CALIFORNIA DEPARTMENT OF FOOD & AGRICULTURE
A. G. Kawamura, Secretary

May 25, 2006

To All Interested Parties:

This letter is in response to a question that was raised at the Pre-Hearing Workshop held May 18, 2006, and subsequently in writing on May 19th by Western United Dairymen (WUD). WUD expressed concern relating to increases in certain cost categories for butter, non-fat dry milk and cheeses between the 2003 and 2004 manufacturing cost studies, and requested an explanation. The percent of change figures stated in WUD's letter are accurate. WUD's correspondence is included with this letter for your reference.

Looking at individual line items by groups may not allow for a complete comparative analysis. The composite of the groups (ranked by lowest costs), does not remain constant from year-to-year; nor does the number of plants in each group. The concept of displaying groups was established as a way to provide stakeholders with more detail for analysis while maintaining confidentiality of proprietary information. Caution should be used when comparing individual line items on a year-to-year basis.

The question regarding the Return On Investment (ROI) category reflects both the explanation listed above and the change in the interest rates used to calculate ROI. As was outlined at the workshop, the Department received a request to change the interest rate used in calculating ROI from the prime rate to something closer to what firms and dairy producers were actually paying. This change was proposed for both manufacturing and production cost exhibits. This change was in effect for the 2004 manufacturing cost exhibits. The Moody BAA rate for 2004 was 6.39%, whereas the Prime Rate for the same time period was 4.34%. Most of the change in the ROI line item is due to the change in the methodology.

The question regarding the change in General & Administrative Expense (G&A) for cheese was discussed at the workshop and a complete explanation can be found in the report from CPS that is included with this letter. The change in the G&A for butter is due to the grouping and number of plants in each group.

Respectfully submitted,

Venetta Reed
Supervising Auditor I
Dairy Marketing Branch

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May 19, 2006

Venetta Reed, Manufacturing Cost Unit
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814

Re: 2004 Manufacturing Cost Study Questions

Dear Venetta:

At the pre-hearing workshop you asked that we provide you with a list of questions regarding the 2004 manufacturing cost study. In particular, we are interested in what fostered large year-to-year increases in certain cost categories for butter, nonfat dry milk and cheese. We have compared the 2004 cost study with the 2003 cost study. The categories we are interested in and their corresponding cost percentage increases are listed below.

Butter:

- Processing Non-Labor in low cost category: +12.3%
- Other Ingredient in low cost category: +80%
- General & Administrative in high cost category: +44.6%
- Return on Investment in low cost category: +134.5%

Nonfat Dry Milk:

- Return on Investment in all categories: +44.7%, +30.3% and +27.1% respectively

Cheese:

- Other Ingredient in high cost category: +77.2%
- General & Administrative in both categories: +48.1% and +89.8%
- Return on Investment in low cost category: +62.1%

We thank you for time on this matter and look forward to your response. Please contact me with any questions.

Very truly yours,

Michael L. H. Marsh, CPA
Chief Executive Officer

cc: David Ikari, Dairy Marketing Branch Chief

May 10, 2006

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

Subject: **Cost Study Consulting Report #1**

Dear Mr. Ikari,

The Department's Dairy Marketing Branch engaged CPS Human Resource Services (CPS) to review, analyze and make recommendations on the methodology and procedures for the release of aggregated data publications, including the allocation of processor penalties, and the documentation and performance of internal operating procedures. This is the first of two reports. The staff on this engagement are Dale Montgomery, CPA, and Jeff Mikles, PMP.

Scope and Methodology

The scope of this first report covers only annual cost study update methodology and presentation. Due to the limited amount of time to research and prepare this first report, our methodology was restricted to performing the following tasks:

- Reviewed applicable California Food and Agricultural Code statutes, Branch cost study procedures, and specifically the methodology and presentation method used to aggregate the annual cost studies and the manner in which annual updates to energy and labor costs are released and incorporated into the cost display;
- Reviewed past cost study consulting reports and communications with dairy industry associations; and
- Interviewed Manufacturing Cost Unit staff, dairy industry economists and executives from producer and processor associations, and a large cheese manufacturer.

Study Results

The following discusses the results of our review of the annual update methodology, update presentation format and penalty allocation methodology, and presents improvement recommendations.

Annual Update Methodology

The primary reason given for preparing annual updates is that the process of completing the annual cost studies is significantly slower than escalating manufacturing costs. In the preparation of annual cost studies, the Manufactured Cost Unit (MCU) utilizes data that manufacturers provide from their annual financial audit. These audits are typically completed between March and May of each year and are provided to the MCU upon completion. Typically, the cost studies are not completed, compiled and available for distribution until November.

The MCU advised CPS that delayed receipt of audited processor data is the primary reason it takes so long to complete the annual cost studies. CPS learned that only one processor submits data electronically soon after the audit is completed, as recommended in a 2002 review of cost study procedures and processes.

Our inquiries into the origins of the annual updates to cost studies resulted in less than conclusive results. Department staff indicate that the updates have been performed for more than 21 years, but voiced uncertainty as to what originally prompted the updates as they are not required by statute or regulations.

Currently, updates are limited to replacing historic unit cost data for labor, energy and packaging with current unit cost data and leaving the remaining elements of the original cost study unchanged. Depending upon the commodity in question, the cost components of labor, utilities and packaging make up approximately 50% of the total manufacturing cost incurred.

Challenges to the reasonableness of this process have arisen citing that it is unreasonable to choose only 50% of the cost elements, while ignoring change to other costs and production volume. Moreover, in our opinion, adjustments should not be based on the application of current year labor, energy and packaging costs to prior year production volume. Instead, a complete cost study should be performed.

Suggestions offered by staff and industry representatives to improve the data quality and timeliness of report preparation include the following:

- The development of an energy index, thus eliminating the need for additional hearings to adjust the "make allowance" as significant changes in the cost of energy occur
- Request processors to submit unaudited production and cost data (volume, labor and energy costs) electronically on a monthly basis
- Request outside auditing firms to prepare a mandated cost study report as part of the annual audit, submitting data in a standardized format

In our opinion, if the annual cost studies were completed in a more timely manner as previously recommended, updates would be unnecessary.

Recommendations

CPS recommends the following:

1. MCU should implement the recommendations made in the July 2002 consulting report, which include:
    a. MCU should communicate the planning, execution and closing of the annual cost studies, including data requirements and schedule, to the highest level of management.
    b. Require processors to submit data on a monthly basis in an electronic format MCU prescribes, rather than upon completion of annual audits. This will allow MCU staff to review the reasonableness of the data and trends on an ongoing basis.
    c. If necessary, ensure industry compliance with the above through regulation.
2. Abandon the practice of preparing annual updates.
3. The MCU should change the purpose of on-sight processor visits to ensuring the accuracy of data submitted on a periodic test basis, rather than collecting data to be used in the completion of cost studies.

Annual Update Report Presentation Format

During our interviews of various industry representatives, readers of the annual update reports have indicated that the report presentation is confusing and does not clearly distinguish between updated data and data that remain unchanged from the original cost study.

The updates that we reviewed appeared to be replications of prior reports without change to format and narrative data presented. There were only slight, unmarked changes to the numbers reported with no explanations.

If the updates are eliminated as previously recommended, revising the reports is a moot point. However, if the updates are continued, CPS recommends the changes below.

Recommendations

If updates are continued, CPS recommends that MCU:

4. Revise the update process in the following manner:
    a. Provide a transmittal letter that briefly explains the purpose of the report, the period covered and the attachments.
    b. Modify the report headers to clearly indicate the nature of the report (i.e. an annual cost study, an update and the period covered).
    c. Contrast and explain differences between the updated numbers and the prior numbers.

Penalty Allocation Methodology

As part of this engagement, CPS was requested to examine the methodology the MCU uses to include penalties in cost studies. This concern has recently come to light because of a large penalty a cheese manufacturer incurred in 2004 that was included in its manufacturing costs as part of its cost study.

Food and Agricultural Code section 61442, which authorizes the Department to collect and summarize cost data from California dairy manufacturing plants, does not provide clear guidance as to which costs are includable in cost studies used to establish reasonable manufacturing cost allowances.

The argument has been made that penalties are not a "reasonable" cost of doing business and therefore should not be included in manufacturing cost.

Our review of the cheese manufacturer's penalty and their stated efforts to comply with regulatory requirements indicates the penalty incurred was far less that the cost of compliance and should probably be included as a manufacturing cost.

This is not to say that CPS recommends that all fines and penalties should be treated as reasonable manufacturing costs. In the absence of clear legal authority for including or excluding such items in manufacturing cost, the MCU will need to evaluate each case based upon the facts and circumstances and make a determination. Such determinations will probably be the subject of future criticism and challenge.

Recommendations

CPS recommends that the MCU:

5. Seek clarification from the Department's legal resources as to the proper handling of penalties.
6. In the interim, the MCU should note the occurrence and reason for penalties, any mitigating circumstances, and the respective treatment in the cost studies.

If you have any questions concerning the work performed or the results, please contact Dale Montgomery at 684-6311 or me at 263-3614 x3040.

Sincerely,

David M. Caffrey
CPS Senior Manager

cc: Kelly Krug
Venetta Reed
Dale Montgomery
Jeff Mikles