraft Foods

Mr. Michael Newell, HP Hood LLC

APPEARANCES CONTINUED

ALSO PRESENT

Mr. William Schiek, Dairy Institute of California

Ms. Patricia Stroup, Nestle USA

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

Mr. Robert VandenHeuvel, Milk Producers Council

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PROCEEDINGS

HEARING OFFICER CLEARY: I guess we'll go on the record at this time, and we'll start this hearing off. Good morning. The hearing will now come to order. California Department of Food and Agriculture is calling this public hearing at the Department's Auditorium at 1220 N Street, Sacramento, California, on this day, Thursday, October 30, 2008, beginning at 10 a.m. The room is also reserved for tomorrow to receive additional testimony starting at 10 a.m. also.

My name is Mike Cleary, and I have been designated as the hearing officer for today's proceedings. And on August 5, 2008, the Department received a petition from the Alliance of Western Milk Producers cosigned by Western United Dairymen of California and California Dairy Women Association requesting a public hearing to consider amendments to Class 1, 2, and 3 pricing formulas of the stabilization and marketing plans for market milk for the Northern and Southern California marketing areas.

The Department announced the call of the hearing on August 19, 2008, to consider the petitioners' proposed changes to the specific components of the current Class 1, 2, and 3 pricing formulas. We'll also consider any other aspects of the Class 1, 2, and 3 pricing formulas that are raised by alternative proposals received by the

September 25, 2008, deadline. Hearing will also consider the factual basis evidence and the legal authority upon which to make any and all of the proposed amendments to the plans.

The Department has received two alternative proposals in response to the call of the hearing. The alternative proposals are from the Dairy Institute and Milk Producers Council. The petitioners will have up to 60 minutes to submit testimony and relative material to support their proposal, which will then be followed by any questions of the panel.

And as a side line, if you'll look over here to my right, you will see the little time keeper thingie -- that's the official term for it, is "thingie." And when you have five minutes left, the little yellow light will come on to let you know you have five minutes left. So just FYI.

Those submitting alternative proposals will each be provided 30 minutes to give testimony and evidence followed by any questions from the panel. Anyone else willing to testify must sign into the hearing witness roster located at the back of the room -- will be allowed 20 minutes to give testimony in evidence. Witnesses will be called upon in the order they sign up. The time clock to my right -- and I told you about that.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing briefing period to amplify, explain, or withdraw your testimony.

Only those individuals who have requested a post-hearing brief period may file a post-hearing brief with the Department.

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

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses, and make recommendations to the Secretary.

Please note that the questioning of witnesses by anyone other than a member of the panel is not permitted. The panel is composed of members of the Department's Dairy Marketing Branch and include David Ikari, Branch Chief; Candace Gates, Research Manager; Hyrum Eastman, Agricultural Economist; and Annie Pelletier, Agricultural Economist.

I'm not a member of the panel and I will not be taking part in any discussions relative to the hearing nor will I be involved in the decision-making process. I'm just here to make sure that the hearing flows as smoothly as possible.

The reporting of the hearing will be handled by the firm of Peters Shorthand Reporting Corporation located in Sacramento. A transcript of today's hearing will be available for review at the Dairy Marketing Branch Headquarters located in Sacramento at 560 J Street, Suite 150. And Kathryn Swank will be taking the transcript today for that particular firm.

Testimony and evidence pertinent to the call of the hearing will now be received. And at this time, Tom Gossard, Agriculture Economist with the Dairy Marketing Branch, will introduce the Department's exhibits. The audience may ask questions of Mr. Gossard only as it relates to the exhibits that he's going to present today.

Sir, do you -- state your name and spell your last name for the record, please.

MR. GOSSARD: I do.

Mr. Hearing Officer, my name is Tom William Gossard, G-O-S-S-A-R-D. I'm the senior agricultural economist with the Dairy Marketing Branch of the California Department of Food and Agricultural.

My purpose here this morning is to introduce the Department's composite hearing exhibits numbered 1 through 44. Relative to these exhibits, previous issues of

Exhibits 9 through 44 are also hereby entered by reference. The exhibits entered here today have been available for review at the offices of the Dairy Marketing Branch since the close of business on October 23, 2008. A copy of these exhibits is available for inspection at the back of the room. A copy of the exhibit list is also available at the back of the room. I ask at this time that the composite exhibits be received.

Mr. Hearing Officer, at the October 15, 2008, prehearing workshop, the Department received several requests for additional information. The exhibit next in order is a document --

HEARING OFFICER CLEARY: Mr. Gossard, we're going to have to rewind just a hair. Before we begin, we're going to have to swear you in. So, you know, you kind of jumped right in there.

(Mr. Gossard was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And you are testifying today on the part of the Department; is that correct?

MR. GOSSARD: I am.

HEARING OFFICER CLEARY: All right. Then you may proceed.

MR. GOSSARD: Mr. Hearing Officer, at the October 15, 2008, prehearing workshop, the Department received several requests for additional information.

The exhibit next in order is a document with Attachment A that addresses these requests. This document with Attachment A entered here today has been available for review on the Dairy Marketing Branch's Web site since October 24, 2008. A copy of this document with Attachment A is available for inspection at the back of the room. I ask at this time that this document be received.

Mr. Hearing Officer, the exhibit next in order is a letter from Farmdale Creamery dated October 29, 2008, and signed by Nicholas Sibilio, owner. Copies of this letter are available at the back of the room. I ask at this time that this letter be received.

Mr. Hearing Officer, the exhibit next in order is a letter from General Mills dated October 29, 2008, signed by Jeff Malbon, Dairy Manager-West. Copies of this letter are available at the back of the room. I ask at this time that the letter be received.

Mr. Hearing Officer, the exhibit next in order is a statement from California Dairy Campaign. Copies of this statement are available at the back of the room. I ask at this time that the statement be received.

HEARING OFFICER CLEARY: Three letters will be entered into the record as Exhibits No. 45, 46, 47, as they were read, along with the Department's Exhibits 1 through 44 exclusive.

(The above-referenced documents were marked as Exhibit Nos. 1 through 47.)

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

HEARING OFFICER CLEARY: Thank you.

MR. GOSSARD: Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER CLEARY: Thank you. You are dismissed.

Any questions of the panel?

Any questions from the audience?

Can we have the first petitioner come up, please? And the first petitioner is Alliance of Western Milk Producers, which was cosigned by the Western United Dairymen and California Dairy Women Association.

Good morning.

MR. VAN DAM: Mr. Hearing Officer, all three of the co-petitioners are going to participate in this first segment.

HEARING OFFICER CLEARY: So you will all need to be sworn in?

MR. VAN DAM: Yes.

HEARING OFFICER CLEARY: Could I get you all to raise your right hands?

(William C. Van Dam, Tiffany LaMendola, and
Linda Lopes were placed under oath by
Hearing Officer Cleary.)

HEARING OFFICER CLEARY: Thank you. And are you testifying on behalf of an organization or individually?

MR. VAN DAM: I am testifying on behalf of the Alliance of Western Milk Producers.

MS. LaMENDOLA: Testifying for Western United Dairymen.

MS. LOPES: Testifying for the California Dairy Women Association.

HEARING OFFICER CLEARY: Thank you. You may begin.

MR. VAN DAM: Mr. Hearing Officer and members of the panel. Good morning. My name is William C. Van Dam. Last name is spelled V-A-N D-A-M. I am the CEO of the Alliance of Western Milk Producers. Our office is at 1225 H Street, Suite 102, Sacramento, California.

Our membership is made up of California Dairies Incorporated, Dairy Farmers of America, the Western Council, and Humboldt Creamery Association. The volume of milk marketed by our members totals just over 23 billion pounds of milk in 2008, or 58 percent of the total milk produced in this state.

The concepts contained in this testimony were approved by -- at a board meeting of the Alliance of Western Milk Producers on July 21, 2008, and reaffirmed at a board meeting on September 22, 2008.

Joining me on the stand this morning are co-petitioners Tiffany LaMendola, Director of Economic Research for Western United Dairymen; and Linda Lopes, president of the California Dairy Women Association.

Before beginning my testimony, it is appropriate to recognize the fine work done by the CDFA staff in preparing the background material for this hearing. It is an extremely thorough compilation of material that is presented in a very useful format. And we thank them for that.

Our proposal: Our proposal is to add four cents to the price per pound of butter fat and 10 cents per pound to the solids not fat on all Class 1, 2, and 3 products. This would be applied as a surcharge after all existing formulas are used to calculate prices. The start and finish dates are within the proposal. It is simple and it is straightforward.

We urge you to consider that our request is a surcharge to apply for six months only. We are fully aware that by putting a surcharge in place, we run the risk of a loss of some Class 1, 2, or 3 sales to out-of-state plants. If our price suggestions were to be made permanent, there certainly would be changes made and sales would be lost. However, the short-term nature of the surcharge gives us reason to believe that there will be little incentive to shift business for such a short period of time. Given the magnitude of the issues facing the producers in the near term, we are willing to take that risk.

We do live in interesting times. While the underlying phrase, "May you live in interesting times" sounds as if it were a blessing, it is, in fact, a curse that means, "May you experience much upheaval and trouble in your life."

As evidence that we do live in interesting times, consider the following:

The price of corn increased from $2 a bushel in October 2006 to $5.20 at its peek in June 2008, an increase of $3.20 per bushel, or 160 percent.

Bullet point 2. The price of corn decreased from $5.20, the high that I just mentioned, in June, to a low of $3.80 at its lowest a few days ago, a decrease of $1.40 or 27 percent.

Yesterday the corn price was limit up 30 cents.

The day before yesterday, the Dow Jones average climbed over 880 points in a two-hour span.

Oil prices have dropped from a high of $147 per barrel to about $65 yesterday, in about the same amount of time that corn prices developed.

Congress has mandated that next year, at least 10.5 billion gallons of ethanol must be added to the gasoline used in this country. The law is such that this ethanol must be made from corn. That means at least 3.9 billion bushels of this year's corn must be converted to ethanol. That is 32.5 percent of the corn grown in this country.

The mandated conversion of corn to ethanol increases every year until 2015, at which time 40 percent of the then much larger corn crop will be burned as ethanol.

Senator John McCain says he will, if elected, eliminate the ethanol subsidy and the tariff. Sugar-based ethanol would then be able to compete for market share. That he would reduce the pressure on the corn supply and allow long-term relief.

Senator Barak Obama was an early and strong supporter of corn-based ethanol. If elected, which he would continue, and perhaps enhance ethanol production.

These are indeed interesting and volatile times.

First two bullet points are included to illustrate the volatility of the times, but more importantly to show how the level of price has worked to the disadvantage of the buyer of corn, which of course include our dairymen.

Note the increase in price of $3.20, in the first bullet point, is followed by a decrease in price of $1.40. In spite of the "good feeling" associated with the current sharp drop in prices, the cost is still a shocking $1.80, or 90 percent, above the beginning price.

The third bullet point is included to make the point that the volatility is not over. A new revision of the USDA Crop Report showed a slight reduction in the expected crop size, which may have triggered this "limit up" jump. But it could be because oil bumped in price yesterday, or it could be because the prices have dropped too far, as is often the case when commodities are correcting and needed to be higher to properly allocate the crop among users.

The point of these sentences is to illustrate that we don't really know for sure what's causing it to move around, but we sure do know it's moving.

The fourth and fifth bullet points simply illustrate that the background economics are just as crazy and volatile as those portions of the economy of direct interest to us.

The sixth and seventh bullet points refer to the most incredible legislative effort at "central planning" ever carried out by the Congress of the United States.

The U.S. dairy industry has been extremely lucky -- and I stress that, extremely lucky -- to have dairy commodity prices driven sharply higher at exactly the same time as our costs were being driven higher. And that's talking about last year. But each set moved for very different and unrelated reasons. World milk prices jumped mostly because of horrible weather conditions in Oceania, where a prolonged drought dramatically cut milk production. A lesser factor was the growing demand for dairy product, particularly in Asia, and the weak dollar also played a role.

The vast majority of the increases of milk cost of production were because of increasing feed costs. Increasing feed costs are the absolute by-product of the mandated ethanol program. The impact is not limited to corn even though that is the only product converted into ethanol. Because the ethanol-mandated requirement for corn is so huge, more acres had to be dedicated to growing corn. The acres came from other crops which, logically enough, were then in short supply, and thus prices increased for nearly all other crops. This is known in the commodity trade as the battle for acres. It will happen again later this year and early next year as planting decisions are made by farmers.

The last two bullet points serve to drive home the political nature of the ethanol program. We are only five days away from the election, and so by next week, we will have the first real clue about the prognosis of our industry.

Cost of production. Figures 1 through 16 of the CDFA background material clearly illustrate the cost factors that apply to the production of milk. Others testifying will refer directly to some of this data, so I will limit my comments to the general observation that the cost increases of the past few years are simply astounding. The $2 increase in cost of production in 2007, from $15 per hundredweight to $17 per hundredweight stands out along with the jump of another dollar in the first six months of 2008, from $17 to $18. There are more increases to come.

Milk prices. Milk values are on a downward slide. Nonfat dry milk is being sold to the CCC at 80 cents per pound. The trade is aware of these sales and prices are rapidly being driven down toward that price. Last week's CWAP price is 90.65 cents per pound and is sure to drop lower in coming weeks.

Earlier I measured the drop of other products from their high in June until currently, and will do the same for nonfat dry milk.

In June 2008, the CWAP price was $1.33 per pound.

That is a decrease -- taking that 90.65 away from it, of 42.4 cents, or 32 percent.

When I apply yesterday's prices to the 4a formula, the resulting price for 4a is $12.87 per hundredweight. That is a drop of $2.64 from the September '08 price.

A $1 surcharge placed on top of a $2.64 drop -- and I stress that that $2.64 is what we have now. We're proposing this going into effect in July -- in July -- I'll say that again, in January, and expect these numbers to be even bigger and more substantial -- will still result in a price decrease on Class 2 and 3 products.

On the next page is a graph of the CME block cheese prices for this year. Every price is the week-end price with the exception of the October 29th, which is yesterday's, price. A pretty clear trend of lower highs and lower lows have been evident since May of this year. The cheese price is now just 2.75 cents above the lowest prices of the year.

Prices in Europe and Oceania have declined to the point that little, if any, commodity cheese will be exported there. And thus, our prices will no longer be protected on the downside by purchases from Europe whenever cheese prices drop.

Using yesterday's prices in the 4b formula yields a price of $14.97 per hundredweight, which is $1.66 per hundredweight below the September 2008 4b price. A surcharge of $4 per hundredweight on top of a $1.66 decrease in the 4b price will still yield a price decrease to Class 1 customers.

There's a graph on the middle of the fourth page there, showing the freehand-drawn lines indicating what the trend appears to be. We'll see how it all plays out.

$1.65 over on the left side is the lowest price of the year so far -- we had two weeks, the second two weeks of the year. And we're now at $1.6775.

Summary. Prices of dairy products are following normal economic rules. The supply of milk is growing closer to the demand and prices are dropping. On the other hand, our costs are not being adjusted by normal economic forces but are instead driven upward -- and I should say driven and held upward by a government policy that mandates the diversion of 32.5 percent of the corn produced in this country this year, and steadily increasing amounts for the next seven years.

If the ethanol program cannot be eliminated or significantly modified, our industry will need to make significant adjustments in how we do business. With high corn prices, we cannot compete in world markets because our competition does not rely on grains as the most important part of the ration.

The added income for six months will not make our producers whole, but it will, in part, help offset some of the costs forced upon them by government policy.

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

Thank you.

HEARING OFFICER CLEARY: Thank you, sir.

Any questions from the panel?

PANEL MEMBER EASTMAN: I actually have a couple of questions. On the first page of your --

MR. VAN DAM: Shouldn't you stop the clock while you are doing the question?

PANEL MEMBER EASTMAN: Since I am the time keeper, I can do whatever I want, I guess.

I guess you are the only one on the hot seat right now. The first question I have is, on the first page, you kind of mentioned that you are going for a temporary price increase. And you do mention that one outcome of that surcharge, so to speak, could be a loss in some Class 1, 2, or 3 sales from outside the state plants.

Are there any factors on the producers' side, for example, the way dairies operate, or is there some sort of contracting rules for feed or anything that sort of led you to go with the six-month time frame as well? Or were you thinking solely on the idea of maybe losing sales as your six-month figure?

MR. VAN DAM: The -- our biggest concern in going for the six-months and why it was chosen was to avoid the possibility of losing the Class 1, 2, and 3 sales on the long term. That would not be useful to us.

There's very few places in the system where we could ask for and get an additional income flow. This is the only one we could think of that -- 4a and 4b, there's no ability to tack on prices and get them from the trade. So that's why we chose the six months.

PANEL MEMBER EASTMAN: Okay. And then a follow-up question to that one: If the Secretary were to decide to go with a different time period other than six months, say, nine months, going over, even shorten it to maybe three months, how would that affect the people in your organizations, the producers?

MR. VAN DAM: We haven't talked about that directly. So I can give you my response to it. Going beyond the six months starts getting worrisome, because that makes a long enough period -- and this is judgmental is all it is. You get a long period and it starts being worth it. You start multiplying by 9 instead, and the other things might happen.

A shorter period -- if in your judgment it needed to be a shorter period, we obviously would be accepting your decision.

PANEL MEMBER EASTMAN: Or the decision of the Secretary.

MR. VAN DAM: Yes.

PANEL MEMBER PELLETIER: I have a follow-up question on that too.

You said that there's a risk of losing sales to out-of-state plants. Did you do any kind of analysis or impacts on what kind of loss could occur on the six-month period?

MR. VAN DAM: Quite frankly, we did not. It's a judgment we made, saying, we're willing to take that risk. And if you try to do analysis on it and say, what if I lose 2 percent, what if I lose 6, what if I lose 10, then that has no more meaning than my statement saying, we're willing to take the risk.

PANEL MEMBER PELLETIER: Okay. Thanks.

HEARING OFFICER CLEARY: Questions on this side?

PANEL MEMBER IKARI: Bill, I have a series of questions that I will ask you and the other witnesses. At various public venues, processors, producers, leaders have expressed concern about the inadequacy of the state's processing capacity. If your organization's proposal is implemented, how does it impact the state's processing capacity?

MR. VAN DAM: It has no impact on the state's processing capacity unless, of course, some trade gets shifted over in the Class 1, 2, or 3 plants. The real issue in this state is, and has been, do we have enough capacity to take care of the 4a and 4b? Because that's the biggest chunk of what we do, and it has no impact on that.

PANEL MEMBER IKARI: Will your organization's proposal have an impact, a positive impact, on the ability of those producers who have been given termination notices to find a home for their milk?

MR. VAN DAM: Not at all. That is a separate issue where, for business reasons, these plants were closed down or cut back or business shifted over to others. These people have got to find their own homes, and I understand significant progress is being made to finding homes for them. So this is no direct impact on them.

PANEL MEMBER IKARI: You partially answered this next question I have, but I will ask it anyway. What information, data, analysis, or assurances can you -- other than your judgment, can your organization provide the hearing that a temporary increase of a dollar in Class 1, 2, and 3, wouldn't add economic incentives for additional producers to receive notices that their buyers will be reducing the amount of milk they buy, or that their supply contracts will be terminated?

MR. VAN DAM: I start by saying that question can go both ways, but that's okay.

We have a lot of factors going on in this state, in this world right now, that have some play on that matter. One of them would be the new California Real Seal for the fluid milk, or Buy California kind of idea -- seems to have taken hold and it would give some protection.

Freight rates and fuel costs are not as high as they used to be. Kind of like what happened with the corn -- you feel good that it's down, but it's still very high. And the cost of transporting product is higher than it used to be, and we feel that we got some added security in that.

The Real Seal doesn't really get at the issue of buy local. Sort of like that. But the buy local move is going on in this world, and people are looking to buy local from local companies and so that will have some bearing on this thing. But those are just all pieces and factors. In the whole our judgment is that there will be very little loss in sales because of the length of the period and it will -- and if it did happen, we would get it back right away at the other end, because conditions will revert back to what they were.

PANEL MEMBER IKARI: I take it from your response to Ms. Pelletier's question that you did not perform an analysis to determine the impact of the reduction of the federal order prices on the competitive relationship between California finished products and those produced outside of California.

MR. VAN DAM: No, we did not. We considered that and thought about that for a while. Things like to make allowance adjustments happen. They happen in California; they happen in other states. On the Class 1, the make allowance itself has -- now I'm mixing up federal and state, and California is not tied to a make allowance. And I know in the federal order -- so strike that part and we'll start over.

I know in the federal order, they are having some discussions to disconnect make allowances and the Class 1 prices. Don't know how far those discussions are and whether they're going to make any headway.

PANEL MEMBER IKARI: I was referring to the October 1 drop in prices.

MR. VAN DAM: Yes, I know.

PANEL MEMBER IKARI: Okay.

MR. VAN DAM: But they want to separate the two so they don't have that impact. That could happen within the six months. There's so much conjecture and so much guessing you have to do that -- and the problems facing us are pretty tough. I tried to share a few numbers on the size of those things. We're willing to take the risk associated with making that move.

PANEL MEMBER IKARI: Finally, did you do any analysis on the impact of your proposals on the competitive relationship between the California production that's purchased by California processors at the minimum Class 1 price versus California milk supplies that are going outside the state that are being purchased at Overbase price?

MR. VAN DAM: We contemplated that and tried to figure how we could figure it, and came up with very, very little concrete data to use on it. It is our -- you know, we have -- the base plants are in place at the three large co-ops and at Hilmar. And that's a lot of the milk in California. And the base plants have controlled their supplies so it fits within their plants. So there should not be large amounts moving to the other states anymore, creating this offset that we're talking about. And if we're right on that, then it's going to have very little impact on that whole movement.

If there's other milk moving over there because of lack of a home, the word is that that plant is being taken care of shortly, and they will have a spot to go with their milk. But those are all moving parts and, again, it's short term and it's money that the producers are going to need.

PANEL MEMBER IKARI: Isn't it fair to say, though, that if there's milk moving to an out-of-state processor that would come back and compete, that raising the Class 1 price by a dollar adds to the uncompetitiveness of the California product?

MR. VAN DAM: That's certainly true; there's no denying that. Like I said, that's a risk we're willing to take.

I do know that Nevada was amazingly quick to pull their price down. I think that somebody put some pressure on them to be amazingly quick in pulling it up also -- maintain the same relationships at worst. Why would they take less for their milk when they could get more? That's a possible reaction to it, and they are nimble.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER CLEARY: Questions?

Thank you, sir.

Mr. Van Dam, was it your intention today to have your written testimony entered into the record?

MR. VAN DAM: Yes, it is.

HEARING OFFICER CLEARY: It will be entered into the record as Exhibit No. 49 at this point in time.

(The above-referenced document was marked as Exhibit No. 49.)

HEARING OFFICER CLEARY: Tiffany LaMendola, would you like to provide testimony today?

MS. LaMENDOLA: Yes, please.

Mr. Hearing Officer and members of the hearing panel, my name is Tiffany LaMendola. I am the director of economic analysis for Western United Dairymen. Our association is the largest dairy producer trade association in California, representing approximately 1100 of the state's dairy families. We are a grass-roots organization headquartered in Modesto, California. An elected board of directors governs our policy. The board of directors met July 18, 2008, to approve the position we will present here today.

We thank the Department for the call of this hearing and for allowing us the opportunity to shed light on the challenges being faced by California dairy families.

Our joint petition calls for a temporary $1.01 per hundredweight increase in Class 1, 2, and 3 prices for a period of six months, January through June 2009.

This increase is accomplished by the addition of a

4 cent per pound surcharge on the calculated fat price, and a 10 cent per pound surcharge on the calculated solids nonfat price. The request for this price increase was fostered by the incredible milk price and production cost squeeze being felt by our members.

Dairy families have done everything in their power to adjust to higher costs, such as adjusting feed rations and contracting feed. However, in many cases, attempts have been futile. Unlike conditions in the past, adjustments to feed rations have proved less effective in lowering costs as all primary feed inputs are high.

Feed contracts gave some producers the ability to weather the high prices of 2007 and early 2008. However, those limited contracts have ended. Hopes that perhaps historically high feed prices were an anomaly have now faded. Even with current declines, prices are still well above previous years and very few, if any, producers have contracted feed at desirable levels. At the same time, milk prices, which have already started a precipitous drop, may register further declines.

The month ahead will prove to be a difficult transition period for dairy families -- a transition to production costs that will be sustained at new, historically high levels; a transition to dramatically lower milk prices; and a transition to costly and time-consuming environmental regulations.

In an address to the Whey Review Committee, the Secretary recognized the challenge faced by dairy producers when input costs cannot be recovered. He affirmed his support to "ensure the profitability of both producers and processors." We agree that both segments of the industry need to prosper and are, therefore, proposing a temporary mechanism to assist dairy families through a turbulent period.

While producers have almost come to expect the cyclical nature of milk prices, they have not yet adjusted to concurrent record high production costs. We are hopeful that our proposed temporary price increase will aid producers in weathering this difficult transition. In particular, the six-month period will give producers time to sort through the current volatility of feed markets to determine where prices will settle.

Producer cost of production. No matter what data series on producer prices and costs are presented, there is no doubt that producer margins are shrinking. Dairy families are painfully aware of the negative margins currently being experienced and of the harder times coming.

A noticeable upward trend in production costs was established in late 2006. The increased costs were difficult to manage given weak milk prices, and many producers have acquired significant debt. Production cost increases showed no mercy in 2007 as the primary mover, feed costs, escalated. Thankfully, these cost increases were somewhat offset by higher milk prices, as global demand for U.S. dairy products soared. Producers were able to start recovering from the devastating conditions of 2006. The higher prices of late 2007 were, however, short-lived and have since declined by over $5.40 per hundredweight from the high, established in November 2007. In the meantime, production costs have continued to soar.

Since late 2006, feed prices in particular have been on an accelerated upward climb. According to the Department data, feed costs have risen from just over 51 percent of the total cost of production in 2003 to nearly 60 percent of the total costs by the second quarter of 2008. Because of these dramatic increases, dairy producers have been forced to become feed market strategists overnight.

Feed price increases have been so dramatic that 2008 average corn prices are running double the average price level for the entire eight-year period of 2000 to 2007. In fact, 2008 rolled corn prices have averaged $254 per ton through October, a 105 percent increase over the average of the preceding eight years. This is despite the fact that prices have retreated from the clearly deplorable high of $310 per ton established in July 2008.

Alfalfa hay prices have followed similar trends with 2008 prices through August, averaging $94 per ton higher, or an increase of 59 percent, than the preceding eight-year average.

Recent declines in feed prices are welcomed, but certainly far from what might be desired as levels are still very high by historical measures. The current spot rolled corn price, at $205 per ton, is down $96 per ton from July's high, but still $81 per ton, or 66 percent higher than the preceding eight-year average.

Many producers may only benefit slightly by the decline as an informal survey of your members revealed that a majority of producers contracted corn for the 2008/2009 season at prices in the range of $240 per $250 per ton.

And whether or not these contracts end up being good bets is still unknown. Right now, they don't appear to be favorable, and these higher costs will be reflected in the next cost comparison. There is clear indication that markets, such as corn, are still very volatile. The unpredictability of feed prices can be witnessed in the futures market, where after several weeks of a general downturn, corn futures were limit up yesterday.

Though cost of production is not yet available, most indications point to even higher third quarter costs as corn, soybean meal, and alfalfa prices reached record highs in July and August and milk production was at a seasonal low.

Furthermore, factors in addition to feed costs will continue to push production costs higher. Requirements with respect to the Central Valley Waste Discharge Requirement will continue to mount.

In the months to come, producers will incur new monitoring and reporting costs as they must employ a certified crop advisor or engineer to further develop their waste management and nutrient management plans in order to prepare for the most comprehensive reporting deadline yet.

Additionally, base programs put in place by both cooperatives and proprietary plants have forced producers to adhere to production limits, and additional fees have been assessed for marketing milk in excess of the producer's production base. This could increase per hundredweight costs for some producers as well as limit economies of scale.

While these factors may not be as significant as feed costs, they serve the purpose of illustrating that the upward trend of production costs will not be reversed any time soon.

Producer prices. A comparison in Table 1 below of actual and projected producer prices to statewide average cost of production figures is frightening. In just 11 months alone, Overbase prices have dropped by an estimated $2.80 per hundredweight. Even if we assume costs stay at second quarter levels, which is unlikely as noted earlier, negative margins of over $2.60 per hundredweight will be experienced for the month of October 2008.

Using projected prices, producers may lose an alarming $3.40 per hundredweight on November milk and indications suggest December conditions may only be worse. This figure will fluctuate slightly depending on what data series is used, but the drastic nature of this trend remains.

Current indicators suggest further weakening in producer prices throughout 2009. Current prices, yet alone even lower prices, will not be sufficient to cover costs. A producer's inability to pass along dramatic cost increases to anyone else along the marketing chain puts dairy producers in an untenable situation.

We urge the Secretary to seriously consider our request for temporary assistance.

Milk Producers Council alternative proposal. We share MPC's concern over the rising costs of transportation incentive programs. Fluid plants are located in areas where milk production is declining, and the cost of production in these areas is substantially higher. As dairies continue to relocate or go out of business, the cost of the transportation system to supply the Class 1 market will continue to rise.

However, we also recognize that the majority of the funds are returned or reallocated to producers who serve the Class 1 market. We also recognize that the cost of the transportation incentive program is borne by the entire pool, not spread across Class 1 revenues alone.

Dairy Institute alternative proposal. For all the reasons stated in our testimony, we oppose the minimum price reductions sought by the Dairy Institute. The already ailing health of the producer community would be put at further risk given the implementation of a mandated regulated price reduction.

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

HEARING OFFICER CLEARY: Thank you very much.

Questions of the panel? And please stop the clock, please.

PANEL MEMBER EASTMAN: I have a question sort of similar to the one that I asked Mr. Van Dam. You mention on about the third page of your testimony that an informal survey of your producers show that the majority, or some of them, have already locked in or contracted corn for the upcoming season above where it's at right now.

Are any of those in the next six months going to be able to change their -- the feed prices? Do you have an idea if there's anybody out there that has a contract and that will be in the near future? Is that something that's pretty much been locked in, or is that something you can speak to?

MS. LaMENDOLA: Yeah. Just based on the producers I spoke to, and maybe Linda can fill you in on her individual situation, it was different for everybody, but I would say the majority lock in for a period of one year. And most of the producers I talked to were locking in somewhere between 50 and 75 percent of their feed -- their corn needs. I asked specifically about corn. And so the rest would be on a spot basis.

Many of them did lock in, even during the times when the flooding was occurring. So the prices I gave you there are probably even more optimistic, when back then it was thought that corn could go even higher. So there was a real range, I would say. But the majority I spoke to, somewhere between 50 and 75 percent in that range. So if they are locked in, they are locked in for that period.

PANEL MEMBER EASTMAN: Thank you.

HEARING OFFICER CLEARY: Any questions?

PANEL MEMBER IKARI: I do.

I'm not quite sure on your statement about the Milk Producers Council's alternative proposal. How should I interpret that? Should I interpret that as a neutral comment, opposed, or support?

MS. LaMENDOLA: We didn't take a formal position. Those were the things we discussed at the board meeting.

PANEL MEMBER IKARI: Okay.

You heard my questions of Bill. Do I need to repeat the questions? Or did you differ in terms of your position?

MS. LaMENDOLA: Yeah. I guess I have a little bit different approach. When our board discussed this, there's certainly risks, as Bill pointed out. But I think the hope is that the temporary nature of our request would alleviate a lot of those concerns, and we're hopeful that any major changes in milk marketing would be avoided because of the well-defined short-term nature of our request. It would seem hard for us that any major changes could be taking place over something that is very well-defined and temporary in nature.

PANEL MEMBER IKARI: One of the questions I asked Bill, is, did your organization do any analysis, any assessment, regarding those issues that I talked about -- the federal order price decrease, the milk supplies available in other areas that could come into California?

MS. LaMENDOLA: I guess without the risk of sounding like a broken record, I sort of say the same thing. I think our assumption is that given the temporary nature, we wouldn't see any major changes in any of those items. At least we're hopeful. That's why we ask for the temporary nature, just to help producers through a rough time. It certainly is not going to be enough to help producers. They are going to need a lot more assistance than that, so we try to be conservative, keep it well-defined and temporary.

I think one of your questions was referring to possibly roundtripping of milk, and that certainly has been something in the past that we have encouraged, or have been hopeful that CDFA would keep an eye on. But I think there aren't good figures, is what we understand on that. So it would be a little hard for us to do an analysis because we just really don't have good figures on those kinds of things.

But again, it's temporary, and we're hopeful that there wouldn't be any major shifts in any of those items that you suggested.

PANEL MEMBER IKARI: Final question I have. And

Bill, I noticed in your testimony, you made no comments toward the Dairy Institute's alternative proposal or the MPC's proposal. Were you planning to comment on their proposals?

MR. VAN DAM: Only if asked.

PANEL MEMBER IKARI: I guess I am asking.

MR. VAN DAM: The Milk Producers Council suggestion is an interesting one, because it does have some basis in the economic realties of the world in transports of a product. However, it is extremely difficult for us to get it to fit within our structure and still achieve everything we need to. So while we recognize it has some validity, we are opposed to that position at this time.

I think it's pretty obvious that on the Dairy Institute Proposal, we're opposed to that. It's the antithesis of what we want to achieve. We see an extreme need of getting some income to producers. This time that's coming up is really going to be tough. So we are obviously opposed.

PANEL MEMBER IKARI: Okay. Thank you.

HEARING OFFICER CLEARY: Ms. LaMendola, would you like your written testimony to be entered into the record?

MS. LaMENDOLA: Yes, please.

HEARING OFFICER CLEARY: Wonderful.

We'll enter the testimony of the Western United Dairymen into the record as Exhibit 50 at this time.

(The above-referenced document was marked as Exhibit No. 50.)

HEARING OFFICER CLEARY: Thank you very much.

Next witness, Linda Lopes.

MS. LOPES: Mr. Hearing Officer and members of the hearing panel, my name is Linda Lopes. I am president of the California Dairy Women Association and also a dairy producer from Turlock, California.

CDWA represents 180 area producers from Sonoma to Tehachapi. The CDWA is a unique group. We do not claim to be experts in milk pricing formulas. Most of our members are in charge of the financial aspects of the dairy operations. We have become experts in balancing checkbooks and knowledgeable in the business's income and expenses.

We thank the Department for the call of this hearing.

The petition that we submitted requests a temporary price increase due to high production costs and falling milk prices. This has been a tough year for dairymen, given sky-high input costs, milk brokers, and now the credit crunch and the challenge of obtaining capital.

On a permanent level, our dairy feed costs in 2008 have increased 40 percent compared to 2007. Fuel prices have increased 30 percent. Many of the vendors we do business with are adding surcharges and increased delivery charges due to their increases in fuel costs. I understand that they have to cover their costs so they pass it on to us. We can't pass our increases in costs to anyone. That is why we are here. We feel it is the responsibility of CDFA that all dairy producers receive a fair minimum price for their milk, established by the Dairy Marketing Branch.

In addition to increased costs, many dairymen are under mandatory production caps, are paying co-op assessments and have to address increases in credit lines, which mean higher bank payments. Dairy producers also are experiencing increased costs to address environmental issues and have to pay more for water, fertilizers and seed.

You might argue that today, feed costs are dropping. That is a good thing, but some feeds were contracted for long-term, earlier in the year, when feed prices were higher. Along with that, the milk price is dropping daily.

Dairymen cannot survive in this high-cost environment. Bills have to be paid. Six months of good milk prices does not balance the preceding 18 months of low milk prices. Dairymen need this small increase to help service increased debt load and plant losses.

During this time of 40 percent increase in costs, we had a decrease in milk price of 71 cents per hundredweight. It is obvious that when expenses are increasing and incomes are decreasing, something must be done. That is why we, the dairy producers, are here. We need, and must have, this temporary increase in price.

Modern dairy experts have long held that unfettered, virtually unregulated, dairy markets can solve all problems. If anything has been learned in the last half of 2008, it is that markets without oversight fail. We don't want to be like the housing market or the Chinese melamine contaminated milk issue. With no regulations, they both have fallen to the bottom and lost customers. The same could happen to the California dairy industry if our minimum price doesn't cover our costs. If the minimum price is too low, dairy producers will not be able to supply a quality product for the consumer.

Again, we feel it is the responsibility of CDFA that all dairy producers receive a fair minimum price for the milk, a price that at least can help cover our costs. CDWA also opposes the minimum price reductions sought by the Dairy Institute.

I know you are very knowledgeable on the dairy situation due to the CDFA cost of production staff and the cost comparison publications. I leave this problem in your very capable hands, and I thank you for your time. Again, I would like to thank the Department for the call of this hearing.

I request the opportunity to file a post-hearing brief.

Thank you.

HEARING OFFICER CLEARY: Thank you, ma'am.

Questions?

PANEL MEMBER EASTMAN: I have a question. On the second page of your testimony, on the third paragraph, it mentions that dairy farmers have had to address increases in credit lines. Are you referring to the fact that since the crop costs have risen, they have had to increase their credit lines due to operational costs? Are you talking about interest rate increases or --

MS. LOPES: I'm talking about, we're paying more for our feed, so our credit lines weren't large enough. So we had to go in and increase our credit lines, so our bank payment is larger to pay off.

PANEL MEMBER EASTMAN: So you haven't had any sort of interest rate increases or additional fees or costs coming -- just from the banking side?

MS. LOPES: With the farm credit, the interest rate fluctuates on your feed line, and the past month, it went up a quarter.

PANEL MEMBER PELLETIER: You just didn't mention -- do you have a position on the Milk Producers Council proposal?

MS. LOPES: Not really.

PANEL MEMBER PELLETIER: Okay. Thanks.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: Linda, I'll give you an opportunity to answer the questions that I asked Bill and Tiffany, if you have anything different in terms of those questions. If you would like, I could repeat them.

MS. LOPES: I think they are both more qualified than I. I am here more on a personal note of the dairymen. On the contracts, the people contracting, I have heard some people contracting as $300 for the year, thinking it was going to go up, and that's locked in for a year. They contracted half. We've contracted about 60 percent at 240 for our corn. So it is lower than what we paid in the last few months, but it's still considerably higher than we paid in 2007.

PANEL MEMBER IKARI: One of the questions that I had, one of the difficulties that I have on this hearing is, if you were sitting across from producers who had gotten a termination notice and still hadn't found a home, how do you explain to them how this proposal, your proposal, will help them?

It seems like the money would flow to those producers who have a home but does little for those producers who don't.

MS. LOPES: Well, from what I understand, the milk broker is getting a good chunk of money from these producers, and I don't really know how they are surviving with that going on. And I really think the Department should do something about the milk brokers because they are not just hurting those dairymen, they are hurting the whole -- all the dairy producers, because that's affecting all our prices in the long run.

PANEL MEMBER IKARI: Tiffany?

MS. LaMENDOLA: Actually, I didn't address that earlier. One thing I might add is, you know, we have been working very hard to try and help those folks and it's a really tough situation. But I guess I would say that a price decline isn't going to help that situation either. If Class 1, 2, and 3 prices are reduced, I don't think we're going to see additional capacity created, and that's really what we need to help those folks, is more capacity.

PANEL MEMBER IKARI: Aren't we looking at the risk that an additional price increase could -- I mean, your own testimony addressed the concern, or the risk, that it could decrease the amount of milk purchased. And if it does, then more producers will get the notice.

MS. LaMENDOLA: I am hopeful that a six-month period that's well-defined isn't going to lead to that situation.

PANEL MEMBER IKARI: That's why I was asking the question, if you got data, objective analysis, or something other than your judgment, that the Department can rely on in evaluating this issue.

MS. LaMENDOLA: No. Just the hope that a short-term period would not validate or sustain any major change in milk marketing in the state.

PANEL MEMBER IKARI: Okay. Thank you. Thank you.

HEARING OFFICER CLEARY: Ms. Lopes, was it your intention today to have your written testimony included into the record?

MS. LOPES: Yes, it is.

PANEL MEMBER IKARI: For the record, it's "Lopes."

HEARING OFFICER CLEARY: I stand corrected. I have a real hard time pronouncing names. You will have to forgive me. I have a hard time pronouncing my own half the time.

But I know numbers. And so this will be Exhibit No. 51. And we will enter it into the record at this time.

(The above-referenced document was marked as Exhibit No. 51.)

Thank you all very much for your testimony. You are dismissed, unless you have anything further you would like to add.

We have reached the point where we have alternative proposals to this particular proposal. And the two alternative proposals from the Dairy Institute and Milk Producers Council, I'm unclear as to whether or not these are both, A, alternative proposals or two separate alternative proposals.

Two separate?

So if we could have, first, the Dairy Institute?

As we're handing things out, has anybody realized the life span of refrigerators has shortened significantly in this country, or am I the only one who realized that? In 16 years, this is the second refrigerator I'm buying today actually, getting it this weekend.

I remember a time when -- I had a father-in-law who had a refrigerator that was, like 36 years old. It was outside in the rain half the time. And the thing ran forever.

And apparently, nowadays, if you have one power outage, it immediately blows up a modern condenser where you have to buy a brand new refrigerator. It's just unbelievable. It has nothing to do with milk, but I figured, since we were handing things out.

Good morning, sir.

If I could have everyone's attention in the audience, please.

Could I please have you state your name and spell your last name for the record?

MR. SCHIEK: My name is William Schiek, S-C-H-I-E-K.

(William Schiek was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization?

MR. SCHIEK: I am.

HEARING OFFICER CLEARY: And what would that be?

MR. SCHIEK: The Dairy Institute of California.

HEARING OFFICER CLEARY: Thank you, sir. You may begin.

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

Dairy Institute is a trade association representing 40 dairy companies which process approximately 75 percent of the fluid milk, cultured, and frozen dairy products, and over 85 percent of the cheese products and a small percentage of the butter and nonfat milk powder processed in the state.

The position presented at this hearing is -- was adopted unanimously by Dairy Institute's board of directors, and member firms operate in both marketing areas in the state.

Dairy Institute appreciates the opportunity to testify at this hearing in support of our alternative proposal to adjust California's formulas for setting Class 1, 2, and 3 prices. We also thank the Department for the opportunity to comment on the petitions submitted by the Alliance and Milk Producers Council, which are under consideration at this hearing.

At issue in this hearing are proposed changes to the pricing formulas for Class 1, 2, and 3. In establishing pricing formulas, the Secretary is directed by the Legislature to weigh the factors found within statute. Among other things, the Legislature requires that the state's dairy policy should serve the public interest, foster intelligent production and orderly marketing of milk, endeavor to provide for uniform prices to competing handlers, and provide an adequate supply of milk for all purposes.

With regard to milk pricing formulas, the statutes call for Class 1 prices that are in reasonable relationship to Class 1 prices in surrounding states, class prices that are in reasonable relationship to each other, and pricing standards that conform to current economic conditions.

The Secretary is also directed to consider any other relevant economic factors when setting prices. And more detail on the statutes as they relate to milk pricing decisions is given on page 2 of Appendix B. The Secretary must consider how to set prices and pricing formulas such that all of the declared intentions of the Legislature are met as closely as possible. In so doing, the Department must look beyond the confines of any single section of the code. When all relevant economic factors are considered in tandem with the specific Legislative directives regarding milk pricing, it is evident that the current plans for market milk no longer provide Class 1 prices that conform with these directives and therefore they must be changed.

The prevailing milk marketing situation in California for the past couple of years could hardly be characterized as orderly. Milk production in California has been rising at an average annual rate of 3.5 percent over the past five years. Unfortunately, dairy plant capacity growth has not kept pace.

In the past 12 months, milk has been dumped, fed to calves, shipped long distances out of state to California plants' competitors at a discount. Worst of all, we have seen dairymen without homes for milk in 2008. Any loss of commercial sales, no matter how small in terms of the state's total, will worsen the existing problem and put more dairy families at risk.

In 2007 and the first part of 2008, milk prices were at or near record levels. According to CDFA cost of production data, net returns to dairy operations, including returns to management and risk, were strongly positive for 2007 as shown in CDFA's background material exhibit for this hearing. And I have reproduced those in Appendix A.

During the first half of 2008, dairy farm revenues exceeded milk production costs as well. High milk prices have driven these trends. There is no question that producers are now facing challenging times in the face of extreme volatility of milk revenues and input costs. Producers and manufacturers are experiencing the challenges of operating in this dynamic environment as well.

While dairy input costs have fallen by over a third from the high levels seen earlier this summer, they are doubtless higher than their historic norms. However, the important point here is that milk prices are not and should not be determined by milk production costs alone, but by supply and demand in the marketplace.

The folly of attempting to make producers "whole" through agricultural policy "fixes" in the face of low output prices or high input costs has been exposed by the past failures of such policies. One need only remember the milk price support program excesses of the early 1980s or the supplemental assistance programs for grain farmers in the middle to late 1990s. These programs led to both low product prices and surplus production. Guaranteed feed incomes lead to guaranteed growth in supply, which is fine as long as there's sufficient demand existing to accommodate the growth. However, adequate demand for California-produced dairy products is unlikely to materialize unless the state's regulated milk prices are lowered.

Consumers have been paying more for the dairy products they buy as farm milk prices have escalated and have been transmitted through the system to the retail level.

Production of Class 2 and 3 products is down. Production of all frozen dairy products was down 5.1 percent for the first eight months of year. Likewise, production of cottage cheese and sour cream were down 10.2 percent and 19.2 percent, respectively.

Class 1 sales were down slightly in 2007 and are about flat for the most recent 12-month period. Per capita consumption of Class 1 products continues to fall.

Against this backdrop, we have concerns that CDFA may not be enforcing minimum payment provisions on surplus milk. There have been rumors circulating in the industry this year that at least one milk broker has been taking milk from producers and not paying them the minimum price. A dairy policy that includes minimum pricing must enforce such prices equally on all handlers in the market.

If doing so results in milk going unpurchased due to inadequate plant capacity, then the required solution is obvious -- regulated minimum prices must be lowered.

We have also noted that the state's dairy cooperatives are invested more heavily in manufacturing facilities for the lowest returning products, and their producer trade associations have worked to squelch investment in higher class products through their hearing positions at this and previous hearings.

The impact of such a strategy can be clearly seen. This year, the average annual class 4b price will exceed the class 4a price by about $2.20 per hundredweight. In fact, in each of the last six years, the annual class 4b prices exceeded the class 4a price with the average difference being $1.23 per hundredweight.

Yet, producers have endeavored through their hearing requests, to drive the cheese industry from the state, and they appear to be having some success. In 2008, California cheese production is down 8.8 percent from the same period last year, while nonfat dry milk output is up 8.3 percent. Class 4b pool utilization in 2008 is down, compared to 2007, while class 4a usage is up, and that table is in Appendix A as Table 1.

Judging from the producers' proposal at this hearing, they are looking to drive down production of Class 1, 2, and 3 products in the state as well. Dairymen's pay prices are being dragged down by their growing milk output, increasing class 4a utilization share, the inability to find adequate homes for milk in the state. Now they are expecting consumers of Class 1, 2, and 3 products to make up the shortfall created by their ill advised policy positions and their dairy cooperatives' poor plant investment decisions.

The impact of these efforts by producers on California processor competitiveness would be bad enough. But while California producers have been trying to increase the state's regulated prices, USDA has increased manufacturing allowances in federal order pricing formulas, thereby lowering regulated prices in contiguous states. So even without the misguided efforts by California dairymen, the competitive position of California processors has deteriorated, and downward adjustments to regulate prices will be required to protect Class 1, 2, and 3 sales and keep more dairymen from losing homes for their milk.

Effective with October pricing, federal order prices have been reduced as a result of increases in the manufacturing allowances contained in the federal milk pricing formulas. These formula changes result in decreases in federal Class 2 prices of 4.84 cents per point of milk fat and 1.07 cents per pound of nonfat solids. On a per hundredweight basis, the reduction is 26 and a quarter cents.

To restore the competitive position of California's Class 2 and 3 manufacturers to what it was before, the federal pricing change, a reduction in California prices of the same magnitude would be in order.

However, a reduction in milk fat prices of more than 3.7 cents a pound in northern California, or more than 3.93 cents a pound in Southern California would bring average Class 2 and 3 milk fat prices below those for class 4a. Consequently, these reductions may represent the practical limit of downward adjustments to Class 2 and

3 fat prices. However, Class 2 and 3 nonfat solids prices can be reduced by an additional amount beyond the corresponding federal nonfat solids price reduction to compensate for the milk fat price reductions we were unable to make.

Doing so would restore the price relationship that existed on a per hundredweight basis before the new federal make allowances took effect.

Therefore, with regard to Class 2 and 3, we are proposing the following amendments:

Eliminate the Class 1 differentials that are added to average class 4a fat prices for Class 2 and 3 in both marketing areas. For northern California, this would be a reduction of 3.7 cents per pound, and for Southern California, 3.93 cents per pound.

Also, reduce the differentials that are added to the Class 4a solids nonfat price by 1.53 cents per pound for Classes 2 and 3 in both marketing areas.

The per hundredweight price changes indicated by the proposed component price changes would be a reduction of about 26 cents for northern California and 27 cents for Southern California.

It should be noted again that our proposed price reduction merely restores the average price relationship with surrounding states, that existed prior to the recent federal order change. Failure to keep pace on pricing will lead to reduced sales of Class 2 and 3 products as customers move to procure product from suppliers in nearby states, and lower pool prices, as Class 2 and 3 utilization falls and more milk moves into class 4a. Mailbox prices to producers will fall even more if reductions in Class 2 and 3 sales mean that milk must be trucked out of state to find a home.

Class 1. Section 62062.1 requires that Class 1 prices in California be in reasonable relationship to Class 1 prices in contiguous states, while we had argued that a lower Class 1 price level was needed. As a result of the 2006 Class 1 hearing, the Secretary established interstate price relationships that he felt were reasonable. Given changes in the industry and differences in pricing formula structures, the Class 1 price relationship established with surrounding states at the time of the 2006 Class 1 hearing had deteriorated by 15 cents per hundredweight even before the most recent change in federal order make allowances.

And I am going to draw your attention to Appendix A, Figures 5 and 6.

In Figure 5, what we've got is California price comparisons, where we take the Portland-Medford Class 1 price and subtract from it the Northern California Class 1 price. And this is actually for 2006 to 2008.

There's two lines there. The one that jumps a around a lot is the month-to-month change. The one that doesn't jump around as much is a 12-month moving average of that price comparison. And what you see highlighted there is, in December of 2006, the Medford price was 14 cents higher on average for the preceding year than the northern California Class 1 price. That's 14 cents a hundredweight. As of September '08, that price was 1 cent lower than California's price, so a change in that price relationship of 15 cents a hundredweight.

If you look on Figure 6, you see the same thing for Arizona in comparison to Southern California prices, where Arizona prices were 31 cents higher at the end of 2006, again, on average for the previous 12 months. And then as of September, they were only 16 cents higher.

With Las Vegas, they were -- the Las Vegas prices were 64 cents per hundredweight lower than California prices in December '06. And now, they are 79 cents per hundredweight lower. So that's that 15-cent deterioration.

Furthermore, the federal order make allowance changes made in October will result in an average drop in federal Class 1 prices of an additional 33 cents per hundredweight. So just to maintain the price relationship with surrounding federal order Class 1 prices that was deemed reasonable by CDFA at the last hearing, Class 1 prices would need to be reduced by at least 48 cents per hundredweight. That's the 15 plus 33.

Unfortunately, changes to federal order price relationships aren't the only factors impacting the competitive situation faced by California processors today. In addition to changes in federal order prices, the Nevada Dairy Commission has recently reduced Class 1 prices in Northern Nevada, where two Class 1 plants are located, and they reduced that by a dollar a hundredweight.

It is our understanding that this change was made to deal with competitive inequities within Nevada, owing to the ability of some plants there to procure California milk at a discount. Nonetheless, the change has ramifications for the competitiveness of California processors against their northern Nevada counterparts.

At past hearings, we have argued that in establishing prices, existing statute requires that CDFA consider the reasonableness of the relationship of prices between the classes within California and establish a price level that fosters intelligent orderly marketing of milk. One way to look at what might constitute a reasonable relationship between utilization -- between the various class prices is to consider the relationship of the Class 1 differential to the utilization percentage of Class 1 milk in the pool. And that table showing that is in Appendix A, Table 2.

The economic theory underlying classified pricing would suggest that lower Class 1 differentials accompany lower Class 1 utilization markets. A regression analysis of federal order and California Class 1 differentials and Class 1 utilization illustrates this principle and suggests that California's Class 1 differential is at least $1.14 per hundredweight too high. And that's Appendix Table A, Figure 7, where you can see that regression line plotted against the various Class 1 differentials in different orders and regions of the country.

Another important indicater of the reasonableness of the relationship between the various classes of milk is the spread between the Class 1 and Overbase price. That is shown in Figure 8, Appendix A.

At the time of the last hearing decision, the 12-month average of this spread was $2.16 per hundredweight and that corresponded to the calendar year 2006. At the time we submitted our proposal in September, we projected Class 1 and Overbase prices through the end of the year using futures prices for dairy commodities and a simple model of the California pool. Based on those calculations, the 12-month average spread for the calendar year 2008 was projected to be of $3.51 per hundredweight, suggesting that a Class 1 price reduction of $1.35 per hundredweight would be needed to restore the price relationship between the various classes of milk that was deemed to be reasonable at the time of the last Class 1 hearing decision.

For the 12-month period ending September 2008, which is the most recent month that we have actual data, the Class 1 Overbase spread was $3.76 per hundredweight, suggesting a Class 1 reduction of $1.60 is needed to restore the spread to the level as it existed as of the last hearing.

As of October 28th, using the same method that we previously employed to forecast prices to the end of the year, we project the 12-month average spread for calendar year 2008 to be $3.80 per hundredweight, implying a needed reduction in Class 1 prices of $1.64 per hundredweight.

Thus, the price change that we have proposed is not overreaching, because the analysis suggests that even larger reductions are warranted. Still, we are proposing $1.35 per hundredweight reduction is appropriate because it moves Class 1 prices significantly in the right direction and acknowledges that there is some volatility in the size of the spread over time, and, therefore, Dairy Institute's Class 1 formulas are proposed in our proposal here -- basically an increase in the butter fat adjuster and the CRP adjusters to the levels shown on the document.

The size of the Class 1 Overbase price spread has really competitive consequences for California processors. In particular, the P-D advantage, which is usually calculated as the Class 1 price, less the quota price, has grown in direct relation to the Class 1 Overbase spread. And the chart showing that is Figure 9 in Appendix A.

Throughout the 2000 to 2007 period, the P-D advantage in both northern and Southern California averaged about 10 cents per gallon on exempt milk. Currently, it appears that exempt quota corresponds to about 18 percent of type 70 P-Ds total Class 1 usage. When the P-D advantage is blended over all of the P-Ds' Class 1 milk, their historic advantage amounted to about 1.8 cents per gallon. This is a substantial number given that customers change suppliers for a price difference of a few hundredths of a percent per gallon.

For the 12-month period ending September 2008, the P-D advantage on exempt quota had swelled to 19.8 cents per gallon, or about 3.6 cents per gallon over all their Class 1 milk. By allowing this spread to grow in a manner that it has, it can be argued that the Department is in violation of Section 61805(b) of the Food and Ag Code, which states that the Department will endeavor to provide for uniform milk prices to handlers operating within a marketing area.

While we recognize that the law also states that no price will be considered to be invalid if prices to handlers are not equal, the rapidly growing spread clearly violates the law's intent.

It is also interesting to note from the Department's background material for this hearing that the Class 1 sales trend for Type 70 exempt P-Ds is increasing -- and that chart is reproduced as Figure 10 in my appendix -- just the opposite of the aggregate sales trend experienced by fully regulated Class 1 processors. The state's current Class 1 pricing policy is creating a windfall for a select group of handlers, and the situation should be remedied in the manner that we have prescribed.

Another crucial concern directly related to the size of the Class 1 Overbase spread is the way it enhances the ability of out-of-state Class 1 processors to competitively roundtrip California's sourced milk and capture Class 1 packaged milk business within California.

While other witnesses will testify in more detail about the use of this milk procurement strategy, I will describe it here briefly: California's excess milk supply creates a situation where dairymen are looking for homes for their milk. Out-of-state processors are able to procure California milk from producers at Overbase prices and haul the milk to Class 1 processing plants located close to California's borders in contiguous states. The milk is processed and packaged, sometimes at a lower cost than can be done within California, owing to more favorable general business costs and nonunion labor. The packaged milk is then hauled back into California and sold in the state's retail outlets. The sad truth is that the current Class 1 Overbase spread provides more than enough money to make this strategy viable.

Finally, the growing Class 1 Overbase spread is evidence that fluid milk consumers are being relied upon too heavily for producer revenue contributions. Total Class 1 sales are down from where they were in the early 1990s, and despite a growing population, they have been basically flat over the past decade and a half.

Per capita consumption of fluid milk continues to plummet, and California Class 1 plants have closed, resulting in fewer market outlets for dairymen and more milk going into lower valued uses. Increased Class 1 prices have a direct impact on retail prices and on retail sales.

Lest anyone be tempted to argue that retail milk prices are unrelated to raw milk prices, I have included a graph of Class 1 prices in comparison to the lowest lawful retail price in Southern California, as Appendix A, Figure 11. The graph illustrates fairly convincingly that changes in Class 1 prices correspond directly to changes in retail prices. Furthermore, there does not appear to be a clear trend in the average farm retail price margin over the past ten years, even though a growing margin might be expected because of the inflation in marketing costs during the period.

For further evidence of the strong relationship of Class 1 prices to retail prices, I ran a simple regression with the lowest lawful retail price as the dependent variable and the Class 1 price as the independent variable. The estimated model indicates that changes in Class 1 prices explain about 94 percent of the variation in changes to retail prices.

It might be tempting to conclude that the widening spread between Class 1 and Overbase prices is a transitory problem, that the market will eventually correct on its own. We do not believe this self-correcting hypothesis is correct. Our view is that the spread is unlikely to narrow to its historic level any time soon without a pricing formula adjustment.

The growth in milk powder production in California and abroad will continue due to expansions in milk powder plant capacity in California and New Zealand. We see slowing demand for nonfat milk powders due to the worldwide economic difficulties and a loss of world powder demand, at least temporarily. Because of the China melamine scandal, that demand will be impacted. The sum of these factors will drive class 4a prices lower.

Furthermore, we foresee the growing share of Class 4a in the California pool will mean that Quota and Overbase prices will be more heavily weighed down by low Class 4a prices than in the past.

Class 4b prices, while they are expected to decline from 2008 levels, are not expected to collapse to the same degree as Class 4a prices, due to the relatively smaller investment in global cheddar cheese production capacity compared to powder, and I think future prices bear that out.

Meanwhile, Class 1 pricing that is based on the "higher of" concept will ensure that Class 1 prices stay relatively higher compared to Overbase prices than was true in the past.

In order to prevent potentially significant losses in Class 1 sales and homes for producer milk, the Class 1 Overbase price spread needs to be reduced now, not at some time in the future, after sales have already been lost.

We urge the Department to adopt our proposal.

Other organizations' proposals. First, with regard to Milk Producers Council. Milk Producers Council's position to recover milk movement incentive pool costs through a Class 1 price increase is both uninformed and illogical. It would hurt the competitive position of Class 1 processers, and it ignores that the already high Class 1 price level provides ample revenue to the pool for milk movement.

MPC's proposal ignores the historic commitment of the producer community to assure that Class 1 markets were served in exchange for processor support for milk pooling. This proposal should be rejected in its entirety.

Alliance of Western Milk Producers. The Alliance, et al.'s proposed six-month $1.01 per hundredweight surcharge would hurt the competitive position of Class 1, 2, and 3 processors and would lead to lost sales of California milk to those classes. It would encourage processors and retailers to procure products from sources in nearby states as opposed to California-made products, and would encourage reconstitution in Class 2 and 3 product manufacturing.

It would cause additional expansion of milk output when capacity is currently at its limit, leading to more milk being dumped, more milk fed to calves, and more milk shipped out of state at a discount to California's competitors, and additional lost sales for the state's processors and manufacturers.

California consumers, who have been paying higher prices for milk during the past 18 months, would be right to ask why they should be paying so much to give dairymen the privilege to produce and dump surplus milk, while the best priced deals go to calf ranchers and out-of-state dairy product manufacturers. While proponents might argue that these surplus milk conditions are a thing of the past because the cooperatives have curtailed milk output through base plans, I would point out that the very existence of the cooperative base plans is a testimony to the failure of our current milk pricing formulas. Giving more money to dairymen when their output already must be controlled through production caps would be unwise at best. Frankly, adoption of this proposal would be an embarrassment to the industry, and it should be rejected in its entirety.

Supply and demand conditions in California are such that regulated price increases should not even be contemplated, and regulated price reductions are needed immediately to preserve California's markets for milk and dairy products.

The amendments we propose will restore

competitiveness and protect sales of Class 1, 2, and 3 products produced in the state for the benefit of the entire industry. If the concerns we have outlined are not addressed, as we suggest, markets will be lost and larger numbers of dairy farm families will be without homes for their milk.

We strongly urge the Secretary to adopt our proposals.

Thank you for the opportunity to testify. I am willing to answer any questions you may have. And I respectfully request the opportunity to file a post-hearing brief.

HEARING OFFICER CLEARY: Thank you, Mr. Schiek.

Any questions of the panel, starting on my right?

PANEL MEMBER EASTMAN: I have a question. Dr. Schiek, are you aware of in Class 1, 2, or 3 processors -- obviously you have in your testimony stated that the price for those classes of milk are too high and need to be lowered. Obviously that's your proposal.

Are you aware of whether or not they have extra capacity to where if the price were to be lowered, they would be able to take in more milk? Or do you know if they are pretty much running full tilt right now?

MR. SCHIEK: You know, that would be an excellent question to ask some of the handler processor witnesses who are going to be here today. My understanding, and they can correct me if I am wrong, is that there is some excess capacity in Class 1, 2, and 3 because sales have been dropping. So currently, there is some ability to take more milk. The problem is the sales aren't there.

PANEL MEMBER PELLETIER: Just a clarification. On Figure 5, you said the Portland less than northern California price, and on top of the graph, it said, "Northern California less Portland." I just wanted to make sure that the title was the correct one.

MR. SCHIEK: Are we talking about Figure 5?

PANEL MEMBER PELLETIER: Figure 5 yeah.

MR. SCHIEK: Okay. So this says "Portland price less Northern California price."

PANEL MEMBER PELLETIER: Yeah. And on the legend, it says, "Northern California less Portland."

MR. SCHIEK: Ah, okay. Sorry. Yes. The title is correct. So that when the number is positive, Portland price would be higher than California price; and when it's negative, it would be lower than the California price. So sorry about that confusion.

PANEL MEMBER PELLETIER: Thanks.

PANEL MEMBER GATES: Dr. Schiek, I have one question for you. Could you speak to the six-month increase -- the minimum amount of time that the dairy producers were speaking to and the impact that that would have? They are thinking that they are not going to lose sales in that time. Would you like to speak to that?

MR. SCHIEK: And I would say that's another good question for people who will be here testifying, who are actually selling products in those markets. But my understanding is that the six-month window is no guarantee. I think what you find is that people are trying to maximize profits and they are going to source product wherever it's cheapest.

And the difficulty that you get into is once that business goes to somebody else, all they have to do to keep it is to be competitive. In other words, so they have an advantage for six months. They go out. They bid the sales. They get the business. All right? And then in six months, when our prices adjust again, all those people, who have captured our sales, have to do is just be competitive. They don't have to outcompete us anymore; they just have to be competitive. Because they got the business. We're going to be the ones that have to go and get the business back. And, you know, if they want to give us a year of lower prices to get that business back, then maybe the six-month won't have that big an impact. But I don't think that's in their proposal.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: I have a few questions that are very similar to the questions that I asked before.

What information -- I understand your testimony in terms of the -- your judgment that the price increase will result in no sales losses. But what information, data, analysis, or assurances can you provide the hearing panel that a permanent decrease in the Class 1, 2, and 3 prices in accordance with your proposal will result in expansion of California milk by Class 1, 2, and 3 processors?

MR. SCHIEK: And that's a good question.

I will just say, first of all, that my assertions are based on conversations with people who actually sell the products in these markets. So it's not a judgment that's based in ignorance.

On the other hand, what the main focus of this proposal is, is to preserve the existing sales, which we are losing right now, currently. A proposal to increase prices will only make that worse.

So I don't know that I can guarantee prices will increase -- or, excuse me, sales will increase. And certainly, other handlers can speak to that, other processor rep testimony will speak to that. But we're trying to protect what we've got and not lose anymore.

PANEL MEMBER IKARI: Related to my other questions of what information, data, and analysis can you provide the hearing that your organization's proposal will have a positive impact on the ability of those producers who have been given termination notices and whom do not currently have a home for their milk, to be able to find a home for their milk in California?

MR. SCHIEK: The current marketing situation is a difficult one. Okay? Because demand is down across the board, just in general. It's down for a couple of reasons. It has been down because of the high-priced environment, so there's a price impact. Now, of course, we're facing an income issue with consumers, people who have seen their home values fall, they have seen their stock portfolios, their 201(k)s, as we call them now, values fall, and so they have less wealth. They feel less wealthy, and they spend less. And for others, you know, unemployment is beginning to rise. Their wage increases are probably not keeping pace with inflation, so there's an income constraint that also makes sales growth difficult.

And so I don't know that I can necessarily offer guarantees, Mr. Ikari. I do think that would be a good question to ask the processor representatives who are here today. They could probably give you a more definitive answer.

But I will refer again, we are trying to keep things from getting worse in terms of lost sales and having more producers get notices or get told they have got to cut back their volume.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER CLEARY: Thank you, Dr. Schiek. I really appreciate your detailed testimony today.

Was it your intention to have your written testimony entered into the record along with your addendums?

MR. SCHIEK: Yes, it is.

HEARING OFFICER CLEARY: What we'll do is we'll enter the testimony in as Exhibit 52, the written testimony; appendix A will be entered in as Exhibit 53; and Appendix B will be entered in as Exhibit 54.

(The above-referenced documents were marked as Exhibit Nos. 52 through 54.)

HEARING OFFICER CLEARY: Thank you very much, sir.

Moving right along, if we could have the Milk Producers Council come up with their alternative proposal. You will have 30 minutes for your testimony today.

And it is hard to shop for a refrigerator. There's so many different kinds out there. Nowadays, they got all these different -- like with the bottom drawer and you got two drawers on the top and one drawer on the bottom, or you can go with two drawers on the side, and then you got the whole ice maker issue. I must have spent an hour in Lowe's looking at all these things, trying to make a decision one way or the other. And some are deeper than others. I won't get into it. You don't want to hear my problems, anyway. You had no sympathy over the moth hole in my sleeve. I don't think you are going to have any sympathy over the refrigerator.

Good morning, sir, could you please state your name and spell your last name for our record?

MR. VANDENHEUVEL: Yes. My name is Robert VandenHeuvel, V-A-N-D-E-N-H-E-U-V-E-L.

(Robert VandenHeuvel was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: Are you testifying today on behalf of an organization or as an individual?

MR. VANDENHEUVEL: Organization, Milk Producers Council.

HEARING OFFICER CLEARY: Very well. You may begin.

MR. VANDENHEUVEL: Thanks. Good morning, Mr. Hearing Officer and members of the panel. My name is Robert VandenHeuvel, and like I said, I am general manager of Milk Producers Council, a producer trade association with the approximately a hundred dairy members located primarily in Southern and Central California. My testimony today is based on positions adopted by the MPC Board of Directors.

The economic realties of the California dairy industry are well known. As you listen to today's testimony from those of us on the producer side of the industry, you will undoubtedly hear about the rising costs of production and a diminishing milk price that's unable to fully cover these escalating expenses.

The unprecedented increases in feed and fuel costs have driven dairy producers to negative margins, and the foreseeable future looks just as bleak. The plights of dairy producers in California is not exaggerated. They need no embellishment. Dairy producers throughout the state are losing money on every pound of milk they produce. And unlike a manufacturing facility that can shut down its machines when times get tight, cows have no shut-off valve. The milk, along with the red ink, keeps flowing.

This hearing was petitioned by producer groups who are concerned about the economic squeeze facing dairy producers in the state. The cost squeeze is real. Input costs on the dairy farm are well above levels seen in prior years. And the overall milk price is weakening by the day. Any price relief from the Department would be greatly appreciated.

At CDFA's transportation subsidy hearing on July 1st, Milk Producers Council submitted an alternative proposal that would have shifted the burden of any new subsidy costs from the producer pool to the market place. Our proposal would have required a change to the Class 1 formula and was therefore not able to be considered at that July 1st hearing. However, because the Class 1, 2, and 3 formulas are the subject of today's hearing, MPC is resubmitting our proposal from July. Our proposal looks at the specific issue of the transportation subsidy system and who should bear the responsibility for funding those subsidies.

Throughout the first nine months of 2008, this system of transportation credits and allowances removed a staggering $19,261,090.50 from the producer's share of the Class 1 revenue, an average of $2,140,121.17 per month. That money was then used to fund the ever growing Class 1 transportation subsidy program.

Starting September 1st, the payment rates that determine the amount of these subsidy payments was substantially increased to reflect higher hauling costs. According to the Department's analysis, the adjustments will amount to a roughly 26 percent increase in the amount of Class 1 revenues being taken out of the pool to pay for these subsidies.

Up until now, dairy producers have fully funded these subsidies out of their share of Class 1 pool revenues. But how long can this be sustained? At what does the consumer need to step in and fund at least part of this system?

Milk Producers Council is proposing today that the system be modified to allow the market place to begin to fund a portion of these transportation subsidies. Since the recent adjustment by CDFA resulted in a 26 percent increase in the cost of these subsidies, MPC is proposing that a quote unquote transportation surcharge be added to the Class 1 formula that would bring enough new revenue into the Class 1 pool to fund these new subsidy costs.

Some in the industry have made the argument that since a majority of the money that is taken from the Class 1 pool revenues is redistributed back to producers as transportation allowances, that this is not a drain on the pool. Essentially, their point has been that the money comes from producers, is then paid pack to producers, making the transaction a wash. This is a hugely distorted view of realty.

Transportation allowances are designed to compensate producers for the difference between what it would cost to haul their milk to a local processing plant and what they are actually paying to haul their milk to a Class 1 plant farther away. However, we should never lose sight of the fact that regardless of where the milk is being hauled, producers pay all the costs of delivering their raw milk to any processing plant. When CDFA increased the transportation allowance payment rates in September, it was because the Department believed that the gap between the local hauling costs and the higher costs of hauling to a Class 1 plant further away had become larger than the prior subsidy system was able to cover. But even with updated payment rates, are producers as a whole better off? Of course not. The additional funds taken out of the pool to pay for these higher subsidies is merely passing through the dairy producer to their milk hauler who has increased the hauling rates that the producer must pay. Individual producers may be quote unquote equalized, but the pool, which is every producer, is completely paying for these increased transportation costs.

Let's step back for a moment from the minutia of the transportation subsidy and look at the big picture. Isn't it the consumers that ultimately benefit from the subsidy system? After all, it's the consumers that ultimately want the dairies to operate as far away from the urban areas as possible. If there were enough dairies in Downtown L.A. to serve that market, this wouldn't be an issue. But the fact is that many of the general public want dairies out of sight and out of mind. They want the milk products on their shelves, but they would much rather have the dairies operating in the Central Valley than in their backyard.

However, that luxury doesn't come free. There's a cost of hauling that milk longer distances to get it to the market. That cost of that is then offset by the transportation subsidy system. It would seem logical to the consumers, who are receiving a fresh farm product without having the farm nearby, would be paying for that subsidy. However, as we all know, this is not the case. It's time for consumers to begin paying a portion of these costs.

Milk producer -- with regard to the Dairy Institute's Proposal, Milk Producers Council is strongly opposed to the alternative proposal put forth by the Dairy Institute of California. At a time when dairy farmers, regardless of farm size, are operating with negative margins, it would be economically devastating to further erode the producer share of revenue from Class 1, 2, and 3 sales.

Among other things, the Dairy Institute points to state-to-state relationships in their analysis. However, what they fail to recognize is that California is in a different position than in other parts of the country. The largest portion of a producer's cost of production is their feed costs. California dairy producers are unable to grow an adequate supply of feed for all our cows and must import much of this feed. Tack on the high fuel costs associated with importing that feed, and you can see that California farmers will logically have a higher cost of production than many other states.

If California is going to sustain a vibrant dairy industry, as I believe everyone in this room would like, producers must receive a price for their milk that allows for their costs to be paid plus a fair return on their investment. Therefore, MPC believes the Dairy Institute's proposal would be very ill-advised.

I request the opportunity to submit a post-hearing brief, and I am available to answer any questions the panel members might have.

HEARING OFFICER CLEARY: Thank you very much, sir.

Questions? Mr. Eastman?

PANEL MEMBER EASTMAN: Yes. I have a question. You mention your opposition to the Dairy Institute proposal. Did Milk Producers Council take a stand on the Alliance, et al., proposal at all?

MR. VANDENHEUVEL: We don't dispute any of the claims by the Alliance and Western Milk Producers -- or Western United Dairymen and the California Dairy Women. Our costs have escalated and the price is not covered in those costs, and any additional revenue back to the farmer would be definitely appreciated.

PANEL MEMBER IKARI: So do I take that as you support their proposal?

MR. VANDENHEUVEL: Take that as, we agree with some of their points, but we don't have an official position on their proposal.

PANEL MEMBER PELLETIER: You mentioned passing on the costs to the consumers. I was just curious, did you do any analysis on the impact that would have if consumers were facing higher prices?

MR. VANDENHEUVEL: The proposal we put forth is extremely modest. I don't have the numbers in front of me. The Department determined what the overall increase would be, and it would be in the cents per hundredweight on Class 1 price. So it's very small, and no, we haven't done any official, you know, third party or even internal analysis, but our feeling was that it was so modest in nature -- because not asking for all of the transportation subsidies to be paid for by the marketplace, just the increase that we saw as a result of last hearing.

PANEL MEMBER PELLETIER: Thank you.

HEARING OFFICER CLEARY: Ms. Gates?

PANEL MEMBER GATES: Just one quick question. With you asking to have the consumers pick up the additional cost, did you do any analysis or look at any other ag commodities that you could pattern that after, that that's why you went in that direction?

MR. VANDENHEUVEL: I didn't think we modeled it after -- we modeled it after good economic policy, what we felt was a good policy to cast those increased costs down the market -- down the chain, to the marketplace. I don't believe there was any specific other commodity that we looked at for that. Just economically speaking, higher costs need to ultimately get passed down the line to consumers in order to sustain an industry.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Mr. Ikari, any questions?

PANEL MEMBER IKARI: Yes, I do.

What information, data, analysis can you provide the Department that your proposal will not reduce the amount of milk that's purchased and used in Class 1?

MR. VANDENHEUVEL: You know, I think that's very similar to what Annie was asking, and we just -- we haven't done any other analysis to show what the effect of our change would be on Class 1 sales. But given the modest nature of the proposal, we felt that it would not be anything substantial or possibly nothing even measurable.

PANEL MEMBER IKARI: Do you have any information, data, analysis that you could provide the hearing regarding your proposal's impact on the ability of the producers who have been given termination notices on their ability to find a home for their milk?

MR. VANDENHEUVEL: No. This is dealing with -- this is not aimed at encouraging additional plant capacity or discouraging plant capacity. This is a change in the policy with regard to the transportation subsidy system. But we have not done any analysis on how it would affect those dairies, but I don't believe it would have any effect on those situations.

PANEL MEMBER IKARI: What data analysis did you perform on the short-term and long-term impacts of implementing your proposal?

MR. VANDENHEUVEL: Well, the analysis the Department provided showed a -- you know, what the price difference would be in Class 1 and, I think, Overbase prices. But other than that, we did not do any additional analysis other than -- you know, we weren't looking specifically at the numbers. We were looking at creating a better public policy, and we felt this was steering the transportation subsidy system into a better policy from an economic standpoint. You know, where the numbers fell in the future and past, we didn't look at that.

PANEL MEMBER IKARI: Well, I guess one of the questions, it's just a question that I had is, those producers that were in Southern California that moved to the Valley, doesn't it, your proposal, reward those, intend to hurt the producers who remain in Southern California? Think about the rewards that they would receive, that they -- if the producer didn't have to bear the responsibility.

The other question I have is, can you provide information to the Department, the hearing panel, on any other ag commodity or natural raw product where the producer doesn't pay the cost of shipping, where it's paid by the consumer?

MR. VANDENHEUVEL: Well, I would look at --

PANEL MEMBER IKARI: You have asked for a post-hearing brief. You can file that in your post-hearing brief.

MR. VANDENHEUVEL: Okay. And I will address that in post-hearing brief, but I would look at other commodities that dairies purchase. I mean, the dairies purchase commodities as well and they pay a fuel surcharge when that fuel cost goes up. And that is passed along to the dairymen, which in that situation is the consumer of that good.

PANEL MEMBER IKARI: The question I asked, though, is raw product, where the raw product -- where a farmer or a person or organization produces copper, whether or not it's the farmer or the producer, that incurs that cost, and give me an example where that is not the case.

Thank you.

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

MR. VANDENHEUVEL: Yes.

HEARING OFFICER CLEARY: Okay. We'll enter it into the record as Exhibit No. 55.

(The above-referenced document was marked as Exhibit No. 55.)

HEARING OFFICER CLEARY: And I have been urged by my panel up here to take a ten-minute break for the sake of the water that we have been drinking. So we'll take a ten-minute break at this time, and we'll reconvene this hearing at 12:05, if we could, please. Thank you very much.

We're off the record at this time.

(Break taken in proceedings)

HEARING OFFICER CLEARY: We can go back on the record at this time.

Randall Dei, I believe is the next -- is our next public witness. Is it "Day" or "Die"? "Day." Okay.

All other individuals giving testimony will have 20 minutes on the clock, just so you know. If you could watch the clock again, five minutes before the end of that 20-minute mark, you will see the clock turn yellow, which will indicate you have five minutes left.

If you could, sir, state your name and spell your last name for our record.

MR. DEI: Name is Randall Dei, last name is D-E-I.

HEARING OFFICER CLEARY: Thank you, sir.

(Randall Dei was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And you are testifying today on behalf of an organization or as an individual?

MR. DEI: Organization, Safeway, Incorporated.

HEARING OFFICER CLEARY: Thank you. You may begin, sir.

MR. DEI: Hearing Officer and members of the panel, my name is Randall Dei. I'm a director, Dairy Industry, for Safeway, Incorporated. I have responsibilities supporting six fluid plants and two ice cream plants in the U.S. Our company operates both fluid processing plants in California as well as retail grocery stores. Our northern and Southern California dairy plants process and distribute Class 1 and 2 products throughout the state of California as well as other states within the U.S.

Safeway is a member of the Dairy Institute of California and participated in the development of alternative proposal submitted by the organization for today's hearing. The alternative proposal submitted by the Dairy Institute will help maintain the reasonable relationship of prices within surrounding states as well as between classes.

The petition to place a surcharge on Class 1 and 3 prices is not the solution to solve the economic pressures that the California dairy farmers are placing. By artificially raising class prices, you send the wrong signal to the milk producer and risk further imbalance of supply and demand.

California milk production continues to exceed plant capacity during certain times of the year. Dairymen continue to ship milk without a home at a discount out of state.

Cooperatives have placed production quotas on their member producers to try to curtail increased production that their balancing plants can't handle. Cooperatives are not willing to invest in additional balancing plants going forward.

High class prices in the past led to more production, not less. Raising class prices is not the solution to fix the hardships facing the dairy producer.

It is also important to look at other factors that could lead to more disorderly milk movements in the state of California. Class 1 prices were recently lowered in the state of Nevada. This reduction in Class 1 prices will lead to more packaged milk moving into California, more milk moving into California at a time producers want to raise class prices within the state makes no sense.

The California consumer is under extreme financial pressure from several different factors. In this economy, this would be viewed as a tax increase on fluid milk. This would come at a time when Class 1 sales are down as well as a risk of further decline in fluid consumption.

One of our California plants located in Southern California is also a Class 2 plant, promptly shipped to multiple states outside of California, thus benefiting the California milk producer. Any increase to Class 2 prices could result in an uncompetitive position and risk sales outside of the state which the producer is currently benefiting from.

The impact of both the Alliance and the MPC proposals, if adopted, will raise Class 1, 2, and 3 prices, place an unfair burden on the California consumer, and make our manufacturing plants within the state less competitive. Price alignment with surrounding states and maintaining competitive positions for processors within the state require reduction of Class 1, 2, and 3 prices.

In conclusion, raising milk prices will in turn grow 4a utilization, not Class 1, 2, and 3. Lower utilization in these higher classes will reduce dairymen's pay price. With the recent change in Nevada pricing, as well as the USDA increasing make allowances, which in turn lower regulated prices, the solution is not to artificially raise class pricing and send the wrong production signal to the dairy farmer.

HEARING OFFICER CLEARY: Thank you, Mr. Dei. I have a question from the panel.

PANEL MEMBER EASTMAN: I have a question, a similar question that I asked Dr. Schiek with regards to, do you feel that there's capacity in plants that could be filled if the price were lower, or are you taking in less milk due to high price right now that would be changed by a lowering of the Class 1, 2, and 3 prices?

MR. DEI: We currently -- I can obviously only talk about Safeway. We currently have capacity in both our northern and Southern California operation. It's always -- you know, we trade sales over pennies, not dollars, and anything that we can do to continue to lower our prices typically lead to increased sales in our plants.

HEARING OFFICER CLEARY: Question, Ms. Gates?

PANEL MEMBER GATES: I am going to ask that same follow-up question that I asked Dr. Schiek on the temporary six-month, you know, proposal that was there. How would that affect Safeway? Maybe explain a little bit about how long your customer contracts are for, that kind of thing.

MR. DEI: We're a vertically integrated company. We operate and own our own processing plants and retail sales. But with excess capacity, we go out on the open market and we bid other business. Some of those businesses are short-term contracts, some are open contracts where you may have a business for a month, and some are more of a structured long-term contract.

If prices change within a month's notice, we look at the economic analysis. Does it make sense to bring packaged milk from, say, our Phoenix plant, because we're located close to the L.A. market. So we constantly do the math. It's a fuel equation and a raw milk cost equation. So six months is -- that's a long time. That's a lot of risk.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: Did I understand that your responsibility is six plants, some of which are in California, some of which are outside of California?

MR. DEI: Yes. We have Class 1 plant in northern California, San Leandro. We have a Class 1 and 2 plant in Southern California, our Mons, plant, and we have a fluid milk and ice cream plant in Phoenix and Tempe, and then Denver Rocky Mountains and Belleview, Washington and Clackamas, Oregon.

PANEL MEMBER IKARI: I have been asking folks about information, data analysis. And you seem to be saying -- but I don't want to put words in your mouth. Are you testifying that it's your company policy to evaluate the costs and whether it's cheaper in California or cheaper out of the state, you are going to do what is the lowest cost?

MR. DEI: Well, we typically -- we're in the business to make money, whether we have to source that from outside the state of California or within the state of California. Our hope would be to source local milk and local processors.

We have our independent producers in northern California for that plant. And in Southern California, we bring a hundred percent of that milk from CDI, so we do different relationships with raw milk depending on the region.

PANEL MEMBER IKARI: If the Department adopted the Dairy Institute's proposal, what data, what analysis, or assurances can you provide that we would actually see increased sales of California milk?

MR. DEI: Well, typically, being in the retail business, I have never seen higher prices lead to higher consumption.

PANEL MEMBER IKARI: What about the impact on the producers who have gotten the notice, the termination notice? How will the Institute's proposal impact them?

MR. DEI: If -- I guess I could speak as a processor. As a processor, if we were -- if we had a more advantageous price and we were able to pick up additional business, we could entertain bringing more producers into our northern California plant.

PANEL MEMBER IKARI: I'm trying to -- Mr. Schiek, Dr. Schiek talked about just trying to bring us back to where we were at a competitive position. And I am trying to determine whether or not that would result in some increased sales.

MR. DEI: Well again, higher prices don't lead to higher consumption. Bringing any commodity price down typically leads to better movement or better consumption. That's been our history with different products in the company.

PANEL MEMBER IKARI: Has your company done any analysis of the impact of the federal order changes that went into effect on October 1 and compared it to the current proposals?

MR. DEI: We've done an analysis on the make allowances changes in relationship to the current California prices. We have not into the relationship to the Dairy Institute proposal.

PANEL MEMBER IKARI: And what is your analysis in just -- in terms of current California prices? What did it show? What did it tell you?

MR. DEI: We are slightly below California prices but not to the point to where it makes it economic, advantageous to move the milk with the cost of freight.

PANEL MEMBER IKARI: So the current prices unchanged, the California prices are slightly lower.

MR. DEI: Yes. But bear in mind too, California milk, being in California, the state orders a fortified product, so we typically have lower prices in the federal order states.

PANEL MEMBER IKARI: I have no further questions.

HEARING OFFICER CLEARY: Thank you, Mr. Dei.

The next witness to be called will be John Hitchell.

Good afternoon, Mr. Hitchell.

MR. HITCHELL: Good afternoon.

HEARING OFFICER CLEARY: How are you today?

MR. HITCHELL: Just fine, thank you.

HEARING OFFICER CLEARY: I see you have come all the way from Cincinnati.

MR. HITCHELL: Yes, I have.

HEARING OFFICER CLEARY: I've been there. I saw the WKRP statue.

(Laughter)

HEARING OFFICER CLEARY: That was my favorite part of the whole trip, seeing that.

If I could get you to state your name, spell your last name for the record, please.

MR. HITCHELL: H-I-T-C-H-E-L-L.

(John Hitchell was placed under oath by
Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization or as an individual?

MR. HITCHELL: An organization.

HEARING OFFICER CLEARY: What would that be?

MR. HITCHELL: The Kroger Company.

HEARING OFFICER CLEARY: Very well. You may begin, sir.

MR. HITCHELL: My name is John Hitchell. I am employed by the Kroger Company as the general manager of

Raw Milk Procurement in Cincinnati, Ohio.

Kroger Company owns and operates Compton Creamery in Compton, California, and Riverside Creamery, Riverside, California. From those plants, we service the Ralph stores out of Compton and our Food 4 Less stores out of Riverside, in Southern California.

I am appearing today to testify in support of the proposal submitted by the Dairy Institute of California.

To begin, milk supplies in California are adequate to supply the demands for milk uses, including Class 1, 2, and 3 milk products. Class 1 utilization in California has averaged 14.1 percent during the first eight months of 2008. Milk supplies were in such oversupply earlier in 2008 that milk was being dumped on the farm. Due to this oversupply, dairy cooperatives instituted supply management programs in order to curtail production. Even with the implementation of supply management, milk production in California has increased 1.15 percent or 1.7 million pounds per day in 2008 compared to 2007.

In addition, under federal order regulation, two hearing decisions in the last two years have reduced the price of the Class 3 and 4 formulas approximately 1 dollar a hundredweight. This will lead to lower Class 1 prices under the federal order program.

During the same time frame, the California Class 1 price formula has not been adjusted. This has led to structural changes in the relationship of the California Class 1 price compared to Class 1 milk costs in the surrounding states.

The current raw milk supply conditions combined with the change in Class 1 pricing formulas in surrounding markets have combined to justify an adjustment in the California Class 1 price formula. The proposed adjustment by Dairy Institute in the California Class 2 and 3 formulas are necessary in order to restore the price relationship that has existed prior to the changes in the federal order Class 4 formulas mentioned earlier.

The Class 4 formula establishes the federal order Class 2 price. The current supply of raw milk in California is more than adequate to meet the requirements for all uses, including Class 1, 2, and 3. In addition, the revisions in milk pricing formulas utilized in the surrounding markets have altered the relationship of the California 1, 2, and 3 milk costs to milk costs in the surrounding markets.

The Kroger Company believes that by implementing the proposal of the Dairy Institute, it will reestablish the historical price relationship between California and the surrounding markets. This will aid in the sales of fluid milk and cultured products and expand the market for dairy products produced in California.

The Kroger Company opposes the proposals made by the Alliance of Western Dairy Producers, Western United Dairymen, and California Dairy Women. These proposals would increase the cost of Class 1, 2, and 3 milk by over $1 a hundredweight. An increase of this magnitude will be a detriment to the sales of fluid and cultured products in California and reduce the demand for these products.

We also oppose the proposal made by Milk Producers Council to increase Class 1 prices to cover increases in milk transportation, allowances, and credits. The Class 1 price differential provides more than enough revenue to cover these costs. If producers no longer feel that it is to their benefit to serve the Class 1 markets, perhaps the state should simply stop pooling the Class 1 revenues.

For the reasons stated above, the Kroger Company supports the adoption of the proposal of the Dairy Institute of California.

Thank you for your consideration, and I will be happy to answer any of your questions.

HEARING OFFICER CLEARY: Thank you.

Mr. Eastman, do you have any questions?

PANEL MEMBER EASTMAN: I guess my first question regards the amount of milk you are taking in and using. Are your plants running full tilt? Is there extra capacity there for -- if your raw product price were lowered, is it based on how your sales are doing? Can you talk to that?

MR. HITCHELL: Our sales have been down in 2008 versus 2007. We believe that is a direct relationship of the higher cost brought about by the higher commodity prices, that were -- that we've had earlier this year compared to the same time in 2007. We have the capacity available to increase our sales without making any major capital investments in both places.

PANEL MEMBER PELLETIER: You mentioned that the Institute's proposal is necessary to restore the price relationship that existed prior to the changes in federal order.

Did you do any sort of analysis or do you have any idea what kind of impact you would face if there was no change, basically, if you were just facing this current difference?

MR. HITCHELL: Well, certainly we have -- we have plants that are outside the state of California right now, who have, as I said, taken the price decrease in the last two years of a dollar a hundredweight, based on the changes in the formulas in the federal order. Certainly, at this time, we have made no major moves to move products back and forth. Certainly, transportation costs would be part of that. But it is something that we take a look at, at all times, about where we could -- where we could source the product for the lowest cost.

I would also rely on the testimony of Dr. Schiek to show what the balance was between the two markets, but we believe it would be helpful to reestablish the balance that was -- that had been between the two markets before the drop in federal order prices.

PANEL MEMBER PELLETIER: Thank you.

HEARING OFFICER CLEARY: Ms. Gates?

PANEL MEMBER GATES: Mr. Dei spoke to that, you know, that contracts are sometimes on different levels and sometimes they can change within a month. And understanding that, you know, the last change in the federal order price is in October, so you might not know yet. But would you -- would your company -- I mean, are you looking at reestablishing or redoing contracts? I mean, are people coming to you saying, you know, "You're not competitive. We want a lower price," or are you just moving that around in your company and losing that out of California into one of your other plants, in one of the other states?

MR. HITCHELL: At this time, we -- as I said earlier, we are vertically integrated. Our plants, by and large, supply our stores. So certainly, we have a -- we have a mandate to make sure we are competitive with all the different potential suppliers that our stores could pull from besides ourselves.

At this point in time, we have not made any -- we have not made a decision to pull milk out of those plants; we have a capital investment there and a commitment to the state to run the operations as long as we possibly can.

So we're not making any major moves yet, but it would be something we would take a look at on a long-term basis.

The other thing I would also state, again, is our sales are down this year compared to last year, and we believe it is a direct relationship of the fact that because of commodity -- because simply because the milk prices are higher in the fist half of 2008 significantly than in the first half of 2007, that the consumer has not purchased as much product as they have a year ago.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: I have no questions.

HEARING OFFICER CLEARY: Thank you, sir.

Thank you very much, sir. Was it your intention to have your written testimony included into the record today?

MR. HITCHELL: It was.

HEARING OFFICER CLEARY: We'll enter the testimony into the record as Exhibit No. 56.

(The above-referenced document was marked as Exhibit No. 56.)

HEARING OFFICER CLEARY: Thank you very much.

MR. HITCHELL: Thank you.

HEARING OFFICER CLEARY: Next witness will be Dennis Brimhall.

Good afternoon, sir.

THE WITNESS: Is it afternoon already?

HEARING OFFICER CLEARY: It sure is. Just broke it.

Could you state your name and spell your last name for our record.

MR. BRIMHALL: Yes. Dennis Brimhall, B-R-I-M-H-A-L-L.

(Dennis Brimhall was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization?

MR. BRIMHALL: On behalf of Super Store Industries.

HEARING OFFICER CLEARY: Thank you very much. You may proceed.

MR. BRIMHALL: Mr. Hearing Officer and members of the hearing panel, my name is Dennis Brimhall. I'm the controller for Super Store Industries.

Our company has plants in Fairfield and Turlock. We process fluid milk products at our Fairfield plant and cottage cheese, sour cream, yogurt and ice cream at our Mid Valley Dairy Plant in Turlock. We supply dairy products primarily to the Raley's and Save Mart Super Market chains.

SSI management has approved this testimony and the company's position at this hearing.

Super Store Industries is a Dairy Institute of California member, and we fully support Dairy Institute's alternative proposal and the testimony given by Mr. Schiek.

Under the circumstances that currently exist in the California dairy industry, I struggle to understand the rationale for raising prices for Class 1, 2, and 3 milk. I don't doubt that producers everywhere are experiencing higher costs, but they are also receiving higher prices for their milk, as shown on the attached chart.

If you wouldn't mind going to the -- it's actually the third page, here. Just a brief explanation. The red line is the Class 1 prices over the last five years; the blue line is Class 2 and 3. I know that Class 2 and three are not exactly the same, but for these purposes, they were so close that the line overlaid each other, so I just called it all one, Class 2 and 3. And the black line is the cost of production plus the returns based on the information that the Department of Food and Ag issued, and that's this chart that's the very last page.

I didn't have the exact numbers, so I kind of eyeballed it, but it's pretty close. It started out in 2003 at about $13 a hundredweight and ended up in the current, most recent numbers, in 2008, at about $18 a hundredweight.

Now back to the testimony.

Over the last five years and especially over the last year, Class 1 prices have exceeded the total cost of the production, including investment and management returns. So these do include the returns as well as the costs. Even with the producers' highest -- even with the producers' higher current Class 1 costs, Class 1 milk still is a net contributor to their income. And I know that income doesn't go to them directly; it goes through the pool, and it's certainly a contributor to increasing the value of the pool.

If the revenue from all classes of milk is not sufficient to cover their costs, it seems that they would want to raise the price on all milk, not just Class 1, 2, and 3, which makes up just 22 percent of the utilization.

When producers expect 22 percent of the milk to bear the burden for all their production is difficult to understand. Doesn't it cost just about the same to produce milk that is used in Class 4a and 4b? Spreading the required increase over all classes of milk would result in a much lower increase than spreading it to just Class 1 through 3.

If producers need a dollar on 22 percent of the milk represented by 1 through 3, they would need only 22 percent on all the milk. If the milk-feed price ratio in the Alliance proposal is their main issue, do the 4a and 4b cows eat less than other cows, or is it just easier to raise the price on Class 1 through 3 milk than it is on Class 4a and 4b milk.

And I may add, parenthetically, that I was surprised that their comments -- that they are willing to give up some sales on Class 1 through 3 milk, someone else's sales, our sales. But they don't want to give up their own sales on Class 4a and 4b milk. That surprised me.

There are processed Class 1 through 3 products and raw milk in Class 1 through 3 products imported into California every day, against which local processors must compete. It is critical that California raw milk be set at a competitive price. As described by Dr. Schiek, maintaining a competitive price in surrounding areas justifies a price decrease, not an increase, as certain producers have requested.

The most obvious example that northern California processors face every day is the fact that northern Nevada producers are willing to accept a dollar per hundredweight less than the northern California price. This lower pricing started in August and was approved to continue indefinitely at the Nevada Dairy Commission meeting on October 22nd.

Furthermore, from discussions at the Nevada Dairy Commission meetings, it is evident that producers in Nevada are willing to sell their milk -- excuse me. The producers in Utah are willing to sell their milk at even lower prices. I doubt that the Nevada and Utah producers are more efficient than the California producers.

Parenthetically, again, it was interesting that a couple -- certainly, one of the processors in Las Vegas, even though Nevada was reducing their price, still wanted to get their milk from Utah.

The underlying economic principle at play here is that of supply and demand. As long as there is an oversupply of raw milk, prices will decrease. We have already seen this in the surrounding areas, and the CDFA is aware of unscrupulous marketers who have illegally sold California milk below state minimums. Any artificial increase -- any artificial influence to increase the price will ultimately fail. Buyers will simply go elsewhere.

Any northern California processor that is not already using lower cost -- that is not already using the lower cost Nevada milk is at a competitive disadvantage. I find it ironic that the few Class 1 processors that bought into the Real California campaign are now being penalized for their loyalty to California producers.

The quality of local milk is not an issue. We enjoy a reputation of having some of the highest quality dairy products in the state and for many years have purchased both California and Nevada milk for our California and Nevada customers. If the producers' proposals are approved at this hearing, there is no doubt in my mind that producers will purchase even more out-of-state milk to maybe contain their competitive position.

I have a great deal of respect for the California milk producers and enjoy my association with them on the Dairy Council and the Producers Security Trust Fund Boards.

All producers should be able to make a fair return on their milk, but they need to be keenly aware of the amount of raw milk they are producing, their cost of production, and the prices their counterparts in surrounding areas are willing to accept.

Thank you for this opportunity to testify. I will try to answer any questions you have and would like the opportunity to file a post-hearing brief.

HEARING OFFICER CLEARY: Thank you, sir. Questions?

PANEL MEMBER EASTMAN: Yes. Mr. Brimhall, I have the same question of you as the other processors: Are your plants running at full capacity right now, or do you actually have space for more milk if your raw product price were lower if your sales were to pick up?

MR. BRIMHALL: Our Fairfield plant is at capacity, but the real question there is the mix between California milk and Nevada milk. If California milk came down in price, and depending on how Nevada responded to that, it may make an opportunity for the mix to have more California milk and less Nevada milk.

Our Turlock plant is not at capacity and could produce more if the sales were there, and that's the big if. You know, the sales of Class 2 and Class 3 products, we don't -- it's hard to get those. It's a very competitive situation. So even though there's a capacity there, the sales may not be there to justify it.

PANEL MEMBER EASTMAN: So right now, what you are saying is, you buy both California and Nevada-produced milk; you have a mixture.

MR. BRIMHALL: In the Fairfield plant, yes. Fairfield.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: I wondered if I could follow up on this question that your testimony -- you said it is evident that producers in Utah are willing to sell their milk at even lower prices. I -- how is it evident? Did they make a public statement at the --

MR. BRIMHALL: At the Nevada Dairy Commission meeting, one of the processors in Las Vegas purchases Utah milk. The Nevada Dairy Commission folks, the board, asked him, if they reduced their prices, would he move some of his milk to Nevada, and he said no. So it seems evident to me -- maybe it's an assumption that I'm making -- that price is a component of that. Certainly, the relationship is also a component of that. But I assume, and I have to make the assumption, that the pricing is a big component as well.

PANEL MEMBER IKARI: Does your company on a regular basis, or some kind of basis, look at the competing milk supplies both in California and outside the state, and measure the cost?

MR. BRIMHALL: Our mission in life is to keep the Raley's and Save Mart chains in the highest quality, lowest cost milk. So if there is lower cost milk, including the cost of transportation to get it to our plant, that it is high quality, if that's there, then we -- it's our obligation to look at that lower cost milk. Absolutely.

PANEL MEMBER IKARI: Isn't there a limit, though, on how much milk Nevada could supply?

MR. BRIMHALL: Absolutely. And there may not even be any more milk available. I don't know.

PANEL MEMBER IKARI: Is there -- have you done any -- has your organization performed any analysis on the competitive relationship of federal order milk?

MR. BRIMHALL: We haven't. We don't sell in any federal orders. It's just in California and in Nevada, so I have to admit, I don't know a whole lot about the federal order situation.

PANEL MEMBER IKARI: Do you have information or analysis on the cost of hauling the milk from the various milk supply areas?

MR. BRIMHALL: No. Producers pay all of the hauling. We look at the final price that we pay, which includes hauling, and obviously including service charges too.

PANEL MEMBER IKARI: Have the Nevada producers ever asked you for a hauling cost?

MR. BRIMHALL: No.

PANEL MEMBER IKARI: I have no other questions.

Thank you.

HEARING OFFICER CLEARY: Thank you, Mr. Brimhall. Was it your intention today to have your written testimony entered into the record?

MR. BRIMHALL: Yes.

HEARING OFFICER CLEARY: We'll enter it in as Exhibit No. 57 testimony at this time.

(The above-referenced document was marked as Exhibit No. 57.)

HEARING OFFICER CLEARY: And I thank you very much for your testimony and also the fact that you are kindred spirit. There's very few people who actually know how to use the phrase "parenthetically," and know what a parenthetical phrase is. So I compliment you on that. Thank you, sir.

MR. BRIMHALL: Thanks.

Next witness is Eric Erba, California Dairies, Incorporated.

Good afternoon.

MR. ERBA: Good afternoon.

HEARING OFFICER CLEARY: Could you state your name and spell your last them for the record, sir?

MR. ERBA: I can do that. It's Eric Erba, E-R-B-A.

(Eric Erba was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization or as an individual?

MR. ERBA: On behalf of an organization, California Dairies, Inc.

HEARING OFFICER CLEARY: Great. You may begin.

MR. ERBA: Mr. Hearing Officer and members of the panel, good afternoon. My name is Eric Erba and I hold the position of senior vice president of Producer and Government Relations for California Dairies, Inc., whom I am representing here today. California Dairies is a full-service milk processing cooperative owned by approximately 600 producer members located throughout the state of California, and collectively they produce over 17 billion pounds of milk per year, or 43 percent of the milk produced in California.

Our producer-members have invested over $400 million in six large processing plants, which are projected to produce 340 million pounds of butter and 750 million pounds of powdered milk products in 2008. On October 23, 2008, California Dairies Board of Directors unanimously approved the position that I will be presenting here today.

Introductory comments. We thank the Department for calling this hearing and allowing us the opportunity to explain the challenges being faced by our members as they try to cope with a production cost milk price squeeze that hasn't been realized before. We are encouraged that the Department of Food and Agriculture has acknowledged the input cost escalation that has affected California dairy producers since 2006. The material reviewed at the prehearing workshop on October 15th is replete with charts developed by the cost of production staff that verifies what we know to be all too true.

Dairy producers are in unchartered waters with astronomical increases for input costs, particularly feed and energy. At the July 17th Whey Review Committee meeting, Secretary Kawamura aptly recognized that dairy producers are facing huge challenges of increasing input costs and not being able to fully recover all of those increases in the form of higher milk prices.

While we appreciate the Secretary's comments, we recognize that attempting to fully recover production cost increases is problematic for both producers and processors in California. We have chosen not to pursue that agenda. Instead, we believe that the petitioners have identified a mechanism that will provide dairy producers higher milk prices for a short period of time, after which, we hope that the markets, which have such a huge impact on their livelihood, will have equilibrated and found some degree of stability that appears so elusive today.

Position of California dairies. We fully support the petition submitted jointly by the Alliance of Western Milk Producers, Western United Dairymen, and California Dairy Women Association, which proposes a temporary increase in the minimum prices for Classes 1, 2, and 3, commencing in January 2009 and ending in June 2009.

The proposal would not alter the details of the pricing formulas for Classes 1, 2, and 3. It would merely add four cents per pound surcharge on the calculated fat price and a 10 cent per pound surcharge on the calculated solids nonfat price. As such, the projected effect is to increase the Class 1, 2, and 3 prices a dollar and 1 cent per hundredweight, irrespective of the marketing area in California.

The proposed changes are easy to understand and, if granted, may be implemented quickly.

We as well as the petitioners recognize that the projected impact on pool prices of granting the petition is not large, at 24 cents per hundredweight. This is not enough of an increase in producer prices to prevent dairy producers from exiting the business. The pricing changes specified in the petition were never intended to provide that sort of financial assistance. Furthermore, the temporary nature of the request is a testament to the intent of the petitioners -- to provide a short-term price increase to producers during a period of transition to see whether feed and energy prices become more stable through the reemergence of market fundamentals.

Supporting material for position. The petition for this hearing was predicated on basic cost and price data, and much of that thought that went into the decision to submit the petition has been captured in the Department's document entitled "Background Material for Class 1, 2, and 3 Hearing." You can select any of the first 16 figures and get a clear picture of what the California dairy producers have been facing in the last two years.

Some examples:

Cost of production, 33 percent higher. That's in Figure 1;

Alfalfa hay prices, 32 percent higher, Figure 3;

Grain, mineral, and supplement prices, 69 percent higher, Figure 3.

Spot corn prices, 40 percent higher, Figure 4;

Hauling costs, 16 percent higher, Figure 7.

The trends highlighted in the data collected by the Department staff and presented at the workshop are startling. However, one additional compelling figure could be used to supplement the data that the Department has compiled, for the sake of completeness: USDA's milk-feed ratio is widely recognized as a barometer of the health of the production side of the dairy industry. It reflects the pounds of 16 percent protein mixed dairy feed equal in value to 1 pound of whole milk. A ratio of 3.0 or higher is generally considered to be a good business environment for producers and favorable enough to encourage producers to expand their operations.

The chart on page 3 verifies a few assertions. First, in the recent past, the milk-feed ratio has not often exceeded 3.0. Second, while most would agree that producers face very poor milk prices in 2006, the low prices were somewhat mitigated by low feed costs. Although not intuitive, the combination of low milk prices and low feed costs resulted in more favorable ratios during 2006 than producers have seen in 2008.

Third, the extraordinary milk prices in 2007 did not send milk-feed place ratio off the chart, as might be expected. The reason, of course, is the relatively high feed prices.

And finally, there has been a clear deterioration in the milk-feed ratio starting in December 2007 to reach the lowest levels on record.

These last several data points in the chart merely underscore the point that while milk prices have been good to very good recently, the extraordinarily high feed prices have more than offset those milk price gains.

The milk-feed ratio data is useful for describing how poor the economic environment has become for the producers throughout the U.S., but it is not unique in that respect. As I stated earlier, virtually any of the charts and data provided by the Department will lead you to the same conclusion -- producers have already faced enormous production cost increases, and there is no assurance that future costs of input will decrease to historic levels.

California dairying. Vulnerable to feed price increases. Feed lot style dairying, i.e. buying instead of growing a large percentage of feed on the dairy has been a hallmark of California dairying. While this type of dairying has contributed to tremendous production gains and growth in dairy operations, it also makes the producer community vulnerable to feed price increases. Unanticipated influences, such as the ethanol boom in response to the mandated Renewable Fuel Standard, a weak dollar and high demand for grains for other countries exposed this vulnerability. Consequently, high feed prices have been plaguing the dairy producers, and, yet, the reasons for the higher feed prices were clearly beyond their control.

You may wonder why producers did not simply rebalance feed rations and substitute away from the more costly feeds. I assure you, these efforts have been made.

The Department's Cost of Production staff can also attest to the fact that dairy nutritionists have been working nonstop for months, attempting to find cost-effective rations without compromising milk production and component levels.

By and large, these efforts have not been successful. Feed substitutes that appear to be less expensive have resulted in increases -- decreases in milk production or milk components so that the net improvement in profitability is unchanged.

Supply management. The Department has historically had concerns about granting price increases and the resulting supply response to higher milk prices. In the last year, new policies were adopted that should alleviate these concerns. Starting in late 2007 and into 2008, the major California cooperatives and some proprietary processors implemented supply management programs. While the programs differ in the details, they all share a common purpose -- to reduce the amount of milk shipped from California dairy farms. California Dairies instituted its own supply management program in April 2008, and it will remain in place until January 2010.

The combined effect of the supply management programs is plainly evident in the production data published by the Department. California milk production started to fall off significantly in March 2008, and milk production has averaged only about 1 percent higher than 2007 since that time, considerably lower than the historic increases of 4 to 5 percent. In fact, the year-over-year changes in milk production for July and August 2008 were negative, rarities in themselves.

The point is that granting higher milk prices on a temporary basis will not lead to further increases in milk production.

First, supply management programs across California are acting as an insurance policy against unchecked milk production increases. With these programs in place, any additional milk being produced will carry with it a potentially significant penalty.

Second, the nature of the dairy business does not allow producers to be able to respond to temporary price increases of any size. Very simply, it takes time and resources to set business plans into motion.

The six-month duration of the price increase is a deterrent, and the unrest in financial markets and the credit crunch are yet further disincentives for a producer who may be considering a facility expansion.

Concluding remarks. During the years I worked for the Department, there was a tendency of not making pricing formula changes based on future events and expected outcomes. The myriad of hearing requests in 2001 and 2002 related to extreme volatility in the cost of energy, and the Department's responses exemplify the Department's clear desire to verify cost increases before making pricing formula changes.

Let me be perfectly clear, I agreed with that philosophy then, and I agree with it now. In the situation that is before us today, however, I think it is safe to say that the aforementioned cost and price increases are not future events or expected outcomes. They are upon us and have already been realized and documented.

When the Department completes its third quarter cost comparison, more of the same should be expected, i.e., the date will show the undesirable trend of higher input costs continuing. Furthermore, it may be tempting to think that assured price and cost relief lies ahead for dairy producers based on the current changes in many of the input markets. That point of view is troubling. What the feed and grain markets have shown us all in the dairy industry in the past two years is that they have become more volatile and remain unpredictable.

Earlier this year, a decision to lock in corn prices at $6, when it appeared as though corn might go to $8, looked like a reasonable hedging strategy. With the current backdrop, that same decision looks imprudent if not foolish. To say that cost relief lies ahead for dairy producers based on current changes in many of the input markets is betting on future events and expected outcomes that have not yet been realized.

Instead, I would urge the Department to use the information and data included in the hearing record, rather than attempting to forecast what markets will do in the future.

Thank you for the opportunity to testify. Mr. Hearing Officer, I request your approval to file a post-hearing brief.

HEARING OFFICER CLEARY: Thank you very much.

Questions of the panel?

PANEL MEMBER EASTMAN: I have a couple questions. On the last page of your testimony, you mention there was unrest in the financial markets and there's a credit crunch going on. Are you referring just to general conditions within the economy today, or are you specifically pointing out that there's been a credit crunch that you are aware of with the producers that belong to your organization or the producer-members?

MR. ERBA: Both. Mr. Eastman, both those would be true. Certainly, I don't need to speak to the global aspects of that. But we have -- our member-producers have all complained to us about the situations they were faced with, much the same as Ms. Lopes mentioned earlier this morning.

PANEL MEMBER EASTMAN: Okay. Thank you.

The second question I have is, obviously you support the proposal of the Alliance, et al., group. Do you have the same feelings regarding the six-month temporary increase? As a time period, do you think going beyond six months becomes problematic? Anything below six months would still be helpful but maybe not -- obviously it wouldn't be six months. But would going beyond that be problematic?

MR. ERBA: I think you have the right idea, and the right idea is that six months gives some opportunity to give price relief to the producers, our members, and yet it doesn't go far enough out into the future where it might start affecting sales, although there's been testimony that that's probably incorrect. So I will leave that up to you guys to decide. Six months seemed to us to be a good time period to get some kind of relief for our producers and yet without affecting sales dramatically.

PANEL MEMBER EASTMAN: Thank you.

PANEL MEMBER PELLETIER: Kind of the same question I've been asking. Do you have any idea or conducted any analysis as to what an increase in price would do to out-of-state milk coming in? Did you get any analysis?

MR. ERBA: Nothing additional to what the Department presented at the workshop. Obviously, you have covered what minimum price changes might be if the proposal were approved. And we have not done anything beyond that.

HEARING OFFICER CLEARY: Ms. Gates?

PANEL MEMBER GATES: Just a quick question on your company's position on the MPC proposal. Can you speak to that in your testimony?

MR. ERBA: That's correct. When I was on hearing panels, I never found it useful for other people to speak on other proposals that weren't their own. So I didn't include it on purpose.

PANEL MEMBER GATES: Just, were you in support or against.

MR. ERBA: Neutral on the Milk Producers Council proposal. I would point out that that'd be a tremendous change in the Department's policy, and that would be something for you guys to consider if that's appropriate or not.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Mr. Ikari?

PANEL MEMBER IKARI: You mentioned production controls. How much of the industry is controlled by production controls? How much of the production?

MR. ERBA: How much of the production? I'm going to say 85 percent. The three major cooperatives are representing something in the neighborhood of 80 percent. It might be higher than 85 percent if you throw in some of the large proprietary processors. So somewhere in the neighborhood of 85 to 90 percent, would be my guess.

PANEL MEMBER IKARI: Is it conceivable that the 15 percent that isn't control could impact the total production, even though the 85 percent is under production controls?

MR. ERBA: Well, they are obviously free to make those choices. It's going to be difficult to find out where to put that milk, though. And that's always been the question is, if you grow in production -- let me just back up a second and talk about our production controls.

Our production controls -- and I think they are similar to the other co-ops -- do not forbid producers from producing more milk. They can produce as much as they want, just as they always have. Except that now, if they go over their production base, they will bear the cost, any risk involved in marketing that milk whatever that may be. So they can still produce whatever they want, Mr. Ikari.

PANEL MEMBER IKARI: Isn't the low prices that we are seeing, or the falling milk prices, a result of more milk than we can market? Or surplus milk supplies relative to demand?

MR. ERBA: I guess I wouldn't totally agree to that. The supply of milk has sort of been -- in my mind, stands alone from what the demand for products has been. I think we are a good supply situation today. We probably weren't there earlier this year, but I think today we are there. And I think that's a testament to the supply management programs that have been put in place and enforced by the cooperatives and some of the proprietary plants.

But just because we're able to handle all the milk and get it processed doesn't necessarily mean we're going to have tremendous demand for that product.

PANEL MEMBER IKARI: Can you say that we're able to handle all the milk when we have a number of producers who have been terminated and -- effective November 1 and end of December? At least until -- we've had testimony that perhaps there's progress being made, but as of today, they don't have homes.

MR. ERBA: But the milk is still getting processed. Do you agree?

PANEL MEMBER IKARI: Effective November 1, will it?

MR. ERBA: I guess we'll find out November 1.

PANEL MEMBER IKARI: How will the proposal impact those producers?

MR. ERBA: You have asked that question repeatedly and I've probably had enough time to come up with a brilliant response, but I am afraid I will have to disappoint you and some of the other ones on that one.

You know, I could look at it very easily and say our proposal would increase pool prices, and because those producers' prices are still based on pool prices, I would expect that they would go up. They would have a deduction. They currently get a deduction for some of that milk that's getting moved to other processors. And they probably still will get that deduction. But it's possible the price could actually go up.

PANEL MEMBER IKARI: Is it CDI's position that there's not surplus production in the nation, in the state?

MR. ERBA: I think the short answer is yes. The other answer would be that I feel the supply management programs have looked very well that way. You can look at the production information that's published by the Department and see that production has been nearly flat since production controls have been put in place in April, in March and April.

PANEL MEMBER IKARI: Yes. Would you clarify? Yes what? Yes, that the milk is --

MR. ERBA: Yes, it's CDI's position that we're in a good supply situation right now.

PANEL MEMBER IKARI: But isn't it CDI's position that CWT shouldn't engage in another buyout?

MR. ERBA: Well, sure, but that just gives producers an opportunity to exit the business they wouldn't normally have. So I don't see why supporting another CWT buyout necessarily isn't a --

PANEL MEMBER IKARI: It's not inconsistent.

MR. ERBA: In my opinion, it's not inconsistent.

PANEL MEMBER IKARI: I understand the testimony that producers are offering. They are suggesting that on a temporary basis, we've got a problem. What about the long-term? Are the proposals by Dairy Institute versus the Alliance and the producers mutually exclusive? In other words, if we get through this short-term situation, if everything goes right, do we still have a fundamental -- with a change in the lower end of the federal order prices, is there a competitive issue in the long term between California minimum prices, especially Class 1, 2, and 3, versus the federal order prices?

MR. ERBA: You have gotten differing opinions on that today, and I'm not going to offer you something that makes it all right.

PANEL MEMBER IKARI: And I am asking the question, are they mutually exclusive? Are they separate or can the Department take some combination of both of those proposals?

MR. ERBA: I think in the short term -- for what we're talking about, in the short term, yes, they are mutually exclusive. I do not see a way to grant something to both sides and end up being okay, unless you end up right at zero. They want a price decrease and they want it for a longer term and we're looking for a price increase --

PANEL MEMBER IKARI: Well, what about the possibility the Department provides some temporary increase in the price and -- but then subsequent to that, lowers the price, changes the structure?

MR. ERBA: Well, that would be the Department's prerogative, and I guess -- I suppose you could find a way to do that and the data to support that, and, certainly, the testimony today that would support that. But in the short term, the Alliance's proposal, the joint proposal submitted, is going to be in conflict with what the Dairy Institute is suggesting.

PANEL MEMBER IKARI: I have no further questions.

HEARING OFFICER CLEARY: Thank you very much, sir.

Was it your intention to have your written testimony be included into the record?

MR. ERBA: Yes, please.

HEARING OFFICER CLEARY: All right. We'll enter it into the record as Exhibit No. 58.

(The above-referenced document was marked as Exhibit No. 58.)

HEARING OFFICER CLEARY: And thank you very much.

Next witness is Michael Newell.

Good afternoon, sir.

MR. NEWELL: Good afternoon.

HEARING OFFICER CLEARY: If I could get you to state your name and spell your last name for the record, please.

MR. NEWELL: Michael Newell, N-E-W-E-L-L.

(Michael Newell was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization or as an individual?

MR. NEWELL: Organization, HP Hood LLC.

HEARING OFFICER CLEARY: You may begin, sir.

MR. NEWELL: Hearing Officer and panel members, my name is Michael Newell, and I am a director of Business Development for HP Hood LLC. HP Hood operates an extended shelf life fluid milk processing plant in Sacramento, California, which produces Class 1, 2, and 3 products.

These products are distributed in California as well as in other western states. I offer the following testimony on behalf of HP Hood with regard to the proposal of the Alliance, Western United Dairymen, and California Dairy Women Association for increases in the current Class 1, 2, and 3 prices.

HP Hood opposes -- HP Hood is opposed to this proposal and in fact supports the alternative proposal put forth by the Dairy Institute of California. On this basis, we feel it is crucial -- I'm sorry. On this basis, we feel it is crucial to long-term interests of the California dairy industry and Californians that these class prices continue to have a reasonable economic relationship with those surrounding states.

HP Hood's business in California. Before I explain our position, I would like to give some background on HP Hood. HP Hood was founded in Boston, Massachusetts, in 1846, and is one of the largest manufacturers of fluid milk, cultured products, and ice cream in the United States. One of Hood's areas of expertise is producing extended shelf life dairy products. HP Hood operates four ESL plants in the United States, including one right here in Sacramento. Hood acquired this asset from Crystal Cream and Butter Company in May of 2007 and has invested a significant amount of capital to retool the operation as an ESL focused facility.

Extended shelf life products differ from HTST products in that they have a shelf code that is approximately four times longer. This longer code enables ESL products to be delivered over greater distances and through warehouse distribution systems.

Hood currently manufactures products in each of the three classes related to today's hearing at its Sacramento facility and would like to expand its California business by gaining market share and introducing new, innovative products.

Rationale for supporting Dairy Institute's proposal. From a macroeconomic perspective, there are two reasons for our support of the Dairy Institute's proposal.

First, the CDFA has long sought to keep the California dairy industry vibrant by maintaining a reasonable economic relationship for farm milk with surrounding states. The Alliance's proposal clearly puts California-produced products at a greater cost disadvantage to those manufactured in surrounding states. As Dr. Schiek of the Dairy Institute has pointed out, the recent changes in the federal order make allowances have already created a situation in which California's class prices are significantly higher than those in surrounding states, and the Alliance's proposal only exacerbates this disadvantage. This is a situation that the Dairy Institute has sought to rectify in their alternative proposal.

The second reason for opposing the Alliance's proposal is that it encourages the overproduction of milk. For some time, the Class 4 processing capacity in the state has not been able to handle the excess milk during the winter holiday season and the summer months. This situation could likely grow worse should cheese makers take advantage of the weak powder milk market and substitute low-cost powder for more expensive Class 4b milk. The Alliance proposal furthers this disequilibrium in two ways: With higher relative class prices, California processors of Class 1, 2, and 3 products will lose volume to more competitive out-of-state manufacturing plants, which will drive more milk to Class 4b plants.

Secondly, the higher price set by the Alliance's proposal will encourage producers to maximize production thus placing an even greater demand on Class 4 processing plants.

The fact that this is positioned as a temporary increase will only encourage that much more overproduction during the upcoming holiday period. It is human nature that producers use what means they have at their disposal to take advantage of the limited offer for incremental revenue. Does this make sense when cooperatives have initiated production caps because they cannot handle the milk that their producers -- that their members want to produce right now?

Competitive environment for ESL products and potential ramifications. From HP Hood's perspective, the fact that we are even having this hearing is concerning. When Hood decided to acquire the Sacramento plant, one of the factors that it considered was California's ample milk supply that historically was competitively priced with surrounding states. Hood's basic plan was to move its existing West Coast ESL volume into the facility and use the plant as a growth platform for both branded and private label ESL products. Given the recent changes in the federal make allowances, even maintaining the status quo relative to California's class pricing will make it difficult to be cost competitive with ESL plants located in Washington, Utah, and Arizona.

Unlike most fluid processors, HP Hood ships a significant portion of its production to surrounding states. HP Hood's Sacramento facility currently manufactures several nationally branded products for markets located in northern California and the rest of the western United States. Hood also has another California processor producing these products for the Southern California market. Creating a larger differential between California and surrounding states will certainly cause margin compression to Hood's existing business and/or a loss of market share to competing products. Should this disadvantage persist, it will encourage Hood to reconsider its current manufacturing plan.

Hood is currently pursuing several private label opportunities that are served by out-of-state manufacturing. It is highly unlikely that we can take advantage of these opportunities if we can't be cost competitive. Furthermore, private label business served by other in-state ESL processors will be increasingly vulnerable to out-of-state competition as well.

Lastly, Hood has been an innovator in ESL processing. Having a stable competitively priced source of milk is crucial to justify the capital investment that this type of processing requires. Should California decide to alter its past practice of maintaining a reasonable economic relationship with surrounding states, potential expansion projects that are under consideration for our Sacramento plant could be abandoned in favor of more competitive predictable regions. I believe this could be the case for other national manufacturers as well.

Conclusion. In closing, we believe that it is essential that the Department give every consideration to the Dairy Institute's proposal. Year after year, these higher value classes of milk continue to make up a smaller share of the California milk pool. Should the Department decide to abandon its policy of maintaining a reasonable pricing relationship with neighboring states, the pace of this erosion will only increase. The stage will be set for out-of-state competitors to utilize their cost advantage to pick up more California business in the Class 1, 2, and 3 markets. This will drive more milk toward lower value Class 4 products. With current capacity constraints, this excess milk may even end up unprocessed.

In the longer term, processors of Class 1, 2, and 3 products may choose to locate plants in adjacent states with friendlier, more consistent pricing policies. This will drive down pool revenue and place an even greater burden on Class 4 plants.

It is for these reasons that we feel that it is in the best interest of both California processors and producers for the Department to adopt the Dairy Institute's recommendation and continue its existing policy of keeping Class 1, 2, and 3 prices competitive with those of surrounding states.

Thank you for giving Hood the opportunity to share its views on this important matter. That concludes my written testimony. I do, however, request the opportunity to file a written brief.

Thank you.

HEARING OFFICER CLEARY: Thank you very much, Mr. Newell.

Any questions from the panel?

PANEL MEMBER EASTMAN: I have a couple questions. On the first page, you mentioned that you produce extended shelf life products compared to HTST. Is that high temperatures?

MR. NEWELL: High temperature short time is kind of traditional. Pasteurized milk, you get maybe 16 to 18 days code on that type of milk. With extended shelf life dairy products, your code is 60 to 75 days.

PANEL MEMBER EASTMAN: And so typically you would consider your competitors are pretty much just the other processors that produce the same extended shelf life products?

MR. NEWELL: Yeah. It's really a niche business.

I was waiting for the capacity question.

PANEL MEMBER EASTMAN: Oh, yeah. This follow-up question prodded onto me by the witness.

No, actually, although you do kind of mention this in your testimony, I know that right now you just have the one facility in Sacramento; correct?

MR. NEWELL: Yes.

PANEL MEMBER EASTMAN: And you do kind of mention you are willing -- or you have been considering expanding it. And earlier, it seemed like you did have a group of producers that you cut some of the milk you were taking to start off with. Is that something that you foresee is going to be your sort of business, sort of plan? You mention you are going to expand. How likely is that? What were your initial plans?

MR. NEWELL: Well, I think initially because we got out of the HTST business, we didn't have a need for about 85 percent of our milk. And we were oversupplied, anyway. So the company had to make a very hard decision to make that change, but there really wasn't a choice.

In terms of expansion, Hood purchased the facility to expand, and they are putting additional filling equipment in early next year. But because it was a large facility, they have lots of room to grow further. It's just a matter of deciding how best to take advantage of that space.

PANEL MEMBER EASTMAN: Do -- I can't remember. Did you mention that you have other processing facilities here in the West?

MR. NEWELL: No. In the West, we do not. We have other co-packing relationships in the West, but Hood has no other processing facilities in the West.

PANEL MEMBER EASTMAN: Do you have any idea how your sales for extended life shelf products, whether they are going to increase, take off? Do you know what sort of customer reaction there is to them? Because typically I would imagine in America, Americans don't tend to gravitate towards those products, or am I wrong?

MR. NEWELL: It's not -- it's a niche business. It's a value-added business. It's an innovative business. So it's something new rather than your traditional white milk in a jug. So I think the goal is to increase that business. But if you are looking at investing a large amount of money, you want to do it at a place where you are sure your raw materials are going to be at least reasonably priced, and that's our concern.

PANEL MEMBER EASTMAN: So it seems to me then, really, part of the ability for you to take on more milk and expand is really going to be based on sales, sort of Business 101.

MR. NEWELL: It's going on sales and opportunities, marketing opportunities we seek.

PANEL MEMBER EASTMAN: Do you have any idea how those are forecast, how well? Do you have a pretty good decent growth right now?

MR. NEWELL: I think that we are on our growth plan for the plant. You know, as far as things that are coming down the -- through the pipeline, I can't really comment on that.

PANEL MEMBER EASTMAN: But it seems like you are on track then.

MR. NEWELL: Yes. I would say that private label business, it's very competitive. That's what we found. So we have gone after some business that is currently coming in from out of state. We have not been successful.

HEARING OFFICER CLEARY: Mr. Ikari, do you have any questions of the witness?

PANEL MEMBER IKARI: On the second page of your testimony, I am trying to see if I can get some clarification. You say, "Creating a larger differential between California and surrounding states will certainly cause margin compression to Hood's existing business and/or a loss of market share to competing products."

Should this disadvantage persist -- I am trying to determine -- the Department has three options: One, for six months raise the price. And clearly you are saying that if the Department raises the price, you are going to lose business and bad things are going to happen.

What happens if the Department does nothing as a result? What is your competitive situation?

MR. NEWELL: Well, I think --

PANEL MEMBER IKARI: And then the third issue is, if the Department adopted the Dairy Institute proposal. What would be the status of your competitive position? Would it be the same as it was before?

MR. NEWELL: Would it be the same as it was -- our competitive position would be a little bit -- if it adopted it? I think, yeah, it would be the same as it has been in the past. If you don't adopt it, we're going to be worse off. Will that cost us business tomorrow? I mean, I can't say that. I mean, I'm sure it will make it difficult to pick up new business. It also gives us a concern over, you know, what the long-term policy thoughts of the Department are when we consider investing in more capacity.

PANEL MEMBER IKARI: So you are saying that even though it's six months and temporary, that's enough to push you over?

MR. NEWELL: I am saying, the make allowance gives us great pause. The temporary -- I think I guess our concern is long term, are we going to keep seeing, you know, these six months -- we're going to raise the price for six months to take care of this concern or that concern? That's a concern from a policy perspective. Short term, I think six months is a long time. If I were still in the traditional HTST Class 1 manufacturing business, I mean, I would think it's a real problem, and that is such a competitive environment.

PANEL MEMBER IKARI: Let me kind of start over. The competitiveness that California, your plant, relative to the other sources of milk, prior to the federal order change -- I want to contrast the position that you were in then versus if the Department does nothing, if the Department increases the price, adopts the Institute's -- or the Alliance proposal, increases the price, I take it from your testimony that would put you over, that, you know, you would -- that six-month increase in price would create such a large difference that you would begin to do some things that would be contrary to California.

MR. NEWELL: Not the six months. But the make allowance and having a long-term differential where we no longer have a reasonable economic relationship, that's really what I was speaking to. The six months, I think, from a competitive standpoint, is concerning.

PANEL MEMBER IKARI: That was what I was trying to get to with Mr. Erba, Dr. Erba.

The proposals are offered as exclusively separate.

MR. NEWELL: Right.

PANEL MEMBER IKARI: But suppose the Department implemented a temporary increase, let's say, just for sake of argument, two months or three months, but then upon that reduction -- I mean, that increase, we reduced the price to provide a better relationship. So in the long term, wouldn't that put you in a better -- or put you back to the competitive position that you were in prior to the federal order change?

MR. NEWELL: Yes, it would. It would put us back to the -- what could happen in the short term, if it's two or three months, certainly the risk of losing business is a whole lot less than six months. That is a briefer period of time. I guess we still would be concerned about, are we going to see these, you know, surcharges or -- you know, historically, is that going to be the new approach, which I don't think is stable.

PANEL MEMBER IKARI: And how can we tell now?

MR. NEWELL: I don't think we can.

PANEL MEMBER IKARI: Okay. Thank you.

HEARING OFFICER CLEARY: Thank you very much, sir.

Was it your intention to have your written testimony entered into the record?

MR. NEWELL: Yes, it was.

HEARING OFFICER CLEARY: Exhibit No. 59 will be entered into the record at this time.

(The above-referenced document was marked as Exhibit No. 59.)

HEARING OFFICER CLEARY: What we're going to do now is we're going to have one more witness, and after this witness testifies, we'll break for one hour and return back again to complete the afternoon.

If I could have Evan Kinser, please come forward.

MR. ERBA: Mr. Hearing Officer, how many left after Mr. Kinser?

HEARING OFFICER CLEARY: I have three witnesses currently signed up after Mr. Kinser.

Good afternoon, sir. Could you please state your name and spell your last name for the record.

MR. KINSER: Evan Kinser, K-I-N-S-E-R.

(Evan Kinser was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization or as an individual?

MR. KINSER: Organization.

HEARING OFFICER CLEARY: And you may begin, sir.

MR. KINSER: Mr. Hearing Officer and members of the hearing panel, my name is Evan Kinser. I am the director of Dairy Policy and Commodities for Dean Foods Company. Dean Foods operates four California fluid processing plants located in Buena Park, City of Industry, Riverside, and Hayward. We have an ice cream plant in Buena Park. We have cultured product plants located in Fullerton and Tulare. We have two UHT operations, COI-Whitewave and Gustine. All these plants will be impacted by the outcome of this hearing.

My testimony is in support of the Dairy Institute of California proposal for modifying the formulas to calculate the Class 1, 2, and 3 prices in California and to be more reasonably aligned with the surrounding markets and current economic conditions. Management of Dean Foods has approved my testimony.

I wish to thank the Department for including the Dairy Institute's proposal in this hearing. I represented Dean Foods in the discussion with other Dairy Institute members to develop the proposal. We understand the implications these decisions have on the industry and feel strongly that the Dairy Institute proposal is the needed action for the California dairy industry. Further, I thank you for the opportunity to testify in support of this proposal.

The issue of competitive alignment with the surrounding market is not a new one. Dean Foods has been in front of the hearing panel multiple times with the same complaint. We appreciate that the hearing panel has understood the conditions, but the Department has been unresponsive and has disregarded the hearing panel's counsel. The action by the Department has continued to garner the same results: Lost business to out-of-state competitors and faster farm production growth than plant capacity.

California has no ability to control the flow of out-of-state milk either in raw or packaged form. However, California does have control over the price level charged to California processors for California produced milk shipped directly to California plants. With the correct alignment, economics and good business practices will direct the movement of milk. Hopefully today's testimony can illustrate the points provided by dairy institute's testimony to support CDFA's leadership to reasonably align California's Class 1 pricing formulas with the contiguous states and maintain remaining California Class 1 sales and increase companies' desire to produce Class 2 and 3 products in California as opposed to other locations.

Out-of-state opportunity. In December 2006, I cautioned CDFA and California dairy producers about believing that the doors to out-of-state milk were closed and locked by the implementation of the Milk Regulatory Equity Act. The MREA merely established a mechanism to regulate at a federal level plants that otherwise escaped regulation entirely. The federal regulation is not controlled by California in any way. Thus, the MREA can result in regulatory equity at the federal level, but CDFA still must consider how the equity applies to California based upon California regulation.

I stated that there were still opportunities and economic incentives for the existing regulation to be short-circuited because CDFA can't stop current out-of-state milk entering California nor prevent new out-of-state milk from entering the state. At the hearing, Dairy Institute and several of its members advocated for protecting the long-term health of Class 1 sales that historically belonged to California dairymen by lessening the economic incentive to make long-term investments in processing capacity either outside of the state for the purpose of capturing California's Class 1 market, or inside the state, utilizing out-of-state bulk milk.

Our concern was the historic price spread between

California and surrounding states' farm prices created opportunities to attract out-of-state unregulated milk. I went so far as to say, "If people who watch markets for investment opportunities expect those spreads to remain over time, they would have an incentive to invest to capture those dollars for themselves rather than leaving them in the California pool."

Now, the California Class 1 processors, specifically those located in northern California, are experiencing the impact of such an opportunistic investment. A new plant located in Nevada is purchasing California Overbase milk and hauling it to Nevada. Once it is processed in Nevada, the plant hauls it back into California and sells it to California retailers. I have some explanation of this map in Appendix 1 and 2.

CDFA does not have the authority to regulate any part of this transaction. Nevada is also limited on what it can do about this transaction for the same legal reasons. With milk production growing at the current rate, limited growth in plant capacity, and plants releasing producers, this availability of milk for such a strategy is increasing. What does CDFA need to do to limit this type of cannibalistic investment that cost California dairy farmers? It needs to lower the class prices in California.

Price spread problem. As a free market economist, the California market of late has been very interesting. It is not to say that I think it's a free market. Rather, one can demonstrate the effects regulations can have on markets with real case study. At its core, the problem is a price spread problem. Yes, there is the price spread between federal order in California. Yes, there is the spread between Nevada price and the federal order in California. Excuse me. Yes, there's a spread between Nevada price and the California price.

However, if you really want to understand the spread problem, you need to focus on California prices. The core problem is the widening gap that has developed between the California Class 1 price and the Overbase price. This is the core problem because it is the advantage available to a Class 1 processor who can construct a supply arrangement to circumvent the California regulation.

This has worsened for three reasons: First, California dairymen continue to produce more milk. This is exaggerated by the loss of California Class 1 sales. And the final culprit is the expansion of Class 4a, typically the lowest price, capacity to handle the milk production growth. The Dairy Institute's proposal gets at all three issues. It will lower dairy farmer prices, likely limiting growth. Secondly, it should stall losses of Class 1 sales to out-of-state processors and could allow some California plants to gain some business back. Finally, the lowering of Class 2 and 3 prices could invite companies to expand production capacity.

Price signals to dairy farms. It is never popular to talk about reducing dairy farmer revenue. Farmers do not like commodity prices, specifically cheese, butter, dry whey, or nonfat dry milk to go down. However, there is some point where there is more supply than demand, and the market corrects by moving prices lower. This marketplace has the same problem.

I understand dairy farmer costs go up and down. I understand recently their costs have been at record highs. I further understand that according to the National Agricultural Statistics Service Milk Production Report, milk production in California is up .8 percent. Admittedly, California production in the third quarter is down .6 percent.

With this recent exception, this is a market that has grown milk faster than plant capacity. Someone needs to take leadership in this situation. Just as lower dairy commodity prices signal dairy farmers to decrease production and invite consumers to increase production, so the last thing that we need to do is raise prices to signal more milk production. I understand lowering milk prices is an unpopular action. While not popular, doing so would more clearly reflect the current supply and demand conditions and would demonstrate leadership by the secretary. Such leadership would be committed to balancing supply and demand and protecting the Class 1 markets for California dairy producers.

Class 2 and 3. The proposal by the Dairy Institute relating to lower Class 2 and 3 prices fits with the current surplus supply in California. These are products that can travel greater distances and compete with identical products produced by federally regulated and unregulated plants. These classes contain products that are actually experiencing sales growth. Thus, a lower price to California processors would invite them to produce more of these products. In Dean Foods' world, it leads us to continue to look at plant consolidation, to think about growing California capacity at the expense of capacity in other areas of the country.

In the inverse, an increase in the California raw milk costs would invite the reverse. Admittedly, we would not close a plant based on a temporary increase. Rather, a temporary increase would lead us to look at limiting production and an alternative formulation. There are options to make high quality Class 2 and 3 products with little to no raw milk. Doing so will exacerbate the plant capacity issue in California, again sending the wrong signal.

While not popular, the Secretary should exercise his authority and lead toward plant capacity expansion in California by supporting Dairy Institute's proposal to lower Class 2 and 3 prices.

Counter arguments. At the risk of suggesting the opponents have a point, I would like to clear the air. The use of temporary solutions is getting old to me, personally. It seems, all the dairy industry problems need to be involved temporarily. As opposed to their federal order counterparts, I have to compliment the proponents for actually providing a sunset date for their use of temporary measures. However, to think that a Class 1 processor could use that claim to calm a customer with an uncompetitive price is unrealistic. A price disadvantage for a few months will not allow us to retain business if the alternative is a competitive price going forward.

Said another way, if after "temporary" has expired, the competition was price disadvantaged by regulation, we might keep the business. However, as I have illustrated in Appendix 1 and 2, California processors are already price disadvantaged today, so to worsen that disadvantage and mask it to customers as temporary will not protect business.

Freight is not free. Moving milk in packaged form or bulk form is not exempt from this rule. However, with the surpluses developing in California and dairy farmers finding themselves without markets, freight could be free to a buyer. Dairy farmers could find themselves better off paying freight costs to move milk out of state to a buyer. This buyer would then have an increased raw milk price advantage large enough to pay for freight on more miles than the local California processor to haul milk to the customers and win on price.

To some degree, this is happening today. Thus, to think that raising the price to California plants is offset in distribution freight costs is to think that California processors have such an advantage today that they could afford to give up margin to retain the business. This is simply not true. Again, I would draw the hearing panel's attention to Appendix 1 and 2.

Prices have moved lower in surrounding areas. The federal order prices move lower as a result of the make allowance decision by USDA. Nevada prices -- excuse me. Nevada lowered their prices to respond to local competitive conditions. California is not the only market threatened by the surplus in California. Nevada dairy farmers face the pressure -- excuse me. Let me try that again. Nevada dairy farmers faced the pressure caused by out-of-state purchase opportunities. Their response was to lessen their price, which decreased the attractiveness of out-of-state milk, the same request being made to California by Dairy Institute. However, to suggest that Nevada price was somehow lowered to induce reductions in the California price, as some have inferred, shows no understanding of the competitive pressures that existed in Nevada.

California producers are being hurt. As we have testified before and again today, this attack from unregulated milk is not limited to processors alone. Indeed, California dairymen are being affected also. Unregulated milk coming into the state, in either packaged or raw form, is displacing California Class 1 sales. Further, the California dairymen are being sent the wrong signal by Class 1 prices that are too high. Unsustainable regulated prices will lead California dairymen to make investment to produce milk that is not needed by the market.

Should the market fail to provide enough sales, the dairy farmers who made those investments will ultimately pay the price. While any price decrease will bring pain, it will be much less pain than a dairy farmer's investment to make -- to learn there is no market. Unfortunately, that is the case for some dairy farmers in California today.

In summary, leadership is a challenge. Hard decisions are not always popular decisions. Unfortunately, the Secretary needs to make an unpopular decision to lead California's dairy industry forward. A decision to support the Dairy Institute of California in the correct -- is the correct signal for the industry. This action would signal to dairy farmers that milk supply growth needs to slow. It would slow the attrition of valuable Class 1 sales. It would also invite plants to expand Class 2 and 3 capacity.

Dean Foods believes the action needed is offered in the Dairy Institute's proposal, which we completely endorse and ask the Secretary to adopt.

I have Appendix 1 and 2, and then I would like to highlight a little bit the last three pages. Tom Murray, our vice president, of the Dean Foods West Direct Store Delivery Division prepared testimony and had every intention of being here and offering it in person. However, a business conflict came up that he just could not move, and so he has given me his testimony and I have attached it to my statement.

I am going to skip over Tom's introduction -- it can be read by the hearing panel later -- and it is my intent for this to become part of the record.

So I will just jump down to the third paragraph. As a businessman in California -- again, this is Tom's testimony -- I am sensitive to any regulations that remove my ability to achieve the lowest cost of goods available in the market I serve. The competitive landscape in California is changing and creating unique challenges. For example, today we have competitors that were never a threat, that are now side by side us in our markets. The specific regulations we are discussing today have enabled these competitors to successfully market milk in California. These competitors are coming in from out of state, shipping packaged products across the state line or are in-state, securing lower cost raw milk from outside of California and bringing that milk to their plants to process and package at a lower cost.

We are good operators and given a level playing field will continue to be a viable business. We are currently faced with regulations that place higher costs on our California operations than some of our competition. In an industry that historically operates on very small margins, where operating cost structures are similar from business to business, an advantage on the largest cost component, raw milk, in the hands of unregulated competition presents us with an algorithm that does not work.

This is not a Dean Foods issue. Class 1 plants in California find themselves with excess capacity today. Anytime one of the processing plants loses volume to any competitor, it destabilizes the market and competitive pressures and activity dominoes through the market. This is just business when the playing field is level. However, it is exaggerated by the regulations we follow in this surplus milk limited manufacturing environment, putting us at a disadvantage.

HEARING OFFICER CLEARY: You have two minutes.

MR. KINSER: Thank you.

I am going to skip over the next -- where he outlines some of his regulatory loopholes.

Continuing at the bottom of the page, "We are sitting in a heavily populated area where milk sales are good. Now regulations invite competition to take advantage of opportunistic cost structure. Competition is good as long as there is not a regulated cost disadvantage. Due to the loopholes and sharp operators out-of-state packaged bulk milk is targeted for this market with lower cost.

"With the stage set and the process defined, California Class 1 milk is positioned as uncompetitive and those of us supporting and regulated by the California Class 1 system see this as unsustainable."

California produces -- let me back up just a little bit. He states he has three options: We can buy milk out of state in unregulated areas; we can process and package milk out of state and ship it in; the third is that we rationalize plants and then we're still competitively disadvantaged; or the fourth is to inform and change the regulations.

"Although I have focused on Class 1 products, please know that I have the same concerns with any changes proposed for Class 2 and 3 milk products. A disadvantage in cost of these products impacts us the same and our options would be as identified above, to look for lower cost products outside of California to support our full line of products or cease selling these products. All options exclude utilization of California milk."

Concluding paragraph. "We desire to purchase and process California milk. We desire to stay in business. These two objectives are not consistent with the proposals offered with the exception of the Dairy Institute's proposal. Adopting any proposal other than Dairy Institute's proposal will simply widen the disadvantage gap. I support the adoption of Dairy Institute's proposal."

HEARING OFFICER CLEARY: Thank you, sir.

Questions of the panel?

PANEL MEMBER EASTMAN: Yes, I have a question. It's a magical plant capacity question, so to speak.

In the testimony of Tom Murray, he states that the Class 1 plants in California that ultimately do have more capacity to take more milk, obviously, I guess they just don't have the sales to justify taking that milk. Is that something, in your experience, that you can talk to, sort of confirm?

MR. KINSER: I would agree with that. I mean, to some degree, you can sort of see it if you look at what Class 1 utilization has been in California and you look at the closings. We, from a Dean Foods perspective, we have rationalized some capacity as we've lost sales. But there's still capacity both in our plants and, we believe, in many other plants that if we could get the sales back from out of state, we don't need to add capacity to process that milk. We just need the chance to sell it.

HEARING OFFICER CLEARY: Thank you very much, Mr. Kinser.

Was it your intention to enter into record your documents?

MR. KINSER: Yes, it was.

HEARING OFFICER CLEARY: Okay. What I am going to do, for the sake of identification, is Exhibit No. 60 will be your statement, along with your documents in support of your statistical documents; and then Exhibit No. 61 will be Mr. Murray's letter statement for the record, both of which will be entered in total so that the panel will have the opportunity to review the entire document that you didn't get a chance to read completely through.

(The above-referenced documents were marked as Exhibit Nos. 60 and 61.)

MR. KINSER: Thank you.

HEARING OFFICER CLEARY: And thank you very much for your testimony.

What we'll do right now is it's 15 minutes till 2:00. What I would like to do is come -- reconvene at 2:30 if that's not too tight a timeframe for folks to get something to eat if they choose to. So 2:30, why don't we meet back here again and we'll begin and we'll go back on the record again.

But for right now, we're off the record.

(Lunch break taken in proceedings)

HEARING OFFICER CLEARY: We're going to go on the record at this time.

Good afternoon, ma'am.

MS. STROUP: Good afternoon.

HEARING OFFICER CLEARY: And if you could state your name and spell your last name for the record, please.

MS. STROUP: Patricia Stroup, S-T-R-O-U-P.

(Patricia Stroup was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: And are you testifying today on behalf of an organization or as an individual?

MS. STROUP: On behalf of an organization.

HEARING OFFICER CLEARY: And what would that be?

MS. STROUP: Nestle USA.

HEARING OFFICER CLEARY: All right. You may begin.

MS. STROUP: Hi. I am Patricia Stroup. I am the group manager for Dairy for Nestle Business Services, NBS, and today I am representing Nestle USA. In my role with NBS, I am responsible for milk and dairy ingredients procurement for Nestle brands in the United States and Canada, including Dreyer's, Edy's and Haagen-Dazs brands of ice cream. This includes procurement relationships with individual dairy farms, cooperatives, proprietary handlers, and manufacturers. I developed today's testimony in cooperation with Nestle staff and present it today with authorization from Nestle executive staff.

Then I talk a little bit about who Nestle is, but I will skip that; you can read that at your leisure.

On page 2, I testify today in opposition to the petition presented by the Alliance of Western Milk Producers, Western United Dairymen and the California Dairy Women Association. The petition seeks to impose a surcharge of approximately $1 per hundredweight on Class 1, 2, and 3 milk in California and cites high feed prices as the reason for this surcharge.

We oppose this petition on the following grounds:

Cost of production fluctuations are already reflected in the structure of California's minimum price regulations. Because California's minimum prices are set using an end product pricing formula, fluctuations in profitability are accommodated through reflection of supply and demand in the underlying commodity prices used to set milk class prices. Adding a surcharge to this price creates an unreasonable relationship to the value of the products yielded from such milk. This is why processors did not request a hearing to request relief from historically high milk prices this year -- because those milk prices were in reasonable relationship to the value of the underlying commodities. Now, I would argue there are many other damaging and long-lasting effects of those historically high product prices, but that's beyond the scope of this hearing.

While I would argue that regulated milk prices are not intended to guarantee dairy farm or processor profitability, and that the formulas intrinsically deal with the cost of production issues the petitioners call out and needs no further support, let's explore their argument further. The petitioners cite the milk-feed price ratio as evidence of producer distress. The use of a ratio for this purpose is fundamentally flawed. The milk-feed ratio has historically been used as a measure of farm level profitability when feed prices were relatively constant. Thus, a change in the ratio was a reflection in the change of the milk price, and the ratio was used much like an index. Now that the denominator, the feed price, has changed, the use of a ratio is not relative to past ratios and cannot be used as an index.

For example, let's look at a couple of milk-feed price ratio scenarios. There are inherent difficulties in using the USDA milk-feed price ratio against California milk prices because of timing, but for simplicity's sake and because the petitioners are using these numbers for California pricing, I will do the same. Either way, the point is made.

First is the 1.88 milk-feed price ratio in June 2008, the month cited by the petitioners. Using June's Overbase price of $17.42, the resulting feed price index was $9.27. That leaves us with a basic milk revenue less feed cost margin index of $8.15.

In November of 2003, the milk-feed ratio was 3.05, above the 3.0 that the petitioners cite as favorable.

In November 2003, the California Overbase price was $11.86. This implies a feed price index of $3.89, and leaves us with a basic milk revenue less feed cost margin of $7.97, 18 cents lower than the margin implied this past June by a much lower ratio. So in this case, a "favorable" milk price ratio resulted in a net revenue index lower than the ratio the petitioners cite as causing a "cost-price squeeze." In its simplest terms, the milk-feed ratio of 2.0, for example, provides a whole lot more net revenue when feed prices are high than when they are low, and so this ratio is not a valid methodology for the petitioner's purpose.

In fact, when one uses an alternate method of profitability, such as, for example, Penn State's published "Income Over Feed Costs" -- and I cite the reference you can look up -- it is apparent that while per hundredweight returns over feed costs have indeed fallen from their recent historic highs in the second half of 2007, they are still not below the most recent five-year average and are substantially above where they stood in all of 2006.

Secondly, increases in the cost of milk will encourage production to move out of California. If the

Secretary decided to impose a surcharge on Class 3 milk in California, my recommendation to our production planners would have to be to shift production out of California and into manufacturing lines that we own in our federal order plants. Given the new federal order make allowances implemented by USDA on October 1st, a $1 surcharge would make the regulated price of our California milk considerably more expensive than our federal order milk, at about 85 cents per hundredweight.

Given that, by far the majority of your consumers do not live in California. We could not justify spending more for milk here to ship it to places with less expensive milk. The temporary nature of the increase would not be helpful. Because of the seasonal nature of ice cream consumption, an ice cream manufacturer's year is made or broken in the first half of the year, precisely when the petitioners advocate for a higher price.

Thirdly, increases in the cost of milk will cause even further demand instruction. The petitioners have asked for this surcharge only on Class 1, 2, and 3 milk. I cannot speak for their reasoning on that approach, but historically, price increases targeted at Classes 1, 2, and 3 were done so with the assumption that processors were able to pass those price increases through to consumers with few repercussions. However, it is entirely incorrect to assume that there is not an impact on usage, and, therefore, on cost -- measured in cost per unit, cost in the net price impact to dairy farmers, and cost in competitiveness of the industry on the store shelf.

Dreyer's independently commissioned research on price and demand issues performed and reported in late fall of 2005 indicates that increases in premium packaged ice cream prices of 8 percent across the category resulted in up to a 9.8 percent decrease in sales volume. According to Dreyer's research, when consumers are not buying ice cream, 75 percent of the time they are spending those potential dairy dollars on nondairy dessert items like cookies and cake, with the remaining 25 percent devoted to snack foods. When a consumer is not eating ice cream, he is not drinking a glass of milk instead; he is eating a potato chip. There is not much benefit to dairy farmers in that.

Increases in the cost of Class 3 milk will encourage manufacturing product and nondairy substitutions.

This can be split into two concerns:

First, the delinkage of Class 3 component prices from Class 4a will encourage substitution of Class 4a finished products for Class 3 liquid inputs. We have the technical ability to substitute nonfat dry milk for condensed milk and other sources of butterfat, such as AMF, for cream. While the temporary nature of this price increase may make the petitioners believe that we would not make those substitutions for such a short period of time, the threat of higher Class 3 prices makes us position ourselves for arbitrage opportunities, to use condensed and cream when those prices are advantageous and to use nonfat dry milk or alternate butterfat when those prices are lower.

Given that there are other advantages to using finished products for manufacturing -- like the ability to forward purchase and store those inputs as well as the ability to purchase ingredients from a greater distance, including importing products at a lower cost -- the arbitrage strategy is a valid one.

Secondly, the overall price level of components puts the use of dairy ingredients at risk. In the case of ice cream, butterfat is particularly vulnerable. Around the world, it is commonly accepted that ice cream is made with vegetable fats. In fact, we at Nestle already make ice cream with vegetable oils in many countries including Canada. Realistically speaking, butterfat is already vulnerable because of the periodic disconnect between the CME butter price and real supply and demand fundamentals. A surcharge on butterfat only adds to the risk of nondairy institution.

The impact of nondairy substitution can be extreme. For example, our recent experience in Canada -- the national butterfat requirement for ice cream is approximately 19 million kilograms. Since the introduction of frozen dairy desserts made with vegetable fats in 2007, the industry in Canada estimates a 3 to 4 million kilogram reduction in butterfat requirements for ice cream. That is a 15 to 20 percent reduction in butterfat usage.

Let me be clear that I am not advocating elimination of U.S. ice cream standards. However, I am pointing out that all viable economic options are on the table for companies such as ours to deliver the best value for their consumers and for their shareholders. As much as I support and advocate for the dairy industry, there is nothing sacred about dairy ingredients or even fluid milk. Dairy products and ingredients must be competitive. We know that to the consumer price matters. It is never a good time to raise prices, but with consumer confidence announced this week at its lowest level ever, now would be among the worst times to do so. In the end, the consumer is the one who always gets to make the final decision.

I also support the Dairy Institute alternative proposal. I testify today in support of the Dairy

Institute of California's alternate proposal, which effectively reduces the cost of Class 1, 2, and 3 milk. In our position as a manufacturer of Class 3 products in California, we now see a distinct advantage in shifting processing capacity to one of our non-California plants because of the recent federal order manufacturing allowance decision. Federal order Class 2 milk is now within 15 cents per hundredweight of California Class 3 milk. As we look at which product lines to maximize, our plants outside of California currently have the advantage as the cost of transportation to move frozen product out of California to many of the areas those plants now serve is well in excess of 15 cents per hundredweight.

The Dairy Institute's proposal would bring California Class 3 and federal order Class 2 pricing back more closely to its historical relationship. In fact, to come back to true parity with competitors in federal orders, even further decreases would be warranted, and I am in support of that.

It is a well-known fact that California has been struggling with insufficient plant capacity for more than a year. Many milk marketers and manufacturers, including ourselves, have imposed production limits and/or decreases on their producers because of a lack of California outlets for milk. My staff and I, myself, have received calls from many dairy farmers who cannot find a buyer for their milk for 2009. It would be unfortunate if even more capacity left the state because of more advantageous dairy pricing elsewhere.

Thank you for the opportunity to express the views of Nestle on this matter today. I would be happy to address any questions you may have and request the opportunity to file a post-hearing brief.

HEARING OFFICER CLEARY: Thank you very much.

Question from the panel, please.

PANEL MEMBER EASTMAN: Yes. I have a question.

You mentioned how there's a possibility to substitute ingredients when making, let's say, ice cream. Is that something you are currently doing? Is there people who analyze the different relative prices of the ingredients and you kind of already use those different mixtures and kind of go with what works out the best?

MS. STROUP: We do. I mean, if you look at it from a dairy farmer perspective, it's kind of a least cost ration approach. We look at the ingredients that go into a specific finished product. Of course, there's a lot of different ways to come up with a finished product and essentially it comes down to what the least cost formulation is.

PANEL MEMBER EASTMAN: So that is something you currently do?

MS. STROUP: We do that all the time. In fact, that's one of the main jobs that my staff and department does.

HEARING OFFICER CLEARY: Question, Ms. Gates.

Mr. Ikari?

PANEL MEMBER IKARI: No.

HEARING OFFICER CLEARY: Was it your intention today to have the within testimony, with an exhibit stamp on it, entered into the record?

MS. STROUP: It is.

HEARING OFFICER CLEARY: Then we will enter it into the record as Exhibit No. 62.

(The above-referenced document was marked as Exhibit No. 62.)

MS. STROUP: Thank you.

HEARING OFFICER CLEARY: Next witness would be Jim Gruebele. I got three pronunciations, one in my left ear, right ear. I guess we're going to find out for sure in a second.

Could you please state your name and spell your last name for the record, sir.

MR. GRUEBELE: James Gruebele, G-R-U-E-B-E-L-E.

(James Gruebele was placed under oath by Hearing Officer Cleary.)

HEARING OFFICER CLEARY: You may sit down.

MR. GRUEBELE: Thank you.

HEARING OFFICER CLEARY: Certainly.

And you are testifying today on behalf of an organization or as an individual?

MR. GRUEBELE: Yes. On behalf of an organization, Land O'Lakes.

HEARING OFFICER CLEARY: Wonderful. You may begin, sir.

MR. GRUEBELE: My name is James Gruebele, and I am here to testify on behalf of Land O'Lakes, Incorporated. My business address is 7196 Secret Garden Loop, Roseville, California.

Land O'Lakes is a dairy cooperative with 3100 dairy farmer member-owners. The cooperative has a national membership base whose members are pooled on the California State Program and six different federal orders. Land O'Lakes members own and operate several cheese, butter-powder and value-added plants in the upper Midwest, East, and California. Currently, our 275 California member-owners supply us with over 16 million pounds of milk per day that are processed at our Tulare and Orland plants.

Land O'Lakes supports the current pricing structure for Class 1, 2, and 3 pricing formulas. In essence, the current formulas provide for movements of Class 1, 2, and 3 prices based upon economic supply and demand conditions. The Class 2 and 3 prices are directly tied to the Class 4a pricing formula. Again, when supply and demand conditions result in an increase in butter and powder prices, then the Class 4a prices rise and vice versa. The same then is true for Class 2 and 3 products.

Land O'Lakes believes that the pricing differential between Class 4a and Class 2 and 3 prices is appropriate and does not need to be changed. By the same token, the Class 2 formula is tied to the higher of butter-powder and cheese and whey formulas. This means that Class 1 prices move in direct relation to economic supply and conditions in the industry.

The price differential between the commodity reference price and the Southern California and northern California Class 1 prices are appropriate and do not need to be changed as a result of this hearing.

Figure 14 -- it was in the background information. I just want to turn to that, if you will. That's right after the formal testimony. The words above that chart were part of the background information and are not part of my specific hearing testimony, as far as words are concerned.

Figure 14 in the hearing background information shows that imports of bulk milk increased significantly in 2001 and continue to be at high levels through 2007. The biggest increases stemmed from Arizona. Table 5 of the background material for Class 1, 2, and 3 shows that the average annual price for Class 1 milk was $20.50 in Southern California for January through October 2008. It was $19.92 per hundredweight in northwest Nevada; $19.72 in southern Nevada; $20.22 in western Oregon; $20.42 in southwest Arizona; and $20.67 in central Arizona. If the make allowance changes for the federal orders had been in effect for all of 2008, the federal order prices would have been 31 cents lower per hundredweight than they actually were for most of 2008. The reason that is, is that the last month, which is October, has the same pricing formula that existed in 2007. That's why the 31 cents. It's a little different than the Dairy Institute testified to, and I do agree with Dairy Institute's numbers as far as the 33 cents, what it actually would be with a new federal order make allowance.

Table 6 shows the average prices using the new make allowance for federal orders. For example, had the make allowances been in effect for all of 2008, the average Class 1 price in central Arizona would have been $20.36 and $20.11 per hundredweight in 2008 in southwest Arizona.

The difference between the blend prices in neighboring markets and the California Class 1 price is the factor that provides the incentive to move bulk milk into California from an out-of-state source. I prepared Table 1 that shows the comparison between the California Class 1 prices and the Arizona blend prices. The difference between the Southern California Class 1 prices and the Phoenix blend price averaged $1.01 per hundredweight in 2007, and $2.18 for the first nine months in 2008.

I also have comparisons for the price difference between the Southern California Class 1 price and the Yuma blend prices. In any case, an increase in the Class 1 prices as recommended by the Alliance, et al., would have made these price differences even larger. The change in the federal order class prices, had they been in effect on January 1, 2008, also would have resulted in a larger difference between the Class 1 price in California and the Arizona blend prices. The point is that there is incentive to move milk into California. Increasing the Class 1 price as suggested by the Alliance would simply provide even more incentive for bulk milk to be shipped into California, which means that the Class 1 utilization percentage in the pool would be further depressed.

Land O'Lakes opposes the petitioners' desire to raise the Class 1 price by a dollar per hundredweight. We are concerned that such a change would make the California Class 1 prices not competitive with out-of-state packaged milk. Each month, there is California Overbase milk that is moved into a processing plant in Nevada. This milk comes into California in packaged form and competes with fluid milk operations in California. A dollar increase in the California Class 1 price would simply encourage more California Overbase milk to move into Nevada, only to be processed in Nevada and sold into California retail outlets. The increase in the California Class 1 price would simply increase the difference between the California Class 1 price and the California Overbase price. The share of California's milk utilized for Class 1 purposes has been declining.

Table 2 shows the average difference between the Southern California Class 1 price and the California Overbase price was $2.79 in 2007 and $3.68 per hundredweight for the first eight months of 2008. The table also shows the comparison between northern California Class 1 price and the California Overbase prices.

California producers stand to lose even more of the California Class 1 market if the proposal by the Alliance of Western Milk Producers, Western United

Dairymen and California Women is adopted.

Considering the out-of-state competition, an increase in the Class 1 prices for California does not make such sense, and Land O'Lakes is opposed to it.

We are opposed to the proposal by the Milk Producers Council. Their basic tenet is that the consumers should bear the cost of the transportation allowance and credit programs in California, at least in part. Again, any increase in the California class prices would simply increase the competition from out-of-state milk.

Furthermore it's difficult to argue for increases in the California milk prices because of the supply and demand conditions in California. There's a lack of manufacturing capacity in California. Some producers are about to lose a market for their milk. It doesn't make economic sense to increase the California class prices when some producers cannot find a home for their milk. Additionally, it doesn't make sense to increase the overall price for milk when some milk during 2008, at least earlier in the year, was not being picked up or shipped out of state or both. The fundamentals of supply and demand in California do not support any increase in Class 1 prices. There was more than an abundant supply of milk in California during 2008.

Furthermore, the current transportation credit and allowance programs were put in place to minimize the costs to California producers. Under the old system, area differentials were used to encourage plant-to-plant movements of milk.

The law of comparative advantage and the law of economics would suggest that commodity prices would be the lowest in the surplus areas of production. That is why corn prices are the lowest in the Corn Belt and higher in other areas. The prices are higher in other areas because of the freight costs involved in moving grain from surplus producing areas to deficit markets.

The same logic applies to milk. In California, area differentials were used to move milk on a plant-to-plant basis from areas of surplus to the deficit market at one time. But the area differential approach was essentially replaced by the transportation credit system to encourage plant-to-plant milk movements of milk into deficit markets. The industry was united in that effort to move California from the area differential to a transportation credit system because the current program is more efficient and is less costly to producers. The reason is that under the current system, the producers would be obligated to defray the cost for only the milk that moved plant to plant from areas of surplus to deficit markets.

The situation was similar for milk moved from producer ranch to Class 1 markets. Under the old system, quota differentials were utilized to cover the freight costs in moving milk from producer ranch to Class 1 markets. Again, the current transportation allowance system was more efficient and less costly to producers. The transportation allowance is large enough to compensate producers for the difference between the local haul rates to manufacturing facilities and the long distance haul rates for moving the milk from surplus -- from areas of surplus to Class 1 markets in deficit markets.

LOL opposes the Dairy Institute proposal to decrease class prices by $1.35 per hundredweight and also decrease Class 2 and 3 prices in California by a smaller amount.

Our producers are concerned about any further class price reductions in California as a result of this hearing. Producer costs of production have increased significantly this year. The current Class 1 prices are in reasonable relationship with Class 1 prices in neighborhood markets.

Conclusion: Land O'Lakes sees little justification to change the Class 1, 2, and 3 pricing formulas. The petitioners want to raise Class 1 prices, and if that results in an increase in the California quota and Overbase price, such a policy would tend to exacerbate the milk capacity problem in California. During the past year, some milk was not picked up or shipped out of state because of a lack of manufacturing capacity in California. And now it looks as if there are some producers that will be losing their market and up to this point, they apparently are still looking for a new home.

Some California grade A producers are paid less than the minimum prices in California. The proposal by the Alliance of Western Milk Producers would tend to encourage further increases in milk output and increase the milk capacity problem.

Land O'Lakes understands that CDFA strives to ensure the integrity of the pooling program by keeping California's milk in-state, to be used by California consumers. However, California is not an island onto itself. Economics determine where milk will flow, and the current market environment reflects those relationships. Any policy change that results in increased California classified prices will only increase incentives to move milk into the state and further exacerbate the state's precarious balance between supply and demand.

To repeat what's been stated before, Land O'Lakes is dependently concerned about inadequate manufacturing capacity in the state. We do not need to expand this problem even further by raising milk prices in California. This concludes my testimony. I would like the opportunity to file a post-hearing brief.

Thank you.

HEARING OFFICER CLEARY: Thank you very much, sir.

Questions of the panel?

PANEL MEMBER EASTMAN: Just one question. So at this point, it appears that you just -- you feel that the status quo would be the best way moving forward, at least for right now, then?

MR. GRUEBELE: That's what the board says, yes.

PANEL MEMBER EASTMAN: And you are here to express the desire of the board?

MR. GRUEBELE: Of course, yes.

HEARING OFFICER CLEARY: Any questions?

Thank you very much. Was it your intention to have this entered into the record today?

MR. GRUEBELE: Certainly.

HEARING OFFICER CLEARY: We'll enter the statements as Exhibit 63 into the record from Land O'Lakes.

(The above-referenced document was marked as Exhibit No. 63.)

HEARING OFFICER CLEARY: Thank you, sir.

I have one last witness for today, Mike McCully.

Good afternoon, sir.

MR. McCULLY: Good afternoon.

HEARING OFFICER CLEARY: I would like to get everybody's attention, please. Don't let me name names now. Thank you.

State your name and spell your last name for the record, please.

MR. McCULLY: My last name is McCully, M-C-C-U-L-L-Y.

HEARING OFFICER CLEARY: Thank you very much.

(Michael McCully was placed under oath by Hearing Officer Cleary.)

MR. McCULLY: Yes, I do.

HEARING OFFICER CLEARY: And are you testifying today as an individual or on behalf of an organization?

MR. McCULLY: On behalf of an organization, Kraft Foods.

HEARING OFFICER CLEARY: Wonderful. You may begin, sir.

MR. McCULLY: Thank you.

Mr. Hearing Officer and members of the hearing panel, my name is Mike McCully. I am director of Dairy Procurement at Kraft Foods in Glenview, Illinois, with responsibilities for dairy market analysis, price forecasting, risk management, and dairy policy.

Kraft owns a multi-product dairy plant in Tulare, California. This plant produces parmesan and other Italian cheeses, dry whey powder, and, most relevant to this hearing, Knudsen cottage cheese and sour cream products.

Kraft opposes both the petition from the Alliance of Western Milk Producers, et al., and the Milk Producers Council Alternative proposal.

As a member of the Dairy Institute of California, we support their alternate proposal.

There are several tenets of a regulated pricing system that are not being met in California. First, a regulated pricing system is intended to create orderly marketing conditions. When milk is regularly being transported out of the state due to inadequate processing capacity in California or is being dumped on the farm, it is clear, orderly marketing conditions do not exist. Another tenet is that the system establishes a regulated price which allows the market to clear. Milk production in California continues to grow while in-state processing capacity has not kept up with this growth.

Within the past year, the major cooperatives in California have put production caps in place in an effort to stop milk supply growth. Given the current conditions in California, changes need to be made to the regulated pricing system in order for the California dairy industry to continue to grow.

Milk supplies. Despite production limits put in place by the major cooperatives, California milk production continues to grow, albeit slower than historical rates. January through September milk production is up 1.5 percent versus 2007, with third quarter down .7 percent and September, up .8 percent. It appears weather and cut backs in rations have negatively impacted milk per cow, which is down .4 percent year to date, but has been offset by continued growth in cow numbers, which were up 1 percent versus a year ago in September.

Even if milk production is flat to down slightly in 2009, it seems the state will continue to have problems handling the milk, as no new processing capacity has come online.

Input costs. There is no doubt input costs have risen dramatically over the past several years for farmers, processors, and consumers alike. However, events over the past one to two months have altered the macroeconomic situation dramatically. Per CDFA's analysis, both corn and soybean meal prices have declined about 35 percent from early July to late October. While the future is more uncertain than normal right now, projections are for grain prices to stabilize near current levels. Energy prices are a greater unknown, but with a global economic slowdown, it is likely safe to say energy prices won't return to the levels seen earlier this year, anytime soon.

Therefore, the main issue for the call of this hearing has largely been mitigated. I realize milk prices have declined and margins have been reduced, but I would caution using the milk-feed ratio as a guide to farm margins. Historically, that was a general measure of farm profitability. However, the elevated price levels have made that calculation irrelevant, and one should use a gross margin calculation instead. One common measure is the income-over-feed cost calculation that more accurately shows the level of profitability on the farm. For the most accurate data, CDFA has production costs for the state.

Rising input costs are not unique to the California industry. Indeed, all dairy farmers across the U.S. have felt the impact of higher input prices, but the impacts vary regionally. In the West, feed is purchased so farmers see those price increases directly. However, farms in the Midwest and East that grow their own crops have not seen the dramatic feed cost increases.

Therefore, opposite of past trends, production and profitability in these areas has increased in relation to the West.

There is also a point to be made here about the importance of hedging input costs as well as milk prices. While farmers have regularly booked feed in advance, the large majority of farmers have chosen to speculate on their milk price. As long as California's cost of production stayed low, the milk price was usually above it so farmers profited. However, as California's cost of production has moved into the mid-teens, there is risk milk prices could fall below, possibly far below, the break-even level. The solution to this problem is not raising the regulated price. Instead, a solution is the development and use of hedging tools for dairymen.

A number of us talked ten years ago about the importance of risk management tools such as forward-contracting. Farmers should ask their cooperatives why they are not offering the opportunity to better manage their milk price income by hedging with forward contracts, futures, options, and other tools.

I've attached a graph from National Milk Producers Federation -- that's on the top of the next page -- that shows Class 3 milk futures prices on selected dates this year. On June 12, milk futures were above $20 per hundredweight every month through 2009. They gradually fell in August and September and now range from $14 to mid-$15 range through 2009. That decline of over $5 a hundredweight, or 25 percent, could have been hedged with futures or forward contracts.

Other risk management tools are also being developed. One new interesting concept is a margin contract which allows a farmer to essentially set the margin between input costs and the milk price. On the bottom line, this is what really counts. We need to spend more time working to develop these tools.

Rising input costs are not just unique to the dairy industry either. The beef, pork, turkey, and chicken segments of livestock industry are all dealing with high input costs. However, how they deal with it is very different than what we are talking about today. Instead of arbitrarily increasing a regulated price, they are cutting back on production or taking other steps to cut costs. Their solutions are market based and not reliant on action by the government.

It should also be noted that when a market is oversupplied, as some segments of the dairy market appear to be, sometimes lower and even negative margins at the farm are necessary to bring supply and demand into balance. Once supply is reduced, milk prices and dairy farm revenue will increase. If policymakers step in to provide revenue for dairymen every time costs increase, or every time there is a potential for negative returns, the market would be chronically oversupplied and milk prices would remain low.

Competitive situation for cottage cheese and sour cream. While most of the focus of this hearing will likely be on Class 1 milk, I wanted to talk about Class 2 products, specifically cottage cheese and sour cream. The Knudsen brand is a long-time California brand, dating back to 1919, with a reputation for quality products. The Knudsen products are made exclusively in California with 100 percent of the milk being produced by California dairy farms. In fact, our current advertising campaign for Knudsen, called Knudsen -- Purely California, features the "California Real Milk" seal and describes the long tradition of producing great quality products here in California.

And I have attached two advertisements -- it's the double-sided copy at the back of the testimony here -- just to give you an idea of what we're working on. This is actually new marketing that's just coming out here in the fourth quarter. Next year is the 90th anniversary of the Knudsen brand here in California, so we're really playing up on the heritage of the brand and the products as well as some of the history and the long tradition of using a California product, so you see -- or California milk. So you see the "Real California Milk" seal, and the tag line is "Purely California."

While the Knudsen brand has a significant presence in California, the products are also distributed throughout the West and Southwest. Once outside California, those products compete with companies that operate in federal orders and whose costs are determined by federal order Class 2 prices.

The competitiveness of California manufacturers would be negatively impacted by the price increases proposed by the Alliance. Since California manufacturers compete both within the state and out of state with companies based outside California, an action by the Department to increase raw product costs for California manufacturers would put them at a competitive disadvantage in relation to an out-of-state manufacturer.

For example, a major out-of-state competitor in cottage cheese and sour cream products is Daisy brand based in Dallas, Texas. Daisy has been gaining market share both nationally and in California over the past several years. If the price increase in California Class 2 prices advocated by the Alliance, et al., would occur, there's a high probability the price of

California-produced products would increase in relation to Daisy's prices. How does an action that would decrease demand for California milk, while increasing demand for out-of-state milk, benefit California dairy producers? Obviously it doesn't, and the Alliance proposal should be rejected for this reason alone.

We believe that Knudsen products are high quality and very competitive in the market place. However, an arbitrary action to increase our raw product costs would not only hurt our competitiveness in California but also in other areas outside California, where Knudsen products are sold. Given recent changes to the federal order formulas, federal order prices have declined. In order to keep the average price relationship with surrounding states that existed prior to the recent federal order changes, the Department should adopt the Dairy Institute proposal.

As milk prices moved to record highs over the past two years, retail prices for dairy products increased and sales declined. Using Nielsen 3-outlet data, 2007 sales of cottage cheese declined 4 percent in the United States, down 5 percent in California; and sour cream sales declined 1 percent in the U.S. while being flat in California.

In 2008, as more price increases were passed on to consumers, cottage cheese sales are projected to climb 8 percent in the U.S. and 11 percent in California. Sour cream sales are projected to develop 10 percent in the U.S. and 9 percent in California.

It should be obvious further price increases advocated by the Alliance et al., will only result in lower cottage cheese and sour cream sales. That milk then ends up most likely in a butter-powder plant, further depressing producer prices. Quite simply, increasing the regulated price level hurts demand, and that is not in the best interest of the dairy industry.

Time for a change. While the regulated pricing system in California served the industry well for years, it is becoming more apparent it is time for a change. Regulating pricing systems in California and the federal orders were established many years ago with vastly different market dynamics than exist today. The dairy markets have evolved from local to regional to national to global in nature.

Dairy farmers, through the California Milk Advisory Board, commissioned a study by McKinsey and Company on the future of the California dairy industry. I strongly believe the industry would be better served focusing on long-term solutions rather than attending hearings for short-term fixes. We should use that study as a basis for developing a regulatory system that best serves the needs of today's dairy industry. I believe the U.S. dairy industry has the potential to fill the growing world demand for dairy products. With 95 percent of the world's consumers outside the U.S., the potential market is enormous.

Unfortunately, outdated regulated systems are holding back the U.S. dairy industry from realizing the full potential of this opportunity. Other countries will eventually grab it if we don't. The time for a change is now. Kraft has long believed in transitioning to a less restrictive regulatory environment and feels the U.S. dairy industry would benefit greatly from this change. The industry needs to work together to develop a long-term policy approach for the California dairy industry.

Summary. In summary, I would like to ask the Department to reject the proposals from the Alliance and Milk Producers Council. Furthermore, I encourage the Department to adopt the alternate proposal from Dairy Institute as its proposed changes are necessary to protect California's markets and competitive position.

I thank you for the opportunity to testify here today, and would like to file a post-hearing brief if necessary. I welcome any questions at this time.

HEARING OFFICER CLEARY: Thank you very much.

Questions from the panel? Mr. Ikari?

PANEL MEMBER IKARI: There hasn't been much testimony on Class 2, 3 products coming in from out of state, and you talked about this Daisy brand.

Do you have any kind of information -- if you can file a post-hearing brief -- on how much product that may be in the California market that's coming in from out of state?

MR. McCULLY: Sure. I have market shares for Daisy, and there's a couple other companies I can get as well. We have it broken down. Actually, I was able to get our Nielsen people to run a report for me that shows market shares here in the state for cottage cheese and sour cream segments. So I can submit that in a post-hearing brief.

PANEL MEMBER IKARI: Do you have an idea or have you done an analysis on what it costs them to ship it from -- I assume that by your testimony, that they are shipping it from Dallas to California?

MR. McCULLY: From what I can tell -- I'm not really familiar with Daisy. They are not terribly public on what they do. But what it says on their Web site, the majority of their milk comes from Texas and New Mexico, and I'm going to assume west Texas. I think they are opening a new plant or something to do in Arizona.

So I'm not sure exactly where the product is coming from, so I'm going to assume west Texas, New Mexico, and that's where their milk supply is. As far as -- you're asking about the cost to get it here?

PANEL MEMBER IKARI: Yeah. Their shipping and hauling costs.

MR. McCULLY: We could probably come up with an estimate for them. There's others that are closer. I think there's some Arizona companies, like maybe were mentioned earlier that are shipping into the state as well, like Shamrock.

PANEL MEMBER IKARI: Well, that would be helpful to know approximately what the hauling costs to ship the product into California is.

MR. McCULLY: Okay.

HEARING OFFICER CLEARY: Any other questions?

Thank you very much, sir.

Was it your intention today to have your written testimony entered into the record?

MR. McCULLY: Yes, please.

HEARING OFFICER CLEARY: We'll enter it in as Exhibit No. 64, and I thank you very much for testifying today.

(The above-referenced document was marked as Exhibit No. 64.)

MR. McCULLY: Thank you.

HEARING OFFICER CLEARY: Is there anyone else who wishes to testify today?

Yes, sir. Would you like to approach the table. Could you please state your name again and spell your last.

MR. KINSER: Evan Kinser, K-I-N-S-E-R.

HEARING OFFICER CLEARY: Okay. You are still sworn and under oath at this time. And if you would like to proceed, please do so.

MR. KINSER: Thank you. I appreciate again the hearing panel being flexible, allowing me to come back. Since last time, I went through my testimony and also highlighted pieces from Mr. Murray's testimony. The one thing I wanted to do that I really didn't have time to do was just to walk the hearing panel through what's contained in Appendix 1 and 2. And I will stick with that as far as this additional testimony.

What Appendix 1 and 2 is, and it's basically the same thing. Appendix 1 looks at raw milk originating in Tracy, California, and being hauled to Yerington, Nevada, and so that's 285 miles at a rate of $1.80 a mile, and assuming there would be 5800 gallons on that load, so that would cost 8.84 cents a gallon.

And the next line is looking at packaged milk coming in from Yerington, back to Sacramento, traveling 215 miles at a rate of $1.75 per mile. Having 4800 gallons on that load would then cost 7.84 cents.

And then deducting out of that the fact that if the retailer is getting service from Sacramento, there's some cost of moving the packaged product from a local plant to that store, and so figuring 50 miles for that and a rate of $2.26, and then having 4320 gallons on that load, then basically the local haul is costing $.0262. So that's already being paid for in the system. So that's net out of it such that the roundtrip of raw milk to Yerington back into California would increase distribution costs of 14.07 cents per gallon, or $1.64 a hundredweight.

That is then applied kind of historically at the difference between the California price and the Overbase price, making the assumption that the California processor serving that Sacramento retailer is paying the California price into the pool, versus the Yerington facility is able to buy a California Overbase. So that's the spread contained in the first column.

So if you look at the 14-year average of 2008 to 1995, the advantage is $2.70, and now I'm bringing down the $1.64 increased freight costs of hauling the milk out and back in. And so then you can see the competitive advantage in a per hundredweight per gallon. And so looking at the 14 years, it would be a 9-cent per gallon advantage, even after paying the additional freight of back out and back in. So when you look at the Dairy Institute proposal and $1.35 decrease in the Class 1 price, even looking in 2008, there's still money on the table for this transaction to happen and be favorable.

But if you look at it over time, most years, that would not be a favorable transaction. Clearly, freight rates move around regularly, and one could make an argument that some of my freight rates are low. We believe that these are basically backhaul-type freight rates that the instance of package, it's being contract carriers that basically once they get the truck loaded, they just have to get it from point A to point B, and then they will find another haul and continue to move their truck around efficiently, so there's very good rates available. And then on the milk moving raw standpoint, that that truck was headed back towards Yerington, anyway, and so they can get a more competitive rate than what most dairy farmers would get, when you think about ranch-to-plant movements.

The other thing this does not acknowledge would be any local haul that the farm would be used to paying, anyway, so this assumes, basically, the local farm would have no haul and assumes that the processing cost in

Yerington and the processing costs in California are equal.

When you look at Appendix 2, it's exactly the same. The only difference is the location of the packaged milk sale. And so in Appendix 2, this illustration is moving the milk from Yerington to San Francisco, and so that's the only modification. And so in that instance, because you are hauling it now more miles, the cost of distribution goes up to 17 cents and $2. So again, still a competitive advantage, only now it's decreased to 6 cents a gallon. And again, thinking about the Dairy Institute's proposal, there's still money on the table when you look at 2008.

That was what I wanted to further expand on.

I don't know if there would be any questions.

HEARING OFFICER CLEARY: We'll find out.

Any questions of the panel?

PANEL MEMBER EASTMAN: So you mentioned that the haul rates, you mentioned they are kind of based on backhaul, but where did the actual numbers come from, though?

MR. KINSER: The $1.80, I actually talked to a company and asked them to quote that for me and I used that. But I also compared it to other instances where we're paying to move milk today, and it aligned very similarly. So I believe that it is competitive.

HEARING OFFICER CLEARY: Anything else?

PANEL MEMBER IKARI: Is the haul more a function of -- or how directly is that haul rate a function of the gas or diesel price? Or is it more a function of whether or not -- the supply-demand situation for those trucks?

MR. KINSER: It's going to be both. So --

PANEL MEMBER IKARI: So if it's both, approximately what was the diesel rate when you calculated this?

MR. KINSER: Actually, all of this would be calculated off of pretty current -- I believe I can clarify on post-hearing brief, but I believe basically a $3.50 diesel price.

PANEL MEMBER IKARI: Okay. So as diesel prices come down, that cost could come down then?

MR. KINSER: Yes.

PANEL MEMBER IKARI: Can I ask one other question? So walk me through -- when you say it leaves money on the table, let's go through the calculation. Let's just take 2008 for your Appendix 1.

MR. KINSER: Okay.

PANEL MEMBER IKARI: And that number is $3.86. So walk me through your calculation.

MR. KINSER: Do you want me to walk you how I got to the $3.86 or we can --

PANEL MEMBER IKARI: No.

MR. KINSER: Okay. We're going to start with, they have a $3.86 advantage, and then the milk is going to have to move -- in order to get Overbase price, in order to have that advantage, it's going to have to move from a California farm to an out-of-state plant and then back to a California customer. So that is the first line. The start in Tracy travel to Yerington is the raw milk moving out to Yerington.

Then the second line is getting it in packaged form and bringing it back to Sacramento, so that's the 7 cents. So it's an increased distribution cost there of about 15 cents. I think that overstates it, because the current sales price includes some local distribution costs. So then I'm basically subtracting out the already existing distribution costs, about two -- a little over two and a half cents so that the net increase is 14.07 cents, or $1.64. So that means that when you take it, they have a $3.86 advantage on milk. They are going to have to pay $1.64 in order to make that transaction work. So that lowers their advantage down to the $2.23.

PANEL MEMBER IKARI: Okay.

HEARING OFFICER CLEARY: Any other questions of the panel?

Thank you, sir. You are dismissed.

MR. KINSER: Thank you.

HEARING OFFICER CLEARY: Anyone else wishing to testify today?

If not, I'm going to recess for today. We will reconvene tomorrow morning at 10 o'clock to continue the hearing.

And I thank you all very much for being collegial, for being respectful of everyone's testimony. And I wouldn't have expected anything else from a group such as you. Thank you very much.

MR. ERBA: Post-hearing brief date?

HEARING OFFICER CLEARY: That will be announced tomorrow at the conclusion of the hearing when we close the record.

MR. VAN DAM: Do you know of anybody testifying tomorrow?

HEARING OFFICER CLEARY: I have no idea.

MR. VAN DAM: Most likely not?

HEARING OFFICER CLEARY: We don't know of any as of yet. But the request was to leave the hearing open for two days, so that's what we're going to do.

MR. KINSER: Since I was adding to my testimony, it's possible, I don't remember whether I actually read, but my statement did contain a request for a post-hearing brief, so I just wanted to officially request the opportunity to file a post-hearing brief.

HEARING OFFICER CLEARY: That's fine. You just caught me right before I went off the record. So you are safe.

MR. KINSER: Thank you.

HEARING OFFICER CLEARY: Not a problem.

All right. With that, we'll close the record at this time.

(The Department of Food and Agriculture, Market Milk Hearing, adjourned at 3:32 p.m.)

CERTIFICATE OF REPORTER

I, KATHRYN S. SWANK, a Certified Shorthand Reporter of the State of California, do hereby certify:

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

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

IN WITNESS WHEREOF, I have hereunto set my hand this 6th day of November, 2008.

KATHRYN S. SWANK, CSR, RPR
Certified Shorthand Reporter
License No. 13061