MILK PRODUCERS COUNCIL

"Serving the Dairy Industry for More Than 60 Years"

November 12, 2009

Ms. Dee Anne Holloway, Hearing Officer
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814

Re: Post-hearing brief for Geoffrey Vanden Heuvel, Milk Producers Council

Dear Hearing Officer and Members of the Panel,

Milk Producers Council appreciates the opportunity to submit a post-hearing brief to expand on our testimony presented at the November 9, 2009 hearing.

"Emergency hearing"

MPC certainly appreciates the efforts put forth by the Department to move the hearing process as quickly as possible. However, there were several witnesses at the hearing that used the "emergency" status of this hearing as a reason to reject permanent proposals. For instance, in the Dairy Institute testimony, Mr. Schiek stated, "To our knowledge, permanent changes to the formulas have never been implemented as a result of an emergency hearing. The Department should continue with its past practice in this regard."

However, the Food and Agricultural Code that outlines the CDFA hearing process includes no special set of rules for an "emergency" hearing. In fact, CDFA's own notice of this hearing clearly stated that, "The hearing will also consider any other temporary ***or permanent*** changes to the Class 1, 2, 3, 4a, and 4b pricing formulas to address emergency conditions that are raised by alternative proposals received in the time and format specified below" *(bold and italics added for emphasis)*.

Further, the issues proposed by MPC for this hearing are in no way new issues. The valuations of both nonfat dry milk and dry whey in our classified pricing formulas have been brought up in previous hearings and in other industry gatherings. To ignore the valid arguments raised by MPC testimony simply because of the implied "emergency" status of this hearing is not only unfair but is completely without basis in the Food and Agricultural Code.

California Weighted Average Price vs. National Agricultural Statistics Service

MPC proposed replacing the California Weighted Average Price (CWAP) with the National Agricultural Statistics Service (NASS) price survey in establishing a value for the solids-not-fat portion of the class 4a price, as well as in the class 1 price. In our

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testimony, MPC laid out the arguments for why it is imperative to address this change immediately.

Our testimony stated that, "the vast majority (in excess of 95%) of the powder that makes up the CWAP comes from two cooperatives that jointly market their powder through a single marketing agency in common." Those two cooperatives are California Dairies, Inc. and Land O'Lakes, both of whom had representatives testifying at the November 9th hearing. MPC would like to highlight one of the specific sentences included in the testimony of Tom Wegner, Director of Economics and Dairy Policy for Land O'Lakes. In his testimony, Mr. Wegner states, "We fully understand that currently California's dairymen are being treated unfairly by utilizing the CWAP price series that typically runs several cents below the NASS weekly averages."

Mr. Wegner's testimony goes on to attempt to justify why Land O'Lakes believes it is acceptable to continue treating California's dairymen unfairly. But these comments simply strengthen the points made in MPC's testimony as to the role CDFA must play in fixing this inequity. When one of California's largest powder makers recognizes in a public hearing that California producers are being treated unfairly, yet that same organization is content to maintain the status quo and take no position on a proposed change that would close that inequity, it is clear that the industry needs CDFA to enforce the law. To wait for industry consensus on this issue is futile. As MPC explained at length in our testimony, our state's powder makers are insulated from price risk in the CWAP, and will fight tooth-and-nail against a move to the NASS.

Our proposal to use the NASS price series for nonfat dry milk instead of the CWAP was based on the unreliability of the CWAP, on what its use cost California producers in 2007 and 2008, and because the likelihood of additional continued losses is almost certain. The likelihood of millions of dollars of additional losses resulting from continuing to use the CWAP price series instead of NASS price series is what makes this proposal urgent and timely.

The background we provided in our testimony illustrated the fact that while most segments of the California dairy industry must compete for business with other California plants as well as with plants outside the state, California plants that manufacture nonfat dry milk, in effect, have no competition whatsoever. California plants that manufacture and sell an estimated 95% of all nonfat powder in the state are members of a single marketing federation. Because of its share of market, the federation's sales determine the basis for what ultimately becomes the cost for the milk that is used to produce their products. Their costs and their prices are almost completely conjoined.

MPC presented evidence that the difference between the NASS prices and the CWAP prices in 2007, said to have resulted from the CWAP's acceptance of fixed-priced long-term contracted sales when prices were rising, resulted in a loss of more than $200 million dollars of income to California producers in a 9 month period that ended in August 2007. That difference between the two sales price series represented the marketing federation's domination of the state's sales of nonfat powder. An additional estimated $200 million of income was lost in 2008 when the CWAP prices failed to reliably reflect prices received from its fixed-priced long-term contracted sales as prices receded. We sought, but failed to receive from the marketing federation, a rational explanation of why the reporting of lagging sales at lower prices affected the CWAP levels in 2007 while their reporting of lagging sales at higher prices did not affect CWAP levels in 2008.

USDA's opinion on the NASS and the CWAP

The sales volume in the NASS reports for the first 9 months this year totaled 78.4% of U.S. nonfat dry milk production during that period. MPC realizes that a comparison of shipments/sales during a

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given period to production during the period is not the most precise comparison to make; we used it only because CDFA used it in comparing CWAP volume for the first 9 months this year to California production for the same period. The 21.6% of production that was not reported to NASS was made up of sales by plants that were exempt from reporting because of the low output, sales of products that were excluded from reporting because their values were not reflective of commodity-grade powder, sales supported with DEIP subsidies, and sales whose prices were set and not adjusted more than 30-days from the time the shipments occurred. A portion of the latter category are sales by the California marketing federation which are included in the CWAP averages. Clearly, the NASS price series is the most representative of nonfat dry milk sales for the entire nation.

The issue of whether sales reflecting non-current market conditions should be used to determine milk prices was thoroughly reviewed by USDA's Agricultural Marketing Service (AMS) in 2007. AMS received comments from producers, manufacturers, and major buyers from throughout the U.S. That hearing began before CDFA held its hearing to consider the same issue and finished well after CDFA announced its decision. AMS took notice of CDFA's position and the arguments that were presented in their hearing that supported CDFA's position – and found them to be completely without merit.

<u>Potential for California's milk price to be significantly out of line with Federal Order areas</u>

One of the processor witnesses at the hearing, Ms. Patricia Stroup from Nestle USA, noted in her testimony that, "Nothing has changed in the relationship between dairy commodity prices, Federal Order and California Class prices." While Ms. Stroup's sentence was specifically referencing the alignment between California's class 3 price and the Federal Order Class II price, it highlights a very important part of MPC's testimony.

With the way California's class 4a and 4b formulas are structured, our state's producers are vulnerable to extreme misalignment with the Federal Order areas. Our testimony includes considerable discussion of the vulnerability of the CWAP, and MPC would like to expand on that and demonstrate the vulnerability we have in the role that whey solids play in our class 4b formula.

The Federal Milk Marketing Orders continue to utilize a variable dry whey factor in their Class III formula. Their formula is driven by the NASS dry whey price and includes a make allowance of $0.1991 per pound and a yield of 5.9 pounds per hundredweight of raw milk. The chart below compares the current California dry whey value in the class 4b formula with the Federal Order formula, as well as the formula proposed at this hearing by MPC.

NASS Dry Whey	Class 4b Factor	FMMO Class III Factor	MPC's Proposal
$0.25	$0.25	$0.31	$0.25
$0.30	$0.25	$0.61	$0.25
$0.35	$0.25	$0.92	$0.25
$0.40	$0.25	$1.22	$0.40
$0.50	$0.25	$1.83	$0.69
$0.60	$0.25	$2.44	$0.98
$0.70	$0.25	$3.04	$1.27
$0.80	$0.25	$3.65	$1.56

As you can see from the chart, California producers **are in danger of falling significantly out of alignment with producers that operate in Federal Order areas**. Even at the current dry whey value – $0.3402 according to the most recent NASS report – there is a gap of $0.61 per hundredweight between the $0.86 per hundredweight value that dry whey is adding to the Federal Order Class III price versus the fixed $0.25 value that is added to the California class 4b price. As the dry whey market continues to strengthen, that gap will continue to grow.

MPC put forth what we believe to be a very generous alternative. Under our proposal, producers share a significant share of the value as dry whey prices move up. However, it was clear from the testimony on November 9, 2009 that the California cheese makers are unified in their unwillingness to compromise. This is not an area where CDFA can expect a unified industry position. Cheese makers are in a comfortable position of having zero price risk as the dry whey market strengthens, and feel no motivation to work on a reasonable sharing of the dry whey revenues. It is up to the Department to enforce the law, as outlined in the Food and Agricultural Code, which dictates that, *"If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products."*

MPC made a plea to California's cheese makers in our testimony to work with producers on a compromise. We stated clearly that the proposal offered by MPC was a generous proposal that the cheese makers should take. While none of the cheese makers showed a willingness to compromise, **it is our hope that the Secretary will recognize the validity of our arguments and strongly consider an adjust to our formula that would product a severely weakened producer sector from being deprived of legitimate market-based revenue**.

More comments on the impact of the Alliance of Western Milk Producers' proposal

Questions were asked of various witnesses in the hearing about potential effects on sales of an increase of $.20 to $.50 per cwt of milk. MPC would like to respond to this concern. Common sense tells us the likely effect on sales of a temporary increase of about a half-cent on a half-pint of yogurt or a half-gallon of ice cream simply would be too small to calculate. As to fluid milk, a review of CDFA's Dairy Information Bulletins (DIB) for the years 2006 through 2009 tells us that AC Nielsen Scantrack data found that changes, up and down, in class 1 prices have been passed through to consumers on a regular and timely basis, in full. The DIBs also show that the daily consumption of fluid milk in California for the latest three months (July-September) of the four year period has increased, even in the recession years of 2008 and 2009. Over that period, class 1 prices went from an average of $12.61 per cwt in 2006, to $23.37 per cwt in 2007, to $20.78 per cwt in 2008, and back to $12.54 per cwt this year. Milk is truly one of nature's great products, and consumers show their confidence in it by sticking with it even as the prices they pay for it do not make sense to them or to any of us.

NASS Reports Are Subject to AMS Audits

To obtain an answer to the question that was asked by a member of the hearing panel about auditing procedures used to verify weekly sales reports to NASS, we contacted AMS representatives in Washington D.C., federal order administrators, and NASS state field office technicians. According to Gary Jablonski with the Seattle Milk Marketing Administrator's office, audits are conducted by the regional market administrator's office nearest where the plants are located.

We also reviewed the report issued by USDA's Office of Inspector General (OIG), dated February 14, 2008, which includes NASS' response to OIG's recommendations for improvement in the procedures for reviewing weekly sales reports. The improvements made by NASS to internal controls in their review and auditing procedures include the following: NASS developed improved means to analyze weekly sales reports using updated charts and the sharing of information among state field offices; NASS obtains annual confirmation from reporters of their detailed understanding of what is to be reported; annual validation worksheets are prepared; the sales reports are mandatory and reporters are required to make available to AMS "original contracts, agreements, receipts, and other records associated with the sale" of nonfat dry milk and other specified dairy products. The auditing authority given to AMS and the directions given to NASS field offices to share and compare information is especially important for California because it enables interstate transactions to be thoroughly investigated, something that is beyond CDFA's legal authority. In its report, OIG concluded that "the most significant improvement in the survey process will be AMS' ability to audit the data the dairy product producing firms are reporting to NASS."

<u>In conclusion</u>

MPC has presented two important policy proposals that address specific vulnerabilities that the producer sector faces as both the dry whey and nonfat dry milk markets begin to show strength. These two vulnerabilities will not be resolved without CDFA action, so the Department can be sure that if they are not addressed through this hearing process, they will come up again in the near future. However, it is a near-certainty that if that indeed is how the future plays out, producers will miss out on their fair share of those legitimate market revenues. Several processor representatives made statements during the hearing that producers should look to the market for addition revenue rather than petitioning for a regulatory change. The fact is that MPC has outlined two specific sources of addition revenue that CDFA should act on immediately. It is certainly our hope that the Department will give our proposals strong consideration.

Sincerely,

Geoffrey Vanden Heuvel
Vice-President, Milk Producers Council

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