STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

CONSOLIDATED PUBLIC HEARING TO CONSIDER TEMPORARY AMENDMENTS TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK FOR THE NORTHERN AND SOUTHERN CALIFORNIA MARKETING AREAS

CALIFORNIA DEPARTMENT OF FOOD & AGRICULTURE

DEPARTMENT AUDITORIUM

1220 N STREET

SACRAMENTO, CALIFORNIA

THURSDAY, SEPTEMBER 12, 2013

8:00 A.M.

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A P P E A R A N C E S

CDFA Panel

Kevin Masuhara, Director
Division of Marketing Services

Candace Gates, Branch Chief
Dairy Marketing Branch

Hyrum Eastman, Dairy Economic Advisor
Division of Marketing Services

CDFA Staff

John Suther, Hearing Officer
Senior Special Investigator

Erica Sanko, Senior Agricultural Economist
Dairy Marketing Branch

Karen Dapper, Research Manager
Dairy Marketing Branch

Michele Dias, Deputy Secretary, Chief Counsel
California Department of Food and Agriculture

Petitioners

Eric Erba, PhD
California Dairies, Inc.

John Moffatt
Milk Producers Council

Lynne McBride
California Dairy Campaign

Tom Barcellos
Western United Dairymen

California State Legislators

The Honorable Anthony Cannella
California State Senate

The Honorable Tom Berryhill
California State Senate

The Honorable Adam Gray
California State Assembly

The Honorable Kristin Olsen
California State Assembly

The Honorable Edward Hernandez
California State Senate

The Honorable Richard Pan, MD
California State Assembly

The Honorable Cathleen Galgiani
California State Senate
Chair of the Senate Agriculture Committee

Also Present

Tom Barcellos
T-Bar Dairy

Richard Sexton, PhD
University of California, Davis
Agricultural & Resource Economics

Greg Dryer
Saputo Cheese USA Inc.

Lantz Adams

Rick Adams

Renee Peets
Kraft Foods North America

Joe E. Paris
Joseph Gallo Farms

Adolfo Sanchez
Los Altos Foods

Also Present

Antoinette Duarte
Duarte Dairy, Inc.

Scott Hofferber
Farmdale Creamery, Inc.

David Ahlem
Hilmar Cheese Company, Inc.

William Schiek, PhD
Dairy Institute of California

John Lemmon
Dairy Institute of California

Pete Garbani
Land O'Lakes, Inc.

Rob Vandenheuvel
Milk Producers Council

Sue Taylor
Leprino Foods Company

I N D E X

E X H I B I T S

E X H I B I T S

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61	Testimony of Sue M. Taylor Leprino Foods Company	263

P R O C E E D I N G S

8:08 a.m.

HEARING OFFICER SUTHER: Good morning, may I have your attention, please.

Before we start the hearing I'd like to go over some important details that will help ensure that this hearing will be as productive as possible.

Please, first, turn off your telephones so they don't disrupt this hearing.

Second, anyone planning to testify, other than the petitioners, must sign in on the hearing witness roster located in the back of the room.

Each person has one opportunity to come forward and provide testimony for up to 20 minutes. Witnesses will be called in the order that they sign up. The time clock on my right has been established to assist you in testifying. You will be testifying from the chair on my left and on your right.

Fourth, it is important if you want to submit an exhibit please bring it up to me before you testify.

Fifth, remember the purpose of this hearing is to take testimony and to gather evidence. It is not to make findings or to render a decision. Therefore, be courteous and respect the hearing process, those testifying and those hearing the testimony.

And sixth, the restrooms are located outside the doors that you came in. Go to your left and then immediately on your right.

We will probably break for lunch around 12:00 o'clock, depending on the flow of the testimony. If necessary the hearing will resume tomorrow morning at 8:00 a.m. in this room.

In case of emergency, exit out the doors there at the rear.

This hearing will now come to order. The California Department of Food and Agriculture has called this public hearing at the Department's Auditorium, 1220 N Street, Sacramento, California, on this day, Thursday, September 12th, 2013, at 8:00 a.m.

My name is John Suther. I am a Special Investigator for the Department. I have been designated as the Hearing Officer for today's proceedings. I have no personal interest in the outcome of this hearing and I will not be personally involved in any decision that may result from this hearing.

On July 22nd, 2013, the Department received a petition requesting a public hearing to consider amendments to the Stabilization and Marketing Plans for Market Milk for the Northern and Southern California Marketing Areas. A group of producer organizations, California Dairies, Inc., Milk Producers Council, California Dairy Campaign and Western United Dairymen submitted the petition proposing a modification to the sliding scale that determines a dry whey factor in the Class 4b formula and replacing the temporary price adjustment currently in place with another.

The Department announced the call of the hearing on August 5th, 2013 to consider the petitioners' proposed changes. This hearing will also consider the factual basis, evidence and legal authority upon which to make any and/or all of the proposed amendments to the plans.

The petitioners will have a combined total of 90 minutes to submit testimony and relative material to support their proposal, which will then be followed by any questions from the Panel.

Anyone who has signed in on the hearing witness roster located in the back of the room will be allowed 20 minutes to give testimony and evidence.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing brief period to amplify, explain or withdraw their testimony. Only those individuals who have requested a post-hearing brief may file a post-hearing brief with the Department. Any information submitted after the close of the hearing will not be included in the record for consideration by the hearing panel.

Testimony will begin with a representative of the Department who will introduce the Department's exhibits. The audience may ask questions of the Department's representative only as it relates to the exhibits. This is the only witness that may be questioned by those other than panel members.

As a courtesy to the panel, the Department staff and the public, please speak directly to the issues and avoid personalizing disagreements. Such conduct does not assist the panel and will not be permitted.

Questioning of the witnesses other than the Department's representative by anyone other than the members of the panel is not permitted.

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses and make recommendations to the Secretary. The panel is composed of members of the Department's Division of Marketing Services and Dairy Marketing Branch and includes Candace Gates, Branch Chief, Hyrum Eastman, Dairy Economic Advisor and Kevin Masuhara, Director of Marketing Services, Again, I am not a member of the panel and will not be taking part in any of the discussions relative to the hearing.

The hearing is being recorded by the firm of All American Reporting located in Sacramento. A transcript of today's hearing will be available for review at the

Marketing Branch Headquarters located in Sacramento at 2800 Gateway Oaks Drive and on the Department's website following the hearing decision announcement.

Testimony and evidence pertinent to the call of the hearing will now be received. At this time I would like to have Erica Sanko, Senior Agricultural Economist with the Dairy Marketing Branch, who will introduce the Department's exhibits. The audience may ask questions of Ms. Sanko only as they relate to the exhibits.

Ms. Sanko, please state your full name and spell your last name for the record.

MS. SANKO: Erica Sanko, S-A-N-K-O.

Whereupon,

ERICA SANKO

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

MS. SANKO: Mr. Hearing Officer, my name is Erica Sanko. I am a Senior Agricultural Economist with the Dairy Marketing Branch of the California Department of Food and Ag. 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 13 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 September 5th, 2013. An abridged copy of the exhibits is available for inspection at the back of the room.

I ask at this time that the composite exhibits be received.

HEARING OFFICER SUTHER: Thank you, Ms. Sanko.

Are there any questions?

Can you please bring me a copy of those.

(Exhibits 1-44 were received into evidence.)

HEARING OFFICER SUTHER: Okay, we will now deviate from our normal script --

Please continue.

MS. SANKO: Mr. Hearing Officer, I request at this time the opportunity to provide a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

MS. SANKO: Thank you.

HEARING OFFICER SUTHER: Thank you.

We have a few legislators here who would like to make statements. They will have three minutes each. We will call them up in the order that they have signed in. Senator Cannella.

Senator Cannella, could you please state your full name and spell your last name for the record, please.

SENATOR CANNELLA: Sure. Anthony Cannella, C-A-N-

N-E-L-L-A.

Whereupon,

ANTHONY CANNELLA

Was duly sworn.

HEARING OFFICER SUTHER: All right, you may proceed.

SENATOR CANNELLA: Okay. Well thank you very much for having us here. I believe it's far overdue. We have lost too many dairy farms over the past six years as pricing has not kept up with the incredible increase in feed costs and other costs associated with dairy farms. Last year alone we lost more than 100 family farms and the trend will continue until action is taken to address milk prices. I am asking you today to find a more equitable pricing formula. We cannot sit by idly as more dairies close.

Earlier, a couple of months ago, Senator Berryhill and I were down in San Diego with the Governor and we were asked to fly back because a deal had been reached on a pricing formula for a year. And roughly -- the deal was all sides had agreed, it was my understanding, that there was going to be a share in the whey pricing formula. It was about $110 million were going to be sent to the dairy farms to help them over this next year until the task force could do their work and hopefully we could adjust those pricing formulas. That was -- all sides had agreed, as I recall, and I think that everybody will testify to that effect. Why that didn't materialize, I don't know, but I know you all have the power to do that.

And I just hope that you understand that -- you know -- I know you base it on economics and whatever theory you use. But please understand there is a real impact to real people out there and so it's very important that you act today and adjust those pricing formulas. So thank you very much.

HEARING OFFICER SUTHER: Thank you. Senator Berryhill.

SENATOR BERRYHILL: On my way.

HEARING OFFICER SUTHER: Senator Berryhill, could you please state your full name and spell your last name for the record, please.

SENATOR BERRYHILL: Yes. Tom Berryhill, B-E-R-R-Y-H-I-L-L.

Whereupon,

TOM BERRYHILL

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

SENATOR BERRYHILL: Okay, folks. Again, like Anthony, I do thank you for having this hearing, it needed to be done.

You've got to understand, throughout the state this last year we have lost over 387 dairies that have closed; 105 family dairies just this year. In Stanislaus County we have seen 85 dairies close down just this year because of the high -- the high cost of feed. It's no big secret.

And what Anthony was saying was true. We were down with the Governor. All of a sudden we heard there was a special hearing that we were going to come back to. and in that hearing there was a deal that was cut and it was a deal on whey. And that deal was $110 million this year to get these guys through it and to develop a task force that could study how we might all get along.

And so, you know, the dairy industry has always had a pricing formula. And because of the whey situation globally, everything has changed a little bit. And there is plenty of room to keep everybody whole in this thing. I think it's imperative that we come to this deal and get this task force going so that we can study this problem and come out at the end of the pipeline here all together.

And that's my goal today, my goal next year when we come back and hopefully we can make this industry whole. Thanks for having us.

HEARING OFFICER SUTHER: Thank you.

SENATOR BERRYHILL: Do you have any questions for me?

MS. GATES: No.

SENATOR BERRYHILL: Okay.

HEARING OFFICER SUTHER: Assembly Member Gray.

Assembly Member Gray, could you please state your full name and spell your last name for the record, please.

ASSEMBLY MEMBER GRAY: My full name is Adam Jamie Gray, my last name is spelled G-R-A-Y.

Whereupon,

ADAM GRAY

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

ASSEMBLY MEMBER GRAY: Very good. Thank you for allowing me to make a short statement this morning prior to your hearing.

As you stated my name is Adam Gray, I am currently the Assembly Member representing the 21st Assembly District, which encompasses all of Merced County and about half of Stanislaus County, primarily the western portion. A great number of dairies in my district. I actually grew up in a family that ran a dairy supply. It was a food supply store and dairy equipment company.

When I first ran for office three/four years ago and began to go out to collect support and talk to my community one of the first things I did was go back and visit with many of our former companies from our family business. We had sold the business in the late '90s. I wanted to reconnect with people on the campaign trail. And one of the thinGs That became increasingly evidence was may of our customers, a third, at times maybe close to half that I would contact, were no longer in business.

The challenges the dairy industry has faced have been devastating to Merced County, to Stanislaus County and to all of our communities and other small family businesses like the one I grew up working in.

Appreciate the opportunity folks have here today to attempt to seek some price relief and I hope you will all take very seriously both the urgency and just the economic devastation this has placed on our community.

So I encourage you to take action as you can. I have been an active participant in the legislative process with some of the legislation trying to both establish a task force and trying to establish some price relief there.

We have unemployment in our district that exceeds levels of the Great Depression, 17, 20, 25, 30. Some of the small farming communities at 40 percent. And the dairy industry just does so much for our families and I hope that you can take some action today to provide some relief, thank you.

HEARING OFFICER SUTHER: Assembly Member Olsen.

ASSEMBLY MEMBER OLSEN: Good morning.

HEARING OFFICER SUTHER: Good morning. Assembly Member Olsen, could you please state your full name and spell your last name for the record, please.

ASSEMBLY MEMBER OLSEN: Assembly Member Kristin Olsen, O-L-S-E-N.

Whereupon,

KRISTIN OLSEN

Was duly sworn.

HEARING OFFICER SUTHER: Could you please speak up. With that air conditioner running in the back I understand some people can't hear.

ASSEMBLY MEMBER OLSEN: Sure. Is that better?

HEARING OFFICER SUTHER: Thank you.

ASSEMBLY MEMBER OLSEN: Okay. I appreciate the time you're giving us this morning. I grew up in dairy country and it is just devastating to see what has been going over the last few years. It's impacting our entire state and it impacts many of my family and friends as well.

The financial crisis for our California family dairy farms, as you know, is in a downward spiral. In fact, it was reported just a week or so in the Modesto Bee that dairies dropped from the number one commodity in Stanislaus County to now number three.

Families have operated these dairies for decades and their employees and their employees' families have been part of the operations. When we lose a family dairy the loss is felt by many more people than just the dairies themselves. It's felt by hay brokers, grain dealers, choppers, pharmaceutical suppliers, hoof trimmers, veterinarians, bankers, grocers and the list goes on and on. They depend on dairies for their livelihood.

We have lost an average of six dairies a month for the last six years and that number will continue to grow this year. For those who say, "Be patient, things will get better, the economy is turning around" they need to talk to my constituents, because it sure doesn't feel that way to us.

There is a simple fairness issue in what they should be paid for whey. Yes, there is the unmanageable feed costs that dairies are having to pay, and I am trying to do something about that in Assembly Joint Resolution 21.

Yes, there is the unwillingness of banks to provide financing. Yes, there is the drilling of new wells to keep up with rapidly declining aquifers. But there is also a pricing problem. The dairy farmers will do the work. But a fair pricing system depends on us in the Legislature and you in the Department of Food and Ag because of the pooling system that exists in California. Doing nothing is not an answer and doing a tiny bit of something is not an answer either. The time is now for letting dairy families and their work ethic be matched with just a fair price for milk.

The California dairy industry creates almost 445,000 jobs. That's more than the motion picture industry and the television industry in California. Clearly the loss of a California dairy has a negative rippling effect on our rural communities and it further diminishes California's entire tax base.

Dairy producers are not asking for anything outrageous, as the previous speakers have spoken, they simply want a fair price for the milk they produce. It is wrong that milk prices in California continue to be lower than the rest of the nation because of an outdated pooling system.

The agreement that was reached in Senate Ag would be a really good first step, that was agreed to by producers and processors alike. And so I respectfully request that the Secretary take substantive action to put the problems to bed that are putting dairies out of business on a daily basis. We need the short-term solution and then we need the task force to work hard together to come up with a long-term solution. Appreciate your time this morning.

HEARING OFFICER SUTHER: Thank you. Senator Hernandez.

SENATOR HERNANDEZ: Good morning.

HEARING OFFICER SUTHER: Good morning. Senator Hernandez, could you please state your full name and spell your last name for the record.

SENATOR HERNANDEZ: Yes, my name is Edward P. Hernandez, that's H-E-R-N-A-N-D-E-Z.

Whereupon,

EDWARD P. HERNANDEZ

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

SENATOR HERNANDEZ: Thank you very much for having me this morning, Mr. Chair, and members.

This is an important hearing. Not only for the dairy farmers but for all of us who live here in California. The problem confronting dairy farmers are a matter of record. I grew up in a California where thousands of family dairy farms were part of this landscape. I grew up in California, where you could see dairy farms from the freeways and get a sense of why milk is our number one agricultural commodity. I grew up in a California that if you drove to the back roads of any county you were in close proximity to the dairy farms that had been in the families for generations.

To their credit, the dairy farmers are not asking for a handout. Let me restate that, are not asking for a handout. They are asking to be treated -- not to be treated in any special way.

To the contrary, the dairy farmers sat down with stakeholders and negotiated an agreement that has a short-term one year benefit as was stated by previous individuals and the framework for a long-term solution. They made an agreement with representatives of the processors where the price for 4b milk is handled in a more sensible manner.

There are others who can speak to the details of the agreement much better than I can, but I am here because I believe once an agreement is made and that agreement is discussed in a special hearing of the Legislature that that agreement becomes a starting point for the long-term solutions.

I am adding my voice to those who are saying it is time for the Secretary to act. Yesterday the Senate agreed to free the bill containing the agreement with a suspense file and keep the issue alive. And keep in mind, this is a rare procedural move by the Senate but it reflects our commitment to finding an immediate remedy for the solution, to dairy farmers, that is. This issue matters and it will shape the kind of California in which our children and grandchildren will live.

And for that I thank you for allowing me the time to present this morning and I am here available for any questions.

HEARING OFFICER SUTHER: Thank you for your testimony.

SENATOR HERNANDEZ: Thank you.

HEARING OFFICER SUTHER: Are there any other legislators that would like to testify?

Seeing none we will take a five minute recess and then we'll start back.

(Off the record at 8:33 a.m.)

(On the record at 8:38 a.m.)

HEARING OFFICER SUTHER: We will now be back on the record.

I will now call the petitioners, beginning with California Dairies, Incorporated. You will have a total of 90 minutes to submit your testimony. Again, please notice the time clock on my right. And that will be 90 minutes, a total of 90 minutes for all four petitioners, so about 22.5 minutes apiece.

Could you please state your full name and spell your last name.

DR. ERBA: My name is Eric Erba, E-R-B-A.

Whereupon,

ERIC ERBA

Was duly sworn.

HEARING OFFICER SUTHER: And I see we have your written statements that you would like into the record. It will be Exhibit number 45.

(Exhibit 45 was entered into the record.)

HEARING OFFICER SUTHER: Are you testifying on behalf of an organization or individually?

DR. ERBA: I am testifying on behalf of California Dairies, Inc.

HEARING OFFICER SUTHER: You may proceed.

DR. ERBA: Thank you. Mr. Hearing Officer and Members of the Panel:

Good morning. My name is Eric Erba and I hold the position of Senior Vice President and Chief Strategy Officer for California Dairies, Inc., whom I am representing here today. California Dairies is a full-service milk processing cooperative owned by 420 producer-members located throughout California and collectively producing over 17 billion pounds of milk per year, or about 44 percent of the milk produced in California. Our producer-members have invested over $500 million in large processing plants at six locations, which will produce about 400 million pounds of butter and 800 million pounds of powdered milk products in 2013. The Board of Directors for California Dairies approved the concepts contained in the testimony that I will be presenting today at their August 27th, 2013 meeting. California Dairies' proposal is consistent with the guidelines given in the Food and Agricultural Code, Division 21, Part 3, Chapter 2, starting with Article 1 and including Article 9 that discusses establishment of minimum prices.

We thank the Department for calling this hearing and allowing us the opportunity to reiterate our concern about the manner in which whey is valued by the California milk pricing system. The disparity between the whey valuation in federal milk marketing orders and California remains too large to ignore and continues to have too grave an impact on our member-owners' milk price. The impact on our member-owners of undervaluing whey has been addressed several times over the past two years in hearings similar to today's proceedings but the same old inequities continue to persist. The reason is that the problem with the Class 4b pricing formula has not yet been corrected.

Part of the hearing announcement refers to the need of proponents of the petition to provide quantifiable economic data on dry whey such as manufacturing costs, marketing and sales costs and whey stream valuation specific to California plants. If read a certain way, this makes compliance with the hearing notice impossible for most witnesses. Even when the Department published information on whey processing that its staff collected from cheese processing plants, we had access to a limited amount of information specific to those plants. Quite clearly, we have even less information about the operation of those plants since the Department ceased to publish dry whey processing cost information. Consequently, I have chosen to interpret the hearing notice in a different way and will provide you with data and information for this hearing that is both meaningful and obtainable.

The hearing notice issued on August 5th set forth the guidelines for a proposal that will be considered at this hearing. The proposal contained in the jointly filed petition that led to the call of the hearing was designed to follow the format found in Article III, Section 300.0 of the Stabilization and Marketing Plans for Market Milk for the Northern California and Southern California Marketing Areas. I have made slight adjustments to the applicable dates in the proposal, which are highlighted below, to allow for some consistency with the hearing time line.

I will skip over the proposed language which mirrors that found in the petition. The applicable dates for the temporary price increase are changed from the ones filed in the petition but are consistent with the intent of the petition.

The focus of the proposed change is to establish a fair price for milk to which producers are entitled. Specifically, the proposal seeks to shrink the Class 4b and federal Class III price spread. An acceptable level of price difference between California milk prices and federal order milk prices exists for all classes with the exception of Class 4b, which has trailed the federal Class III price by almost $2.00 per cwt. over the past two years. As proposed, the projected effect of moving to a new sliding scale for dry whey will be to increase the Class 4b price by about $0.22 pe cwt.; this change would be permanent. The temporary adjustment in the Class 4b solids-not-fat price results in an increase of $0.46 per cwt. and the combined impact of the proposal would increase the overbase price by $0.31 per cwt. for the 12 month period commencing on November 1st, 2013.

The milk pricing proposal that we are supporting has a foundation based on common sense, economics and forward planning. Following the May 20th hearing in 2013, we continued our discussions and negotiations with processor representatives in hopes of being able to arrive at a resolution on the matter of whey valuation. We made a good-faith effort to develop a proposal that achieved middle ground in the discussions, that is to say, one that recognized and satisfied the positions of both producers and processors, but required concessions from both sides.

The proposal that came from this effort has two basic tenets. First, the existing price relief that was implemented as a result of the May 20th, 2013 hearing will be replaced with an amended price relief for up to one year that increases the Class 4b price by up to $0.46 per cwt. Second, the sliding scale used to value whey in the Class 4b formula is restructured to result in a new ceiling of $1.00 per cwt. contributed to Class 4b, achievable at current market prices. This change to the Class 4b pricing formula will be permanent.

These two tenets are captured succinctly in the letter dated July 8th, 2013 to Assemblyman Richard Pan from Joe Lang, representing the Dairy Institute. A copy of the letter is attached to my testimony.

Clearly, this proposal represents a significant concession from the position that California Dairies had adopted for the last three hearings on whey valuation. California Dairies and other producer representatives made these concessions in recognition of the larger issue that the collective dairy industry must engage in an immediate and thorough analysis of its current pricing system and develop recommendations for modifications as appropriate.

The proposal itself will generate $110 million in new monies to dairy producers during a 12 month period. Concurrently, the Dairy Industry Task Force will engage in meaningful discussions regarding California's milk pricing system and prepare recommendations for consideration by the Department and Legislature if necessary.

Finally, the proposal is meant to address the singular issue of fair compensation to dairy producers for the milk and its components provided to processors. While the numbers represented in the proposal fall short of the federal Class III price, we see it as a step in the right direction.

I want to introduce a thought of a new beginning and I will start off talking about it this way.

You will recall the decision from the June 30, 2011 hearing that replaced the $0.25 per cwt. fixed factor in the Class 4b formula with a sliding scale. While this decision was directionally correct and provided a more appropriate Class 4b milk price, it did not provide the pricing equity and pricing level that was sought by producers.

That decision was made at a different time and under different dairy industry conditions. We have over two additional years of experiences since the date of that hearing. We can draw on some of those experiences, and it seems now that we are in need of a new beginning for the dairy industry. Despite positions taken and testimony offered in previous hearings, it is time to rethink what action is required to prevent a mass exodus of dairy producers, which would place additional stresses on an already fragile industry.

We have struggled to find appropriate supporting data for a message that resonates with the Department to the extent that appropriate action is taken. We have heard repeatedly that a change may be made to the minimum pricing formulas "if economic conditions warrant." We submit to you that we are there; the threshold for action has already been met.

Let me paint a quick picture of the dairy industry for you. The dairy industry is the leading agricultural industry in California and milk and dairy products have generated the most value of any of the agricultural commodities produced in California, over $6 billion in sales for each of the last three years. However, as hard as it may be to comprehend given the dairy industry's legendary status in California, there are signs that the industry is not only struggling, but a significant and vital part of the industry is on the verge of collapse. Simply, the billions of dollars cited for milk sales do not translate directly to dairy farm profitability, and the lack of profitability has predictable effects on businesses. Over 400 dairies have exited the dairy industry since 2007. From California Dairies' own perspective, we now have 150 fewer dairies in operation that we did in 2007. The trend has not abated but has continued into 2013. In the last 12 months, California Dairies has lost 35 dairies that were producing a combined 2.5 million pounds of milk per day. Some simple math will tell you that these were not small dairies; the average herd size of these 35 dairies was more than 1,000 cows.

The direction that the industry has taken for the last two years is not sustainable without widespread consequences. Banks, vendors, suppliers, feed companies, milk hauling companies and milk processing plants are all mindful of the conditions being faced by their dairy customers. They also know the dairy industry well enough to understand what it means when California's milk production in 2013 is down by 3.2 percent compared to last year. Their businesses depend on the health of dairy farming operations, and a collapse on the milk production side of the industry has grave consequences for the survivability of their own operations.

The regions of the state where the dairy industry has flourished have also been the leading areas of unemployment. These counties are already reporting high unemployment numbers relative to the state average and further increases in unemployment rates can be expected as dairies continue to exit the business. I've included the table, Table 1, that goes through -- that contains data for the state and seven leading dairy counties. Unemployment ranges from 11 percent to 15 percent for those counties and averages 9 percent for the state.

In addition, we submit into the hearing record updates of several more traditional key indicators that collectively describe a disturbing trend in the producer landscape.

First, the disparity between California Class 4b prices and federal Class III prices persists. I have a graph called Figure 1 that shows the result of subtracting the Class III from the Class 4b price since 2007. And for comparison and reference, the whey market price for dry whey is overlaid on the graph. And since the Department has moved to a sliding scale approach for valuing whey, the difference between the two class pricing series has increased and averages $1.91 per cwt.

Second, the financial stress on the producer side has not abated. Feed costs have been high since the third quarter of 2012, resulting in high milk production costs and low or even negative margins. I have a graph, Figure 2, that explains that. While feed costs are starting to come down now, milk prices are also forecast to trend downward well into 2014. Consequently, dairy farm margins will remain near historic lows.

Third, USDA's milk-feed ratio is widely recognized as a barometer of the health of the production side of the industry. At one time a milk-feed ratio of 3.0 was considered to be favorable to dairy producers. I have a figure called Figure 3 that shows a stark and continued trend away from what would be considered a favorable ratio.

These three quantitative measures presented in Figures 1, 2 and 3, combined with the economic conditions described above, are sufficient to warrant action by the Department.

We recognize that attempting to establish a milk price high enough to erase the financial losses sustained by producers as a result of inappropriate whey valuation and high feed costs is problematic. As stated earlier in my testimony, the proposal that we support is meant to address the singular issue of fair compensation to dairy producers for the milk and its components provided to processors. Said in another way, producers are entitled to be compensated fairly for the product they produce.

There seems to be a common theme underlying past hearing decisions, that is to say, if there is a sufficient milk supply to service milk processing plants then there is no need to increase the milk price. A corollary to this basic notion is that establishing higher minimum prices will only lead to more milk production. It does not take much of an analyst or a historian to conclude that managing the state's milk supply by adjusting minimum pricing formulas once a year is ineffective and inefficient. All of the major cooperatives and some of the proprietary plants arrived at that same conclusion years ago and adopted programs that allocate milk production shares to producers based on milk handling capacity. These programs are actively managed and can adjust with market conditions. As far as I know, the cost of oversupply of milk is borne entirely by the producers and not by any other entity.

My concluding remarks, the milk pricing proposal that we are supporting has a foundation based on common sense, economics and forward planning. It was developed in concert with processor representatives with both parties making concessions to arrive at a mutually satisfactory resolution. In discussions there was recognition of the larger issue that a collective dairy industry must engage in an immediate and thorough analysis of its current pricing system and develop recommendations for modifications. Let the proposal that the dairy industry has brought forth be the establishment of a new beginning for the dairy industry. We urge you to adopt the proposal as a means to bridge the financial gap from where California milk prices are today and where they need to be to prevent further attrition on the producer side of the California dairy industry.

Thank you for your attention and I request the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Any questions from the panel?

MR. EASTMAN: I have a couple of questions. Dr. Erba, obviously the co-petitioners, you have your proposal here set and you list some -- the criteria, I believe, of how you arrived at these numbers. I was wondering if you could describe in terms of the exact level of say the permanent change in the whey table or the actual level of the temporary price increase, was there some target number that you were looking to get at based on analysis of these economic conditions? How did you arrive or how was this, the exact impact, the increase, how was that arrived at, so to speak?

DR. ERBA: Well you will recall that at the last hearing we talked about changing the decision on the December hearing so that the entire price increase is borne by Class 4b. So taking the price increases that were assigned to Classes 1, 2, 3 and 4a and moving that all to 4b. And, of course, that was not an acceptable solution.

We also talked about adjusting the whey scale, and something similar to what was presented a couple of years ago in a hearing, so this sliding scale could move up farther so we were not maxxed out as we have been for quite some time now.

So the combination of those two plus the negotiations of what would be acceptable. And again, these numbers were arrived at in negotiations with processor representatives. The $0.46 that we have in the petition and in my testimony was part of that negotiated solution. And it is also contained in the letter that is from Joe Lang to Assemblyman Pan, that $0.46 is specified in that letter.

MR. EASTMAN: Okay, good. And then in your testimony you mention a couple of economic factors such as the difference between the California 4b price and the federal order Class III price and also a little bit of the cost of production numbers, sort of the financial outlook or condition of dairy producers. Do you feel that your petition, the impact of your petition gets at an appropriate level of the difference between the 4b and the Class III price? Does it rectify that and get it at the right number? Will the impact of the increase get the financial condition of dairy producers to the point that would be adequate or sustainable?

DR. ERBA: I think the point, Mr. Eastman, is that we are trying to establish what we consider to be a fair price and it's a price that producers are entitled to receive for the product that they produce. Now, should it be higher? We have testified in the past that it should be. But we realize that some of these things, that you have to give up, you have to make concessions, you've got to move off your position if you're getting to any kind of agreement.

What we have today, what I've presented today and what we petitioned for is an agreement, and it's an agreement that involved both sides of the dairy industry, producers and processors. We think the number should be higher. I'm sure that they will testify that they think the number should be lower. But through the negotiations this is what we arrived at.

MR. EASTMAN: Okay. Do you feel that -- so do you feel the negotiations between producers and processor entities, was that the major, sort of factor, the major energy, so to speak, that got to that number? Rather than were there really -- I guess -- let me start over that question.

Do you feel that in these negotiations, was it mostly tit for tat rather than move the, sort of the number rather than were these discussions focused on certain data points or certain acceptable conditions on both sides that would provide that stability?

DR. ERBA: I think in order to engage in the discussion at all you've got to have both sides recognizing some of the data that's covered in my testimony, and that is covered in Figures 1, 2 and 3. One is a disparity between federal prices and state prices, one is a cost of production issue, one is essentially a survivability index on dairy farms. You have to recognize and agree that those things are meaningful and do have an impact.

Now, again, as I pointed out before and I think as you realize, how we arrived at the exact number was more of a negotiated process. But in order to even engage in the discussion you have to agree that those points that are made in those tables, in those charges, are meaningful, otherwise you'd never engage in the discussion.

MR. EASTMAN: Gotcha. In your testimony on page four where you're talking about the new beginning you mention that a couple of years ago when the fixed factor for whey values was replaced with the sliding scale that's currently in the formula that conditions were different at that time. So based on your testimony, are the differing conditions from two years ago, is that just a deterioration of the financial condition, the spread between the Class 4b and Class III prices? Is it just a deterioration in your graphs or is there any additional factor that highlights the change in conditions, so to speak, that you talked to?

DR. ERBA: I don't want to put too much emphasis on this one particular chart but I will just use it as a springboard, and that's Figure 3, it talks about the milk-feed ratio. I don't think we have ever seen a period of time like we have since 2007 where the milk-feed ratio has been not only below what people consider to be favorable but trending downward. It has always been the case that it may go below for awhile but it's going to move up. And it's that same thing that was mentioned this morning is if you hang around long enough -- the notion has been if you hang round long enough things will turn around and things are going to get better.

Well, since 2007 we have been on a track that is really unsustainable and a track that I don't think anybody anticipated in 2007. In 2007 you could make an argument, hey, things are going to turn around, prices are going to come back, profitability will be restored on the farm. That hasn't happened. The dairy farmers are waiting, waiting, waiting for the industry to turn and it hasn't happened,

And I think that's what I am trying to get across in this statement of a new beginning. So let's dismiss the positions and the testimony that was submitted back in those days and rethink what it's really going to take to keep this industry going forward. And keeping from the producer side going through some terrible levels of attrition to the point where we don't have a dairy industry that's sustainable anymore.

MR. EASTMAN: Okay. Then I just have one more sort of -- well, a slight technical question, I think. On Figure 2 you show production, cost of production on the farm and then you show the overbase price as a measure of income. Historically and if you look at hearings, oftentimes people use different measures of income to show the health of the industry. Was there any particular reason why you chose the overbase price compared to other ones that we may see today or have been presented in the past?

DR. ERBA: No reason in particular other than it's the one that most people understand, the one that most people they reference the most, they understand what those numbers mean. You could certainly put other prices in there, a combination of quota and overbase, you could put the quota price in there. There's other ways of putting it in there. But I think for the most part this is the one level of price that people understand.

MR. EASTMAN: Gotcha.

MS. GATES: Dr. Erba, I have a question for you, kind of in regards to page five where you spoke to the decrease in the number of dairies at CDI. How does that relate to the volume, the decrease in volume? Could you go into that?

DR. ERBA: Well, as we recognize, we are cyclical in terms of our production. We actually hit our high point in production as a full year back in 2007 before we had our capacity allocation program put in place. Things have basically been trending downward ever since then.

We had an anomaly last year. We had some terrific winter weather, we had an explosion in milk production, and that was very quickly followed by the lowest point in milk production we've hit in five years in September of last year. So we had some of the highest highs last year and some of the lowest lows last year.

We have had -- we accepted some new dairies as of January 1st this year and that changes our outlook in terms of what our milk production is today. We have dairies today we didn't have a year ago. But if you look at where we are in terms of the same dairies, discounting those new dairies that were added, we are considerably down in milk production. We are four percent down in milk production year over year if you don't include in the new dairies. The new dairies, they're basically keeping us even over the last year. And I think that's reflected in the state numbers as well, the entire state is down by over three percent year to date in 2013.

MS. GATES: So how does that then translate to your customers that you are supplying milk to? Have you had to increase/decrease your contracts or the milk that you are able to supply? I mean, how is that working?

DR. ERBA: Well we have a really interesting situation going on today with how we're trying to allocate our milk. We are actually quite a bit higher in our milk production today than we were last year but we are having more difficulty than we've ever had trying to get milk to our customers in the quantities that they are ordering. We simply don't have the milk that we had or expected to have at this time of year and so we are having to go through almost a rationing of our milk allocation.

MS. GATES: Are you garnering higher prices because of that?

DR. ERBA: No. Most of those sales are under contract so we do not get additional premium for those sales under contract. And we don't have the ability to make spot sales at this point.

MS. GATES: Okay, thank you.

MR. MASUHARA: I have a couple of questions, Dr. Erba.

DR. ERBA: Sure.

MR. MASUHARA: And this might seem like it deviates a little bit but you're aware from the hearing announcement we are also evaluating the sufficiency of these formulas. And part of that is to make evaluations of how they are performing relative to how they are structured in terms of what products are being made out there and how those products perform in the marketplace. And to that I have a question about CDI's portfolio on the 4a side, although we are talking about 4b but it helps us to establish comparisons for when we do our analysis.

Are all of the products that CDI is making, are they reflected in the current 4a formula?

DR. ERBA: Do you mean that everything that we made is captured in the pricing formula?

MR. MASUHARA: Yes, basically 4a covers end-product pricing as far as nonfat dry milk powder and butter. Are there other products that are being manufactured that aren't correlated directly to those?

DR. ERBA: We would have some powders that are not reportable, if that's what you're getting at. As you well know, the California weighted average price for nonfat dry milk has specific requirements about what shall be reported and not everything we make goes in there. Just as on the cheese side you've got mozzarella that's made in great quantities in the state that are not reported to the -- not reported to the state either in terms of the pricing formula.

MR. MASUHARA: And as a trend would it be your estimation that these products over time are evolving more towards some of these products that aren't represented in the formula?

DR. ERBA: I would say that it is a very slow evolution. Our plants were designed to produce specific products and you cannot just simply run -- say, today I am going to make a product I have never made before. The equipment is not designed to make it. So that as we are able to modify our equipment or add to our processing capacity we may be able to add some capacity to do some different products. But that evolution is going to be slow, it's going to be over a period of years, perhaps even decades. It is not a, hit the switch and today you're producing product you've never produced before on the same equipment, it doesn't work that way.

MR. MASUHARA: And it's driven more or less by the marketplace?

DR. ERBA: Well in our case we set -- we have a relatively new plant in Visalia and it was designed to do some different products. That's the only one in the system that was really designed to do that, everything else was designed to do low-heat commodity nonfat dry milk and butter and that's how they operate, basically. So as we are able to add different kinds of equipment or modify the equipment we have, we may be able to do what you're talking about but it will be an evolution over a period of years.

MR. MASUHARA: And as a hypothetical, if that formula were to be modified in such a way that wasn't reflective of your current product portfolio how would that impact your operations?

DR. ERBA: I guess I'd have to know exactly what the change was going to be. Probably we would have to change, make some changes in the way we run product but not necessarily. We don't always have the opportunity to run the kind of products we want to, we have to be responsive to the milk supply we have. So if we don't have the milk but we have too much to run some of our more specialized products then we don't make those, we can't make those products. So I'd have to know what specific change you're talking about in order to tell you how it might change our operation.

MR. MASUHARA: But it would have an impact?

DR. ERBA: It's possible it could have an impact. I can't say that it would but it's possible it would.

MR. MASUHARA: And generally, are some of these products that you're making that aren't reflected in that formula, do they generally perform in the marketplace at a premium to current nonfat dry milk product powders as far as an index goes?

DR. ERBA: It's cyclical, sometimes they do, sometimes they don't. This year those products have actually been in pretty good demand but that is not always the case. We export a large volume, a large percentage of our milk powders. On occasion we have exported a decent percentage of our butter products but that doesn't always happen, it kind of depends on what that year's product planning looks like. It depends on what contracts we have, what sales we're expecting in terms of intermediate products, cream, condensed and so forth. Several things go into that discussion before it gets reset every year.

MR. MASUHARA: Okay, thank you.

HEARING OFFICER SUTHER: Okay.

MR. EASTMAN: I just have one more quick question to piggyback on the question that Candace asked. You mentioned that to a certain extent you're having problems with supplying milk to your customers. And obviously, as you said, you have contracts, milk supply contracts in place. Have you had any of your customers ask you for more milk at this time?

DR. ERBA: Absolutely. Some of the contracts we've got are not fixed, it's not set loads on a daily basis or a weekly basis. It's flexible so they can order within a range of whatever the range is set under the contract. And what we have lately is people moving off of the lower end of the range toward the middle of the range asking for milk and it's milk we simply don't have.

MR. EASTMAN: Has anybody approached you with an idea in order to somehow spur that milk production? Paying a premium or paying additional monies or dollars to try and provide an incentive for some of your producers to actually produce more milk so they could get more milk?

DR. ERBA: No. And again, this is very situational; it's the here and now. Perhaps over time it might evolve to something like that but right now it's under contract and the contract covers whatever premiums shall be paid. Unless both parties agree that you are going to amend the contract then the contract is a contract, it's enforceable.

MR. EASTMAN: Thank you.

MR. MASUHARA: Sorry, this is to follow up on some earlier questions Hyrum had too, I was looking over my list of things that we're trying to establish here.

You had mentioned that the proposal contains numbers that were part of the negotiated process. With respect to that, I understand that negotiations always start with two sets of numbers, one represents a low side and a high side. But to your knowledge, does there exist any quantitative analysis that might be available to be filed as a post-hearing brief that offers a little bit more detail as to what numbers were involved in that negotiation and what those impacts might have been described from that analysis?

DR. ERBA: I am fairly certain I can come up with something that would satisfy that in a post-hearing brief.

MR. MASUHARA: Okay, thank you.

HEARING OFFICER SUTHER: Thank you, Dr. Erba.

DR. ERBA: You're welcome.

HEARING OFFICER SUTHER: I would now like to call Milk Producers Council.

MR. MOFFATT: Mr. Hearing Officer and members of the Panel, John Moffatt here representing the Milk Producers Council. Milk Producers Council supports the --

HEARING OFFICER SUTHER: Excuse me, John. Could you please state your full name and spell your last name for the record.

MR. MOFFATT: John James Moffatt, the last name is spelled M-O-F-F-A-T-T.

Whereupon,

JOHN JAMES MOFFATT

Was duly sworn.

HEARING OFFICER SUTHER: Thank you, you may proceed.

MR. MOFFATT: Thank you. Sorry, I got a little ahead of myself there, didn't I?

I am here today to express the Milk Producers Council's support for the proposal before the panel today. I will keep my remarks brief.

Over the last several months the Milk Producers Council, other members of the producer industry as well as the representatives of the dairy processor industry have worked very hard to come to a solution to find a way forward both in the short-term and the long-term to produce -- to protect the economic viability of both parts of this industry, both the producer and the processor. Those discussions culminated in an agreement that is captured both in the proposal that you see before you today but also a bill that is currently moving its way through the Legislature.

I testified in the Senate Agriculture Committee on July 11th, 2013, in support of that bill and I am here testifying today on behalf of Milk Producers Council in support of this petition that is in front of you. We believe that both components are necessary to deal with both the short-term and the long-term issues facing this industry in California and we would like to request that CDFA grant the petition that is before you today.

With that I will conclude my remarks and ask that we have the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Would you like to enter this as an exhibit?

MR. MOFFATT: I believe that's the same -- I am happy to enter this as an exhibit. And if I don't I'm sure the next testifier will, but I am happy to do it now.

HEARING OFFICER SUTHER: This will be entered as Exhibit number 46. Thank you, Mr. Moffatt.

(Exhibit 46 was entered into the record.)

MR. MOFFATT: Thank you.

HEARING OFFICER SUTHER: I would now like to call a representative from California Dairy Campaign.

Will you please state your full name and spell your last name for the record, please.

MS. McBRIDE: Lynne McBride, M-C, capital B-R-I-D-E.

Whereupon,

LYNNE McBRIDe

Was duly sworn.

HEARING OFFICER SUTHER: Would you like this written statement entered as an exhibit?

MS. McBRIDE: I would.

HEARING OFFICER SUTHER: This will be exhibit number 47.

(Exhibit 47 was entered into the record.)

HEARING OFFICER SUTHER: Are you testifying on behalf of yourself or an organization?

MS. McBRIDE: I am testifying on behalf of the California Dairy Campaign.

HEARING OFFICER SUTHER: Thank you. You may proceed.

MS. McBRIDE: Thank you. Mr. Hearing Officer and Members of the Panel, my name is Lynne McBride. I currently serve as Executive Director of the California Dairy Campaign. The testimony I will present today is based on positions adopted by the CDC Board of Directors.

I would like to begin by thanking California Department of Food and Agriculture Secretary Karen Ross for holding this hearing today to consider specific modifications to the California minimum price formulas. We join California Dairies, Inc., Milk Producers Council and Western United Dairymen in calling for an increase in the 4b price in the amount of $0.46 per hundredweight and an increase in the whey factor value from $0.75 to $1.00 per cwt. We consider this increase to be a compromise position due to the fact that it represents a fraction of the equivalent federal order Class III value. However, we strongly support all efforts to increase California minimum prices so that they are at levels that are closer to a reasonable and sound economic relationship with prices paid in other states.

California Dairies Continue to Close

The California Department of Food and Agriculture Mid-Year Review for 2013 indicated that there are 1509 dairies remaining in the state. Last year 105 dairies went out of business in California and in the first six months of this year now more than 50 dairies have closed their doors. We believe that the steep decline in the number of dairies in California is largely due to the fact that dairy producers in our state are paid significantly less than dairy producers in the federal milk marketing order system.

We urge that our state dairy pricing system be reformed to close the gap between federal order prices and California prices which has led the average sized dairy in our state to be paid more than $800,000 less than the same sized dairy in the federal order system since January 2009.

Although dairy producer prices have improved since 2012, prices on the Chicago Mercantile Exchange have been volatile over the past several weeks and producers in our state continue to struggle to remain in operation. Attached please find a document that shows the accumulated losses for a typical dairy farm in our state over the last 10 years. It is important to recognize that although prices have improved since this time last year, dairy income would have to increase substantially for an extensive period in order to make up for the devastating losses that dairy producers have incurred up until this point. In the last five years, California dairy farmers experienced a net loss in income in all but one year. 2009 was the worst year by far with average income losses of more than $5 per cwt. Conditions improved in 2011 with dairy farmers earning an average net profit of $0.71 per cwt, but then the situation deteriorated dramatically in 2012 as dairy farmers lost more than $2 per cwt on average. The economic conditions faced by dairy farmers in our state have led to the loss of now more than 400 dairy farms over the last five years.

A number of our members have gone out of business last year and in recent months. It is important to recognize the factors that contributed to their decision to close their dairies and how it relates to the minimum pricing formulas established by CDFA. One dairy that sold that I would like to talk about was a 700 cow dairy in the Central Valley that had been in operation for generations. The owners of the dairy were able to utilize some of their equity in order to withstand the price collapse of 2009 and began to make progress towards positive cash flow in 2011, but then in 2012 when feed prices escalated and the California minimum prices remained more depressed compared to other states, the owners of this dairy started to question how long they would continue.

During hearing after hearing before CDFA they along with all the other dairy producers in the state waited for some improvement in milk prices due to the increased value of milk, particularly 4b milk in the marketplace, but in the end the modest increases granted by the Department made them continue to question how long they would remain in operation. The next generation of their family was not interested in continuing to own and operate the dairy given the losses that were incurring each month as dairy producer prices failed to keep up with production costs. Even though conditions improved in 2013 and the margins were better, they decided to sell the dairy because they were not optimistic about the future. They determined the risk and sacrifice required to own and operate a dairy in this state are simply too great given the chronic losses dairies like them have sustained. The dairy I have described is just one example of many, now hundreds in recent years, who have chosen to exit the industry. Many of these dairies who sold, immigrated to this country with nothing, worked to build their dairy through hard work and sacrifice and have seen their businesses dissolve due to the fact that dairy income in our state does not cover costs. Many were forced to sell by the banks and others like the one I described decided to sell because of the grim economic outlook they faced. They simply decided that enough was enough. They couldn't afford to lose any more money and they sold the cows.

For those who are not dairy producers it may be hard to understand what the sale of a dairy means to a dairy family. The panel will hear from a number of dairy producers today who can speak to that firsthand, including one young producer who wants to continue into the future in the dairy business. The hard work, sacrifice, commitment and dedication of a typical dairy family are tremendous. It is a challenge to manage the day-to-day operations of a dairy and many consider it a calling because of the sacrifice and commitment it requires. It is an even greater challenge to put forward that type of effort and sacrifice and lose money month after month. The owner I described who sold his dairy still misses his cows to this day. Many other former dairy owners feel the same way. The only reason many of these dairies closed was because they are forced to due to the difficult economic circumstances they faced and the fact that the bank was no longer willing to lend money to enable them to run their operations. Some of the closures that have occurred are by dairy owners who no longer see a future for themselves as a dairy producer in this state due to the fact that California dairy producer prices are so much lower than prices paid in other states.

One of our board members currently has his dairy operation up for sale and plans to move to the Northwest where dairy prices are significantly higher than here in California and the future seems more promising. He has been a board member and a leader in our organization since it began. He is able to grow a substantial amount of his own feed for his 1,000 cow dairy so he is more financially secure. To him and many, many other dairy owners, it just doesn't make sense to operate a dairy here due to the fact that our state prices are some of the lowest paid across the nation and the costs to run a dairy in California, including all of the regulatory costs, are some of the highest in the country.

The losses would not have been as great if our California pricing system had paid dairy producers a price that was in line with prices paid in the federal milk marketing order system. The greatest disparity exists between our 4b cheese price and the equivalent federal order Class III price amounting to a $2.11 difference in June of 2013. The average difference between the California 4b price and the equivalent federal order Class III price totaled $1.90 per cwt in 2012 and $1.98 per cwt the year prior. The gap between the Class III and California 4b is wide and the justifications for maintaining the disparity from CDFA range from concern about disrupting current marketing conditions to improved dairy margins. The end result is our state's minimum prices are not in reasonable sound economic relationship with prices paid for comparable milk sold around the country.

The Latest cost of production data available from CDFA is the first quarter of 2013, which indicated the cost to produce milk in the sate amounted to $19.16 per cwt, a 5.9 percent increase compared to the first quarter of 2012. The most recent California overbase price for July 2013 amounted to just $16.65 per cwt, which is an increase from the $14.44 per cwt price one year ago, but not enough to cover the average cost of production in the state.

According to Section 62062 of the California Food and Ag Code, the secretary shall, "Consider the cost of management and a reasonable return on necessary capital investment" when establishing prices. The current pricing formulas do not result in a price that is adequate to cover production costs, proving that an increase in the minimum prices is more than justified.

The fact that our state system underpays dairy producers compared to other states has caused California dairy farmers to be paid on average $1 per hundredweight less than dairy farmers in the federal milk marketing order system. As I mentioned before, leading to a more than $800 million loss in income for the average size dairy over the last -- since January 2009. Had our state dairy system paid California dairy producer prices that were in line with prices paid in other states, the losses would not have been as great and more dairies would be in operation today. Many of the dairy operations that closed were in operation for generations, causing irreparable harm to the local and regional economy and the social fabric of the affected communities.

California mailbox prices are consistently some of the lowest of any regulated state in the nation. The most significant reason for the lower prices paid here is due to the inequity in the current 4b price formula that fails to reflect the current value of whey in the marketplace. According to the latest Dairy Market News from the United States Department of Agriculture Agricultural Marketing Service, the mailbox price in California was the second lowest in any regulated state in the nation. In May of 2013, the California mailbox price was just $17.95 per cwt while, again, the latest cost of production from CDFA indicates the cost to produce milk is $19.16 per cwt. In contrast, the federal order mailbox prices averaged $19.63 per cwt. May 2013 prices were a significant improvement from May 2012 prices which were nearly $3 lower than they are today. So while prices have improved, the losses from 2012 were record setting, the number of dairies that exited that year was the highest in memory and it is a constant struggle for the dairy operations that remain, largely due to the fact that our state pays dairy producers prices that are significantly below prices paid in the federal order system.

As has been said many times during these hearings, the California Food and Agriculture Code requires the secretary to set prices that are in reasonable sound economic relationship with the national value of manufactured milk products. A nearly $2.00 average per cwt gap between the California price and the equivalent federal order price in 2011 and 2012 demonstrates that the current

4b pricing formula fails to meet the standard set out in the code. We along with other producer organizations have called for an end to this price disparity, however, up until now the department has failed to restore equity to our dairy pricing system. The petition put before CDFA today is a compromise position between producers and processors that falls short of closing the significant gap that has long existed and widened greatly since 2012, but it would move our state 4b price somewhat closer to the national value of cheese milk.

California is the nation's leading milk producing state, yet dairy producers are not able to find markets if they want to change to a new buyer. This year and last year some plants were short of milk, however due to complex marketing agreements, producers were not able to access those short markets or benefit from the increased demand in the marketplace through higher prices above the state's minimum prices. Due to the consolidation and concentration that exists and the lack of competition in the marketplace, the minimum prices established by CDFA are more critical than during any other time in our state's history. It is imperative that CDFA adhere to each standard set out in the food and agriculture code so that the minimum price system is fair and equitable to producers.

Dairy operations cannot continue to sustain chronic losses while there is considerable profitability experienced further up in the food chain. As we have testified at previous hearings, CDC believes the only way to restore equity to our state dairy pricing system is to increase all class prices so that they are aligned with the federal order prices. Alignment with the federal order is the only way to end the inequity in our state dairy pricing system. It would improve the outlook for dairies across the state and enable the next generation of dairy producers to have a brighter future than the one that exists today.

As a compromise for this hearing we are instead focused on changes to the 4b price where the greatest gap between the federal order class price and the California class price continues to exist. It is clear that the increase called for in the petition put before CDFA for consideration today is long overdue. Not only have dairy producers and cooperatives supported the increases called for in the petition put before the Department today but the Dairy Institute put its support for the increase in writing in a letter to CDFA dated July 8th. For the last two months, the Dairy Institute has been on record supporting this increase yet now months have passed before the increase called for has been granted. Dairy producers and processors have been told countless times by lawmakers at both the state and federal level that in order for government to act, it is critical that they get together and agree on a compromise. In this case the compromise has been reached and now it is time for CDFA to respond immediately granting the increase called for in the petition.

In order to send a unified message to the department again we have joined with other dairy producer organizations and cooperatives in our state to call for an increase in the 4b price of $0.46 and an increase in the whey scale from $0.75 to $1.00. Adoption of the petition we have jointly submitted to the Department will bring California prices in somewhat closer relationship to prices paid in other states.

The increase called for in our petition will provide much needed additional revenue that is well deserved by dairy producers who have continued to lose substantial income over countless months. Our proposal is a compromise position that would increase producer prices, a step that is long overdue. Adoption of the producer price increases that we have called for today will provide, again, much needed and well-deserved revenue to dairy producers across the state who continue to struggle to remain in operation under continued difficult circumstances.

On behalf of the California Dairy Campaign I would like to thank the Department for the opportunity to present our testimony today. We look forward to working with CDFA to improve the outlook for California dairy producers now and in the future and we would like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER SUTHER: Your post-hearing brief is granted.

Any questions?

MR. EASTMAN: Yes, I have a few questions regarding some of the -- some of the information that you supplied in your testimony. On the last page of your testimony you have the chart or the graph that you were referring to. I just wanted to make sure I understand how the calculation was done.

MS. McBRIDE: Yeah, that was similar to the one we submitted during the last hearing where we tried to reflect the value of quota in the calculation, that's why we took the blend less $0.20.

MR. EASTMAN: Okay. So in essence you're looking -- I assume this is a measurement of some amount of income and you compare that with costs and then you get, you arrive at the figures in the graph, correct?

MS. McBRIDE: Mm-hmm, mm-hmm.

MR. EASTMAN: Okay. And so the milk price you're using, it says "Blend less $0.20." So by "blend" did you mean the quota price or is that?

MS. McBRIDE: We took the blend less $0.20 to reflect the fact that a certain percentage of producers don't own quota.

MR. EASTMAN: Okay. So by "blend" you mean the quota price then.

MS. McBRIDE: Yes.

MR. EASTMAN: Or is that not true?

MS. McBRIDE: Yeah.

MR. EASTMAN: Yes, okay. And then the cost figures you're using are just CDFA's cost of production.

MS. McBRIDE: Correct, we study that. It's very helpful, we appreciate the cost of production unit.

MR. EASTMAN: Okay. And then -- So on page three of your testimony at the very end you mention that California dairy producers are paid on average $1 per cwt less than dairy farmers in the federal milk marketing order system. How did you arrive at that dollar difference? What price -- what California price are you using and what price are you using for the federal order comparison?

MS. McBRIDE: Yeah, that's a piece I can submit to you for the record and certainly in my post-hearing brief.

MR. EASTMAN: Okay.

MS. McBRIDE: We just basically did it based on our class utilization and the federal order classes, you know, published.

MR. EASTMAN: Okay.

MS. McBRIDE: And that, again, runs from January 2009 through July 2013. And I would be happy to introduce that as part of the record, it's a pretty extensive series of numbers.

MR. EASTMAN: I understand.

MS. McBRIDE: I think it would be helpful.

MR. EASTMAN: Okay, perfect. So you're going to supply that in post-hearing brief?

MS. McBRIDE: Yeah.

MR. EASTMAN: Okay, good. And then I -- in your testimony you cite the California Food and Ag Code and you also cite the differences between California minimum class prices and the federal order class prices.

MS. McBRIDE: Mm-hmm.

MR. EASTMAN: In your opinion, does the proposal of the co-petitioners, does it arrive at the appropriate level in order to make the comparison of the California 4b price to the California 3 price at the acceptable level based on the economic conditions as you see it? Or do you feel that that number is not exactly what you feel the economic conditions would warrant?

MS. McBRIDE: We consider it a compromise position and a step forward but we don't think that it would close the gap between the California prices and federal order prices. And I think that's seen clearly in the comparisons that we have made and the information that I'll submit in our post-hearing brief. But the gap continues to be significantly larger than that.

But again, we consider this a compromise position and we think it's important to act on the compromise that was struck and so we are supportive of, again, this step, At least to get us somewhat closer.

MR. EASTMAN: Gotcha. What do you think would be the appropriate comparison or does that figure in your mind exist?

MS. McBRIDE: Well, I think, again, and you know, I'll submit this, but just that producers are aware, looking at the numbers, that the difference on average has been about $1, a $1 per cwt between the federal order and the California prices. And so what we would see as fair would be alignment with those federal order prices.

MR. EASTMAN: Okay. And what would that alignment be, though?

MS. McBRIDE: For our prices to increase at that level.

MR. EASTMAN: Okay. So does that mean that you would feel the California minimum prices would be the same as federal order prices?

MS. McBRIDE: Ideally, yes.

MR. EASTMAN: Okay.

MR. MASUHARA: On the first page of your testimony, Lynne, you make a statement that you believe that the steep decline in the number of dairies in California is largely due to the fact that dairy producers in our state are paid significantly less than dairy producers in the federal milk marketing orders. Have you done any analysis to make those comparisons and seen on a comparable basis, is that a true statement? Has there been an exit in other federal milk marketing orders of the same magnitude or on a percentage basis compared to their overall industry in terms of size, number of cows, milk production? Has CDC done that type of an analysis?

MS. McBRIDE: Yeah, we definitely monitor what's occurred in other states, certainly, and I know there has been declines. For example, Wisconsin and other states. But if you look at their mailbox price, it's the second-highest in the country, indicates that they have better prices than here in California. And in terms of the statement that we think it's largely the reason for the steep drop. I mean, again, looking at the difference between our price and the federal order price over the period of time that I mentioned, since January 2009, an over $800,000 difference. I think many of the dairies that we represent that we have seen go out of business and continue to struggle see that figure and realize that if that had been income that they were able to have, their situation financially would be a lot different than it is today. And certainly the dairies that have exited have indicated that that certainly would have enabled them to continue longer than they did.

MR. MASUHARA: So in your monitoring that situation and you're saying that you guys have actually come up with some results of other FMMO areas of exiting dairies, say, over the last five years. Can you quantify that to see how many dairies in, say, the Pacific Northwest or the Upper Midwest order that left?

MS. McBRIDE: Well basically we looked at --

MR. MASUHARA: And for a comparable period that we're talking about in California.

MS. McBRIDE: Yeah, the numbers and the costs in those states compared to the numbers and the costs in California. And again, it's well-known both here and across the country, working with dairy organizations in other states, that our prices here are, you know, they're they second-lowest of any mailbox price in the nation. But I would be happy to submit more specific information about what we've understood that has occurred in other regions of the country in a post-hearing brief.

MR. MASUHARA: Yeah, I'd be curious to know how many dairies in a comparable period that you make comparison here of exited in those orders that have, what you have characterized as, a better pricing structure.

MS. McBRIDE: We'd be happy to do that.

MR. MASUHARA: Okay. And then also on page five you reference the letter from the Dairy Institute to CDFA. I am not aware that Dairy Institute sent CDFA a letter on July 8th about the contents of the petition; my understanding is that was a letter that circulated to a legislator but not CDFA. Do you have another letter that you could submit to us?

MS. McBRIDE: You're correct, it was submitted to Assembly Member Pan on July 8th. So that's the letter that I'm mentioning.

MR. MASUHARA: That's the one you're referencing.

MS. McBRIDE: It's incorrect, my statement there.

MR. MASUHARA: Okay, thank you.

MS. GATES: Just one quick question. You kind of reference going back and forth between the overbase price, the blend price and the mailbox prices. So I am trying to figure out what do you see as a true reflection of what dairy producers receive?

MS. McBRIDE: Well, I think we need to look at all those indicators to get information about the situation that dairy producers are facing. I would say an important indicator that we look at probably most closely would be the mailbox price, but the minimum price pays such a critical role in that we look at those closely as well. So I wouldn't -- I wouldn't necessarily pick one or the other, I think they are all important indicators.

MS. GATES: Okay, thank you.

HEARING OFFICER SUTHER: Thank you, Ms. McBride.

I would like to now call the representative from Western United Dairymen.

Would you please state your full name and spell your last name.

MR. BARCELLOS: Yes. Tom Barcellos, B-A-R-C-E-L-L-O-S.

Whereupon,

TOM BARCELLOS

Was duly sworn.

HEARING OFFICER SUTHER: Would you like this written statement entered in as an exhibit?

MR. BARCELLOS: Yes, please.

HEARING OFFICER SUTHER: It will be exhibit number 48.

(Exhibit 48 was entered into the record.)

HEARING OFFICER SUTHER: And your testimony is as an individual or as a organization?

MR. BARCELLOS: I am testifying in my capacity as President of Western United Dairymen.

HEARING OFFICER SUTHER: Thank you. You may proceed.

MR. BARCELLOS: My name is Tom Barcellos. I am the President of Western United Dairymen. Our association is the largest dairy producer trade association in California, representing approximately 900 of the state's dairy families. We are a grassroots organization headquartered in Modesto, California. An elected board of directors governs our policy. The board of directors approved the position I will present here today at the July 19, 2013 board meeting.

We would like to thank Secretary Ross for the call of this hearing on our petition. Western United advocates for price relief at the last two emergency hearings held on December 20th, 2012 and May 20th, 2013 and continued to believe that price relief is necessary. Dairy families in the state have struggled in 2012, especially in the second half of the year. 2013 certainly has not been easier, with months of milk prices remaining under the cost of production. While we appreciate the Secretary's goal of finding a long-term solution with the implementation of the Dairy Futures Task Force, we need dairy families to make it through these difficult financial times.

Beyond emergency price relief is the need to fix the whey portion of the Class 4b formula. Producer groups have advocated for the last few years that the Department needs to modify the Class 4b formula to better track the whey value generated in the Federal Order Class III formula and the market price for cheese. The Class 4b formula was slightly modified over recent years, but we still believe it falls far short of generating a fair value from whey.

To expand on both of those issues, WUD respectfully submits a proposal to consider amendments to the Stabilization and Marketing Plans for the Northern and Southern California Marketing Areas. Specifically, WUD proposes a temporary price increase on the Class 4b formula; for Class 4b milk solids-not-fat, $0.0528 per pound. The appropriate changes to the Plan are presented in Appendix A. The second request for change is to increase the current whey scale's cap from $0.75 to $1 per cwt.

Background on this:

Arriving at this position was a lengthy process that did not begin with this petition. With the whey factor implemented on December 1st, 2007, it was only a matter of time before prices would fall significantly out of alignment with federal order pricing and the market price for cheese. The issue became particularly apparent in 2011 as the value of dry whey started to rise. The producer community, concerned with the inequity, overwhelmingly supported change.

Agreeing the issue should be revisited, the Department called for a hearing on June 30th, 2011. Support from dairy producer organizations and cooperatives was unparalleled. All sought changes that would bring the California 4b price in closer alignment with the federal order price and the market price for cheese. Western United specifically submitted an alternative proposal requesting changes that would have allowed the whey value in California to track very closely with the whey value generated by the federal Class III price formula. As a result of the hearing, the Department decided to implement changes, eliminating the fixed whey factor and replacing it with a sliding scale.

The changes resulting from the June 30, 2011 hearing were implemented on September 1st of 2011 and were a slight improvement for producers; the whey value was now allowed to fluctuate. However, while WUD appreciated the modifications, it still fell far short of a fair method to determine the whey value in the Class 4b formula. Hence, WUD submitted a petition to the Department on December 2nd, 2011. In that petition, WUD proposed modifying the current sliding scale in the Class 4b formula to allow the whey factor to more closely reflect the whey value generated by the current Class III formula and the market value. At that time, the difference between California's whey value and the federal orders since the new sliding scale's implementation averaged a staggering $1.75 per cwt. California dairy families clearly needed a better way to capture whey value. Unfortunately, the Department decided not to act on the matter and denied the hearing request.

After the Department's denial, the issue remained and producer discontent intensified. Our board discussed asking for reconsideration or immediately filing another petition. We stressed the imperative of resolving the issue sooner rather than later. Our Board was not going to give up on lost producer revenue and decided to petition again. Industry-wide support on the producer side was evident. Lengthy discussions took place and producer groups agreed on the requested changes that were argued for at the May 31st-June 1st, 2012 hearing. The Secretary agreed to raise the top end of the whey scale by an unfortunately very small $0.10.

Following ever increasing producer discontent, WUD decided to petition the Department again in August of 2012. The objective, once again, was the hearing that whey value on the 4b formula more in line with the whey value generated in the Class III formula and the market price for cheese. That petition also included a dry whey credit concept. The Department denied that petition on the grounds that the Secretary lacks the authority to implement such a credit.

This moved Dr. Pan to introduce a bill in the California Legislature in December of 2012. The producer community has rallied behind this bill and fought for its passage since. The price relief needed from a fair adjustment to the Class 4b formula is crucial to the producer community. While we appreciate the Secretary's willingness to act by calling this emergency hearing, we continue to believe relief needs to come from the significant discrepancy that exists in the pricing of whey in the Class 4b formula. In short, the inflexibility of the Panel to recommend bringing pricing of whey in closer alignment with Federal Orders and the market price has been a source of frustration for the producer community since producer prices were disconnected from the market by CDFA in 2007.

Not only does the producer side of the industry believes a change is warranted, but the processor side also agrees. After many disagreements over potential legislation, the proposed changes in our petition were agreed upon by the processor side of the industry as being reasonable. The agreement is outlined in the attachment letter from Joe Lang, representing the Dairy Institute of California. See Appendix B.

The need for emergency price relief is real.

Given current conditions in the industry, the years ahead will undeniably be more challenging for California dairy families. Economic and regulatory pressures are escalating in the state. Current and proposed environmental regulations have led and will continue to lead to additional costs, something farmers in other states do not have to deal with. Aside from this regulatory burden, costs of production on the dairy have increased significantly. The Secretary, with the appointment of the task force, understands the challenges ahead and the need for a long-term solution. In the meantime, dairy producers are facing tough economic times. If producers are to make it through these difficult times, price relief is needed.

To understand why dairy families are in such a precarious situation, a little historical perspective is helpful. As everyone well remembers, producer milk prices fell significantly through most of 2009, posting an overbase price of $9.60 per hundredweight in July of 2009. For the second half of 2009, prices slowly increased, but by the beginning of 2010, prices dropped again to the $12-$13 range. With a statewide average cost of production of $15.02 per hundredweight for the first quarter of 2010, the financial situation for the dairy producers was unbearable. Prices eventually showed some signs of improvement and the overbase made it all the way to $15.94 per hundredweight in October. With the statewide average cost of production at

$15.13 per hundredweight at the time, some producers were likely experiencing positive margins again.

While milk prices were improving, the cost of production was also increasing. Improving dairy prices is good news, but it will take prolonged periods of improved margins for a dairy producer to recover the immense losses and eroded equity that arose from the economic disaster of 2009 through 2010. Revenues per cow in 2010 did not come close to the losses per cow incurred in 2008 through 2009. And 2011 was an improvement but 2012 has proved to be financially challenging for a lot of dairymen. After all the aforementioned losses, another downturn proved unbearable for many.

According to CDFA data, 105 dairies went out of business in 2012 alone. Just in our association membership, 16 additional dairy sellouts have occurred since the beginning of 2013. In addition to these disturbing figures, reports of family dairies having filed for bankruptcy in the last 12 months are abundant. Conversations with a few dairy producers seeking bankruptcy protection revealed that attorneys have had a hard time keeping up with the dairy demand.

As environmental regulations related to California dairies have multiplied, Western United Dairymen has worked very closely with USDA and NRCS on strategies to conserve and protect California's air and water qualities. We have written and administered many grants in advance of this noble work. The number of USDA/EQIP contracts cancelled in this state is striking evidence of the impact dairies going out of business have. The values of cancelled contracts per year for are staggering, over $2,700,000, $2,500,000, $1,700,000, $650,000 for 2009 through 2012, respectively. These cost share cancellations are grim environmental consequences of the Department's decision to disconnect the farmer's milk price from the marketplace in 2007. The number of dairy families in distress is not surprising if you take a look at financial data compiled by the accounting firm Frazer. According to their latest available data, which is 2012, dairies in Southern California, the San Joaquin Valley and Kern County have lost a significant amount of money with average net incomes of -$3.41/cwt, -$2.87/cwt and -$2.83/cwt, respectively. Those numbers were not available at the last hearing, and those alone should strike the Department as clear evidence dairies are financially struggling and orderly marketing of milk on the producer side is not happening.

If the Frazer numbers are not sufficient enough, a comparison of California overbase price to the average cost of production in California since 2001 reveals the challenge faced by producers. Production cots were on a steady upward trend until the beginning of 2009. The difference between the cost of production and overbase prices in 2009 is striking evidence of the catastrophe that occurred for California dairy families. See Table 1. The years following 2009 were unfortunately plagued by more volatility and negative margins. It is hard to imagine how dairy producers were able to recoup these staggering financial losses.

A disturbing fact about this picture is the trend that stands out. Clearly, margins have been deteriorating.

According to CDFA data, feed cots rose from just over 51 percent of the total cost of production in 2003 to 60 percent of the total cost by the third quarter of 2008. Feed costs dropped to an average of 56.5 percent of the cost of production for the second quarter of 2010; which was lower but still historically high. The slow decline in feed costs were short lived; since fall of 2010, feed prices have skyrocketed and reached a record high in the third quarter of 2012 at $12.09/cwt. This caused a record high cost of production of $19.94/cwt. These records were soon broken with the fourth quarter of 2012 data, with feed costs at $12.24 and cost of production above $20. Figure 2 shows the dramatic increase in feed costs experienced at the dairy.

While feed costs appear to have softened some for the first quarter of 2013, they still represent nearly 67 percent of the total cost of production, the highest percentage on record. And despite the small drop, one can clearly see by looking at Figure 2 that they remain clearly above historical norms.

The significant declines in overbase prices combined with fairly steady record high feed prices struck California dairy families in ways no one could see coming. The drought that plagued most of the US during summer of 2012, created a never-before-seen feed price escalation, it is an unusual situation. While the latest USDA World Ag Supply and Demand Estimate Report came out somewhat bearish for corn prices, the forecasted range is $4.50 to $5.30 per bushel for the 2013/14 season, we have to keep in mind that this is an estimate. After three straight adverse growing seasons we are not out of the woods. And even if that range looks good compared to last year's prices, compared to historical averages, it is still representative of expensive grain.

We review the cost of production information because the Department must take it into account: "In establishing the price, the director shall take into consideration any relevant economic factors, including but not limited to, the following: (a) the reasonableness and economic soundness of market milk for all classes, giving consideration to the combined income from those class prices, in relation to the cost of producing and marketing milk for all purposes, including manufacturing purposes. In determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment."

At previous hearings we have testified that milk production is not necessarily a measure of the industry's health and that base programs have been put in place in the state to take care of potential plant capacity issues. Keeping a lower milk price in our state, we argued, would only contribute to the financial plight of dairy producers. This is exactly what happened. Unfortunately, looking at past hearing decisions, the Department does not seem overly concerned with the losses of dairy farms in the state of California so long as processors can procure enough milk. Looking at the Dairy Marketing Branch legislative charge, "It is the policy of the state to promote, foster and encourage the intelligent production and orderly marketing of milk necessary to its citizens in relation to demand" one could conclude milk production in the state is currently growing. After all, the population of California is not shrinking. However, a look at milk production data shows a completely different story. In fact, milk production in California has been declining for over a year now. Indeed, year-over-year production has been experiencing negative growth since 2012. July 2013 milk production, the latest month of data available, was the lowest July production since July 2009. And Figure 4 illustrates the trend.

Comparing the milk production trend experienced in California with that experienced in other parts of the country shows disturbing results. More specifically, comparing the milk production in California to that of Wisconsin, where the Federal Order Class III price is in effect and the farmer's milk price is connected to the market, is striking. While milk production in the number one dairy state has been declining, the number two dairy state's production has been thriving.

The temporary increase proposed for Class 4b is to get to what the producer side of the industry has been advocating for almost three years; a more fair pool value from cheese making revenues.

The change resulting from the May 31st-June 1st, 2012 hearing and implemented on August 1st of 2012 were a minimal improvement for producers: the whey value was now allowed to reach $0.75 instead of the previous $0.65. However, while WUD appreciated the modification, we believe it still fell far short of a fair value for whey in the Class 4b formula. While we understand the Secretary believes the dry whey issue shouldn't be the only factor to look at when providing price relief, WUD continues to believe that the whey factor should more closely reflect the whey value generated by the current Class III formula and the market price for cheese. The difference between California's whey value and the federal orders in 2012 averaged a staggering $1.69/cwt. California dairy families clearly need a better means to capture whey value.

We stressed the imperative of resolving this issue sooner rather than later and impressed upon the Secretary that waiting would not work. Our board was not going to give up on lost producer revenues and as you are aware decided to support legislation to fix that issue. In the meantime, we propose two separate changes as mentioned above. Those changes were agreed upon by the processor side of the industry as being reasonable. The agreement is outlined in the attached letter from Joe Lang, representing the Dairy Institute of California. Also in Appendix B. The impact of our proposed change would result in approximately a $0.35 increase in the overbase price.

While this is not enough to recoup the immense losses incurred in the recent past, it will not only help bridge the gap between cost of production and milk revenues; it will provide a much-needed closer relationship between Class III and Class 4b prices. We would rather have asked for a lot more than this, but rarely does the processor and producer side of the industry come to an agreement. If processors feel it is a viable alternative, we hope the Secretary will realize this is a workable and reasonable solution to the financial plight of dairy families.

When looking at 2012 data, the Federal Class III price has averaged $1.91/cwt higher than 4b. The deviation between Class III and 4b prices were caused by several factors. Notably, formula differences such as different price series, CME versus NASS, make allowances, yield and formula construct all contribute to the divergence. But the whey value is what creates the most variance between the two class prices and it is a significant concern to the members of WUD. According to our analysis, since April 2007, over 80 percent of the difference between Class 4b and Class III was attributed to the whey value.

More specifically, the average difference between the whey value in Class III and Class 4b since the beginning of the year has been $1.65/cwt. With whey values that follow market involvements in Class III and a sliding scale value in Class 4b capped at $0.75/cwt, such a discrepancy is not surprising.

The concept of pooling was created to allow sharing of revenues among producers. This is what allowed producers shipping to different plants to get the same price for the same commodity, regardless of where they ship their milk. In any given month, depending on where class prices settle, some plants need to pay more into the pool than the average overbase price, whereas some other months they have to pay less. To give an example, the first month of 2012, a producer shipping to a cheese plant got an overbase price of $15.55. The cheese plant had to contribute $13.42 to the pool. Without the pool, the plant would have been required to pay the producer at least the minimum price of $13.42/ cwt. In 2012, the 4b price was lower than the overbase price in seven months. By not including a fair whey value in the Class 4b formula, Class 4b plants are not sharing into the pool like other classes are. Producers shipping to the cheese plants benefit from higher blended prices from Class 1, 2, 3 and 4a when the Class 4b price is lower than the overbase, but the Class 4b plant does not share in the full value of what it produces into the pool. In 2013, the overbase price has been higher than the Class 4b price every single month, it is the cheese processors -- it is time the cheese processors start sharing a fair value with the pool.

As mentioned above, margins at the dairy are still very fragile. The memory of the 2009 dairy crisis is still fresh in the producers' minds. Waiting for good times does not suffice. Volatility has been a buzzword in the last few years for a reason: it is here to stay. As you know, dairymen have no way of passing along added costs. To avoid a repeat of the economic catastrophe, many producers have turned to risk management tools to protect their operations. More specifically, hedging has become an increasing part of dairy operation management.

Hedging allows parties to secure prices months in advance. But it's not as simple as that. The effectiveness of hedging relies on many things, but especially on the relationship between the futures prices and cash prices.

The futures contract most commonly used by California dairymen is tied to Class III. The differences between futures and cash prices is called the basis. A hedge will never be perfect due to changes on the basis, which can be negative or positive. But over time, with similar formulas, dairymen can assess their basis risk more effectively. As illustrated earlier, the spread between Class III and our milk price has gotten much larger due to the higher whey values being reflected in Class III and the market, but not in the California milk price. Effectively, the issue of lower milk prices in California is exacerbated by the fact that the fixed whey factor in the California formula makes Class III futures contracts a less-effective hedge than it otherwise would be. As a result, the very insurance dairymen attempt to buy to insure some operating margin, does not perform as they expected nor intended. Ironically, cheesemakers can use such a tool but the farmers cannot since the farmer's price was disconnected from the market by CDFA in 2007.

The unpredictability of the spread, due to the completely different structure of the whey value, makes it riskier for dairymen to hedge by preventing them from being able to determine their basis effectively. Looking back at historical relationships between prices received at the dairy and Class III, which is how one can determine the basis, is certainly not a good predictor of basis because of this disparity.

If the crisis is fresh in a dairymen's minds, it is not very far from the lenders' minds either. Risk management tools could be very useful for dairymen to show strong business plans to their bankers, reassuring them of less volatile margins. Lending standards have tightened and banks like to know where the borrower's bottom line would be. With all the dairy families being forced out of business, it is becoming less and less of an option.

Even processors recognize the importance of these tools and want producers to be able to use them effectively. Adjusting the whey factor to allow fluctuation with market prices would better enable California dairymen to utilize these risk management tools.

The Secretary has the legal authority to implement a temporary price increase according to the following additional code sections.

Section 61805, especially paragraphs b) and d), give the Secretary authority to determine minimum prices to be paid to producers by handlers for market milk, which is necessary due to varying factors of costs of production, health regulations, transportation and other factors in the marketing areas of the state.

And I will dispense with reading the code section.

Without a price increase, as outlined previously, the milk production in the state is jeopardized. According to Section 61802, it is the policy of the state to foster intelligent milk production, therefore a price increase is not only recommended, it is warranted.

And again I'll dispense with the reading of that section.

This concludes our testimony. The members of Western United Dairymen thank CDFA staff for their effort in preparing for this hearing. And I would be pleased to answer any questions if possible and would like to ask for a post-hearing brief.

HEARING OFFICER SUTHER: Mr. Barcellos, your request for a post-hearing brief is granted.

MR. EASTMAN: I do have a couple of questions for you, Tom. On about page three or four you kind of mention some cost of production figures by the firm of Frazer LLP. I was wondering, I don't see any information other than that citation. Is it possible in your post-hearing brief to submit an idea of kind of how those numbers were arrived at or what type of dairies in those areas would have been included in that survey that came up with that number? Just some an additional information to get a sense of the makeup of that number.

MR. BARCELLOS: Absolutely, I'd be happy to do that. And also let me say that this testimony was supposed to be presented by Annie. Of course, prior to this hearing date being set she had a previous commitment to deliver a little girl three days ago.

MR. EASTMAN: That's right.

MR. BARCELLOS: A healthy baby girl.

MR. EASTMAN: So you're putting the blame on her then.

MR. BARCELLOS: Absolutely.

(Laughter.)

MR. EASTMAN: That's understandable. Well, I have a couple of other questions. If you are not able to answer those, obviously, we'll throw those in the post-hearing brief as well.

MR. BARCELLOS: Yeah.

MR. EASTMAN: The second thing, the second question I had is a question that I also asked of the CDI witness. And that is, on that same sort of page you mention

-- you have Table 1 that shows dairy production margins or margins of dairy producers, which show the cost of production base on, I believe, the CDFA cost of production survey and then you use the overbase price. And I'm curious. Over time sometimes different entities will use different price series as a representative measure of income. And so I'm curious if the overbase price was chosen for a particular reason over others, if it has a certain significance? Why that was chosen?

MR. BARCELLOS: I'll have to defer that also to Annie for post-hearing.

MR. EASTMAN: Sure. And then the other question I had is in your testimony you cite in various locations where you are making citations to the California Food and Ag Code that stipulates the different relevant economic factors that the Secretary of the Department would consider when making milk pricing decisions. And you listed a number of things like milk production or combined income from the various classes, cost of production, things of that nature. I assume that later on in this hearing when some witnesses from processor organizations get up they'll probably mention other relevant economic factors, things like product prices or yields or manufacturing cost allowances, things of that nature. Do you have a sense of which factors you believe would be the most pertinent at this time? Do you feel that the Secretary should heed certain relevant economic factors with more weight than others?

MR. BARCELLOS: Well, I believe that the system that is in place is what built this industry. And all of the aligning prices are somewhat similar, surrounding areas, with the exception of the whey factor. And, you know, all factors are to be considered but also not limiting to -- you know, the Secretary has broad discretion, you know, as has been pointed out before and will continue to be pointed out. The call of the hearing is broad and I think all things need to be considered. But as to the weight of each consideration, you know, I can't speculate.

MR. EASTMAN: Got you. And then the other question I had was, in terms of the price impact of the co-petitioners' proposal, do you think that that impact will have a significant effect on dairy producers where that will turn the tide or allow them to function with some sort of stability going into the future?

MR. BARCELLOS: I believe stability is a key word. Yes, it would give stability. Right now there is none.

MR. EASTMAN: Okay.

MR. MASUHARA: I have a question, Tom. You mentioned several times in your testimony referencing 2007 when CDFA disconnected the price from the marketplace. Is that in specific reference to the action that was taken on the fixed whey factor that moved into the sliding scale.

MR. BARCELLOS: That is correct.

MR. MASUHARA: Okay. And so when you say "disconnected from the marketplace" what specifically are you referring to? Are you talking about the marketplace in California for dry whey?

MR. BARCELLOS: Yes.

MR. MASUHARA: Okay. Thank you.

HEARING OFFICER SUTHER: With no further questions, thank you, Mr. Barcellos.

MR. BARCELLOS: Thank you.

HEARING OFFICER SUTHER: We are again going to deviate a little bit from our normal script. Assembly Member Pan.

ASSEMBLY MEMBER PAN: Thank you.

HEARING OFFICER SUTHER: Thank you. Assembly Member Pan, could you please state your full name and spell your last name for the record, please.

ASSEMBLY MEMBER PAN: Sure. Dr. Richard Pan, P-A-N, Assembly Member 9th District.

Whereupon,

RICHARD PAN, MD

Was duly sworn.

ASSEMBLY MEMBER PAN: Thank you so very much for allowing me to speak to you today.

There is a crisis in California agriculture and it is not just an immediate crisis but also a long-term crisis. We are at a crossroads and must make decisions quickly if the historic California family dairy industry is to survive.

I know you have been spending this morning looking at the numbers and I think they speak for themselves. And I know many others have been talking about the loss column statewide but I want to say that when I drive through my own district it is not unusual to see an empty family dairy that is now out of -- out of production. The economic conditions for family dairies warrant the Legislature and the Secretary working together to guarantee short-term relief by providing a fair price for milk and long-term sustainability developed through a stakeholder task force.

The answer is certainly not a handout. The answer begins with an agreed $110 million of new money being paid by processors to producers and the appropriate calculation for the price of whey so that California dairies can earn a fair and competitive price for the milk that they produce.

The answer includes the California Dairy Futures Task Force, which will hold mandated workshops and solicit timely input from the dairy industry and related businesses. The California Dairy Futures Task Force will make real recommendations to the Legislature and the Secretary of Agriculture in 2014 that must lead to long-term sustainability of the industry.

Now as a physician I remember the long hours of medical training, and I have learned that the long hours of dairy farmers are also constant. I too -- I have visited a dairy farm in my district at 4:30 in the morning, a farm that has been in the family for generations as not only a labor of love but a constant source of labor. The cows, unfortunately, don't wait for a political compromise. Unfortunately, the reward for working 365 days a year in rain or shine, a recent recession, skyrocketing feed prices and an outdated milk pricing system puts our California family dairies at a competitive disadvantage to other states.

I have authorized legislation this year which would have empowered the Secretary to stabilize the dairy cost structure that allows companies making cheese to pay our dairy farmers much less than is paid in other states. My legislation prompted stakeholders from both sides to forge a reasonable compromise as we move forward. And now I'm asking the Secretary to use that compromise as a starting point for finding solutions.

Let me be clear, the idea of doing nothing is not an option. The setting of this hearing delayed legislative response but we will not remain silent; the Legislature will not be complacent. I look forward to working with the

Secretary and my colleagues in the Legislature as we put together a reasonable plan to guarantee both the long-term success of producers and processors in California.

If you have any questions I invite you to call me or my staff at any time. Thank you.

HEARING OFFICER SUTHER: Thank you, Assembly Member Pan.

ASSEMBLY MEMBER PAN: Thank you.

HEARING OFFICER SUTHER: We will now take a short, ten minute recess.

(Off the record at 10:19 a.m.)

(On the record at 10:29 a.m.)

HEARING OFFICER SUTHER: May I have your attention. We would now like to go back on the record.

And again we will be calling witnesses that have signed up for up to 20 minutes and the first witness will be Mr. Barcellos.

Mr. Barcellos, will you again state your full name and spell your last name for the record, please.

MR. BARCELLOS: Tom Barcellos, B-A-R-C-E-L-L-O-S.

HEARING OFFICER SUTHER: And are you testifying --

MR. BARCELLOS: I'm still under oath.

HEARING OFFICER SUTHER: Still under oath, yes.

And are you testifying individually?

MR. BARCELLOS: I am testifying individually.

HEARING OFFICER SUTHER: Okay. These written statements, would you like them marked as an exhibit?

MR. BARCELLOS: Please. And the attachment that I gave you with the flyers that will be referred to in my testimony.

HEARING OFFICER SUTHER: Thank you. That will be Exhibit number 49.

(Exhibit 49 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. BARCELLOS: Mr. Hearing Officer and Panel, thank you for the opportunity to testify today. I am Tom Barcellos, owner of T-Bar Dairy, an 800 cow dairy facility in Porterville, California. I also own Barcellos Farms, a diversified farming operation providing feed and services to local dairies. My testimony and supporting documents will not be technical in natures, but the documents will represent the position of the industry.

Reasons why changes are needed:

Cheese manufacturers in California are facing an economic crisis due to the detrimental effect of the current dry whey cost factor in the Class 4b milk pricing formula. Cheese manufacturers do not realize the full revenue that is attributed to them by the current 4b formulas and are incurring losses that threaten their financial viability. In order for California cheese manufacturers to continue production the whey cost factor should be removed from the Class 4b formula immediately.

The Department must act immediately and on an emergency basis to change the Class 4b milk formula to protect the long term viability of cheese manufacturers and the dairy farmers in the state of California.

This is taken directly from the petition submitted on August 14th, 2007 by F&A Cheese to then-Secretary Kawamura. At that time a hearing was called for due to the plight of the cheese processors. The testimony given at that time by all parties agreed that something needed to be done in various degrees and ultimately a determination was reached. That same urgency exists today. The difference is that it is the producer community that is no longer viable in its present state.

"Pursuant to Food and Ag Code Sections 62031 through 62079, the Secretary has broad discretion in deciding these issues. By custom and practice, the Secretary's decision is based on the hearing record and on the Panel Report to the Secretary of Food and Agriculture. The Secretary may adopt, deny, or alter the Panel's recommendations based upon the Secretary's independent assessment of the testimony and documentation entered into the record."

This is quoted from the Secretary's determination of that 2007 hearing which clearly states the Secretary's "broad Discretion" in providing solutions to protect the viability of the industry. It allows the Secretary the ability to assess independently the testimony presented.

Determinations.

"CDFA remains committed to the long-term viability of the producer, producer-cooperatives and the processor sectors of the California dairy industry and to the consumption of healthy dairy products by California consumers at reasonable prices. The Department invests considerable resources in conducting annual cost studies to use as a guide in determining reasonable dairy manufactured cost allowances."

This is also taken from the 2007 Determination and states some of the duties of CDFA and one aspect such as the "make allowance" used to protect the viability of the industry as a whole by providing funds for plant capacity. Now the Department has challenges to determine a proper manufacturing cost allowance due to the privatization of the cheese processors, but that in itself does not discharge the Department from establishing a reasonable cost allowance for those same processors. Should a whey manufacturing allowance calculation be included?

The viability of the dairy producers began to unravel following the determination in 2009 due largely to extremely low milk prices. The dairy producer did at that time what he has always done and that is to use equity to pay his bills and continue in business. This was business as usual as prices have always been cyclical and on the rebound side equity would be replenished. That did not occur due to the high feed costs brought on by the ethanol policy and the dairy equity no longer exists today, causing the collapse you have seen over the last several years and continue as we sit here today.

"The Department Cost Survey data and hearing record testimony provided significant evidence that amendments are necessary to the Class 4 formulas."

Again this is from the 2007 determination indicating changes going forward were needed. CDFA's own current cost study showed the losses suffered by the producers, yet the Department's commitment to the entire industry as stated earlier has failed miserably as the necessary amendments to whey factors and manufacturing allowances have been ignored.

In an analysis I requested from Ms. Annie AcMoody, a highly respected economist and former CDFA employee, the following was determined:

If the 2007 formula had stayed in place, the average cow would have generated in each of the following years: -$20.20 in 2009, a +$45.10 for '10, a +$117.02 for

'11 and a +$109.93 for 2012. In the first half of 2013, $52.95.

I doubt that any other reputable economist would have a different conclusion. The calculation would then conclude that dairy producers gave up $304.80 per cow in the whey factor alone from 2009 through June 30, 2013. A 500 cow herd gave the cheese processing sector $152,400 in concessions over that period of time. One 1100 cow dairy herd, selling at the end of this month, which has been operating in bankruptcy, would have had a chance to pay me and other creditors had they had the $335,280 due from previous true whey prices. So there goes 45 years of work for that dairyman and his family and 8 employees with families who are now looking for work. Let's not forget all the providers of supplies and products who lost their customer. That facility will be demolished, which is a crime as the freestall barns and manure handling system is as modern as many newer dairies.

The documents attached, the flyers which are in the record, from sales no different than the one I just described. You have heard testimony in previous hearings, and I expect other testimony at this one, about the millions of dollars that have been and continue to be tied up and/or lost in bankruptcy. You will see that no dairy is immune based on its size as the entire spectrum is covered from 250 cow herds to 6,000 cow herds. These are just a sample that cover over 50,000 cows and over 20,000 heifers. While many of these animals may have gone to other herds, keep in mind that they were for the most part replacing other lower producing cows which were sent to slaughter. These numbers also reflect the top end of the herds being sold as beef got sent off prior to the sale. They also do not reflect the loss of support industry businesses that have been forced to lay off employees, or in some cases, close completely.

And here are some additional conclusions from the 2007 Determination:

"The Secretary agrees and adopts the following Hearing Panel recommendation for amendment to the Stabilization Plans."

"Changing the 4a f.o.b. Adjuster for butter" won't cover the numbers.

"However, the Secretary modifies the Hearing Panel recommendations for amendment to the Stabilization Plans as follows:" And it goes on to some technical numbers there.

This, to me, clearly points out the Secretary's ability to make a decision based on current facts. The current fact is that whey is no longer a salvage product. It has been possible to process in some form since 1965 when Frank Thomas used membrane technology to isolate whey protein concentrate in Wisconsin. Current uses include sports nutrition drinks, protein shakes and many dietary supplements. It is no longer a salvage product and producers are entitled to receive a fair price for a component derived from their milk as they are compensated fairly for all other components of their milk. We gave the incentive and the money for processors to develop the product, yet we are condemned for wanting the value of that component.

Many processors have seen the value of whey in marketing whey protein concentrate or other forms and have done so with profits by not having to compensate producers. Others have not made the investment and treated it as wasted since there was no need to pay for it. Processors have had ample time using producer money to capture higher value uses for whey or finding companies who can convert perceived waste to profit. It is no longer the responsibility of the producer to carry the burden. The processor could and has found ways to capture value of whey and it is the producer who has paid the price for the market to develop. It is time the return comes back to stabilize the dairy producer community.

In closing, I submitted the evidence, the flyers that I spoke of, and please take time to review these and consider this. Most of these dairymen, as you see 15, 20 or 50 years of service and more, worked for another dairyman before going into business for himself. That means a lifetime of taking care of cows and grasping an opportunity. Hard work would yield rewards of your own business. Today they are broke, out of options and that hard work can't fix. Just the fact that you can fix this and have not done so have led some to suicide. That is real. And the following chart is very telling of the direction of the producer side of the industry. Please correct the inequity.

Respectfully, thank you.

MR. EASTMAN: I have a question. On the second or third page of your testimony you talk about some of the additional conclusions from the 2007 determinations from that hearing held that summer. And it lists a number of modifications, things like make allowance changes, f.o.b. adjuster changes, things of that nature. And you state that you believe that the Secretary does have the ability to make changes based on current facts. At that time there was data that was transparent and releasable. Some of the data used to make some of those decisions are now proprietary in nature and no longer releasable to the public, so to speak. Do you think the Secretary still has the ability to make certain changes to the formulas, the pricing decisions, even if some of the data that has historically been used for such decisions is no longer public or publishable?

MR. BARCELLOS: I believe so because I don't believe that that data is unavailable. I think it would be available. I believe the Department has the right to collect that data, even though they cannot make it public. And if there is not data out there, there are people who are able to conclude within a fraction an educated guess. And I believe that that's something that needs to be considered.

MR. EASTMAN: So in essence you would believe that the Secretary would have the discretion to make some calls, so to speak, to make adjustments if such data were limited or not available?

MR. BARCELLOS: I believe it's clearly stated that the Secretary has broad discretion and it has been proven that the Secretary has also made decisions outside of hearing record. And again, I believe there is data available that the Department would have access to that could be used in consideration that would have to be held privately.

MR. EASTMAN: So in essence you would be okay with the Secretary making decisions with data that is not publishable or apparent to the industry as a whole. That she could use whatever data available to make such decisions then.

MR. BARCELLOS: I believe it is her responsibility and duty.

HEARING OFFICER SUTHER: No further questions, thank you for your testimony, Mr. Barcellos.

MR. BARCELLOS: Thank you.

HEARING OFFICER SUTHER: Dr. Sexton. Dr. Sexton, could you say your first name and last name and spell your last name.

DR. SEXTON: Richard Sexton, S-E-X-T-O-N.

Whereupon,

RICHARD SEXTON

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements or other things you would like for the record at this time?

DR. SEXTON: I don't have a written statement. I have a video presentation, if I have your permission to present it.

HEARING OFFICER SUTHER: Yes, you have my permission.

DR. SEXTON: I am a professor and the Department Chair in the Department of Agricultural & Resource Economics at UC Davis. I was requested by Western United Dairymen to take an independent look at the situation with our California dairy today and to -- specifically with respect to the petition that is before you now.

A lot of the previous testimony has pertained to fairness of the pricing situation and so forth and I want to focus my testimony more, if I can, on the economic implications of the current situation.

I am trying to make this go full screen but I really can't read it sufficiently well to do it.

MR. EASTMAN: I think you're in the right toolbar. Go down a little bit further. One more. One more. Try that one.

DR. SEXTON: Perfect, thank you.

MR. EASTMAN: Young eyes, younger eyes.

(Laughter.)

DR. SEXTON: I knew I was there, it was just trying to find the right, the right row.

So let me begin with -- let me begin with just a bit of background. And certainly there has been testimony to this effect already.

But when I began looking at this I saw that the action that the Secretary took at the end of 2007 really disconnected our California prices from the marketplace. So we replaced a whey value allowance that tracked the market value fairly closely with this flat $0.25 allowance.

The subsequent change made in 2011 to introduce the sliding $0.25 to $0.75 scale helped somewhat but certainly didn't solve the problem.

We're dealing with a situation where the 4b milk, the cheese milk is 43 percent of the milk production now and so the pricing disparities caused by failing to value the whey at a market value are large and creating some considerable distortions that I'll talk about.

I'd like to just introduce a few of what I see as the implications of the current situation and then I have a few slides that I will, that I will present that will document some of this. And I apologize to the Committee for not having made written copies of the slides for you. And while I'm thinking about I would request permission to present at least the written slides to you all as a post-hearing brief.

HEARING OFFICER SUTHER: We will accept those.

DR. SEXTON: Thank you.

Certainly, as other testimony has indicated, one consequence is that now California is paid a considerably lower price than their peers in almost every other state. Those that are producing under the federal orders, the federal orders are a regulated pricing system but the prices are set based upon the market values of the products that are produced from the raw milk. And so even though it's a regulated price it is intended to approximate what a market price would be under competition. Of course, those operating outside the orders, it is a pure market price.

The low prices that California has had have been exacerbated by this run-up in feed costs that the testimony has pertained to as well. I want to make the additional point that it is -- the run-up in feed costs is, of course, affecting producers across the country but disproportionately affecting our California producers because most of our feed is imported. And that during the same period, all of it tied to ethanol and those relationships to the petroleum market, energy prices have risen dramatically, which of course is the main driver of transportation costs. So not only have the feed costs themselves increased but the cost of transporting it into California to the dairies has increased as well, so California dairies have been disproportionately impacted by the run-up in feed costs.

As Tom Barcellos indicated, a key consequence in terms of risk management, and I'll show you the slide on this momentarily, is that because our price is disconnected from the market it is basically impossible now to use the CME for our dairy farmers to hedge price risks and lock in prices because the basis is just too widely fluctuating.

Consequences. There are several ways to look at the consequences. People have talked about dairy farms exiting, which has certainly been a significant phenomenon and I'll show a slide on that in a moment.

The feature I want to emphasize here is that since this change was put into place through 2012, California has lost one percentage point of it's national market share. We are still, of course, by a long stretch the national market leader but we have lost one percentage point of our market share during this period.

And the evidence as I have seen it, and there has been testimony to this effect already this morning, is that the reduction in production and loss of our market share is probably accelerating as we are moving into 2013 and our share is going to be falling as we continue to move forward.

We have lost 300 dairy farms.

I think a very important point -- I think Mr. Barcellos' testimony to this was quite eloquent. If you are incurring losses you hang in there in the short run. It's the difference between the short run and the long run in economics. You endure those losses in the short run. But if they persist into the long run you go out of business. And I think that's the situation that we are facing unless something is done to improve the pricing situation for our California dairy farms, that the losses have been relatively unabated since the 2008-2009 period. There was a brief respite for one year but the losses have been persisting. And of course they can't be sustained and the rational decision eventually then is to go out of business. I think we are seeing that that's what a number of farms are facing increasingly.

I estimate that to date, based upon the loss of our dairy herd, not just loss of farms but I'm looking at it in terms of the reduction in the number of cows in our state, that we have lost about 15,000 California jobs. And most of these jobs have been lost in areas of high unemployment where we can little afford to lose jobs. These are areas where farming, and dairy in particular, is a key primary industry. So this 15,000 number that I am giving you is the direct, the primary impacts plus the secondary impacts on suppliers, the communities where these dairies are operating and so forth.

And the final implication I want to make before giving you some documentation of these effects is that we really have a distortion now. We have created a distortion in the mix of dairy products that we -- that we produce. We are subsidizing, basically, the production of one product, namely cheese, relative to all the other products that can be produced from raw milk. I think over time that distortion, unless it's rectified, will have increasingly negative consequences.

One observation I make in this regard is that -- is that even though we are subsidizing the cheese production, most of it is exported out of the state so that there is not a commensurate benefit to California because of our ability, you know, frankly, to produce cheese cheaply because the whey value is not reflected in the price that the cheese manufacturers are making.

Here is the graph that a number of other speakers have alluded to where up until 2008 -- so the whey value is the blue line and the value that is assigned to California is the red line. They track very, very closely up until about 2008. And then we see the decision by the Secretary to fix the whey value at $0.25.

And meanwhile, this is a reflection of the technology of dairy processing and even changing consumer preferences. Whey has become a very, very valuable product, as you can see from the blue line, but the value that the California farmer has gotten has been drastically below that. And even with the sliding $0.25 to $0.75 scale it hasn't really addressed that problem at all so the disparity remains to this day.

This slide plots the uniform price in Wisconsin, the gray line, and California, the red line, versus the Class III price, the federal Class III price, which is pegged off of the CME value for a cheese block. So this is a good representation of the basis as a farmer in California would see it versus a farmer in Wisconsin.

Again, the first thing to note is obviously the prices are much higher for all but one or two time periods on that slide in Wisconsin than in California. But then the dramatic feature, the feature to my point is that the basis is just wildly fluctuating. Why? Well, it's because the price that our California producers are receiving is not tied to the marketplace. And that, I submit to you, is a bad thing in many dimensions and this is just indicating that it's basically rendering that risk management tool inoperable now for our California farmers.

Here is really the essential slide, this is 2012 operating margins. Again, this just includes revenues and variable costs, it doesn't include the fixed costs of a dairy. And I plotted here for the ten largest dairy states. The top bar is Washington, which obviously is not doing well either but it's a very minor dairy state compared to California.

But as you can see for 2012, California dairy farms were earning -- this is USDA data, incidently. California dairy farms were earning substantially negative margins, whereas all of the other leading dairy states, save Washington, were earning positive margins. And notice the gap is -- we are not talking a few cents per hundredweight here, we're talking dollars per hundredweight. So not only is it indicating that, you know, for 2012 the situation for California dairies which is not sustainable, but the thing I see as an economist is, is the situation relatively?

And there was already testimony where about one

California dairy closing up shop and basically moving to the Northwest. We weren't told where in the Northwest. I'm guessing it's not Washington, it's probably Idaho based upon those, those bars. We are going to see, you know, we are going to continue to lose production and market share as a state relative to other states as long as this disparity remains in place. And it's a big disparity as these bars indicate.

Here is just the loss over time in the last several years of the California dairies. There has been testimony to that effect already so I won't dwell on it.

Here is the most recent data, which is plotting year-over-year percentage changes in production for California, the blue line, versus Wisconsin, the second largest producing state, the red line. And here you can see that just relative -- for about the past 12 or so months, just relative to the 12 months preceding this, our California production is down relatively dramatically, whereas the main competing state, Wisconsin, has had higher production relative to a year ago in every one of these months. And again, that's reflecting a situation that I think is going to become only more pronounced if there isn't some relief put into place.

Here is the chart that gives my calculations in the job losses that we had from the reduction in our

California dairy herds since 2008. I am basing this on the -- on the number of employment -- the amount of employment for California from the CMAB study that was done in 2008 so it's 440,000 jobs. And so I am just computing that on a jobs per cow basis; it works out to about a quarter of a job per dairy cow.

And again, this is employment not just on the farms but throughout the whole economy that is tied to dairy production, the primary impacts and what we call the secondary or multiplier impacts. So I can then go in and use that .24 factor, look at the decrease in the number of cows we have had in the state over these past several years and that's where I come up with the almost 15,000 jobs lost. That's through 2012. There has been testimony, of course, as to the number of farms going out of business in 2013 so those job losses will be tacked on to the 15,000 that I am estimating have occurred so far.

Just to reaffirm the point I made a little bit. These are the unemployment rates in some of our largest dairy states relative to the state average. And you can see those counties are well above the state's average unemployment rate in each instance. So not only are these job losses important, they're coming in parts of our state where we can ill afford to lose these jobs.

So in summing up, certainly the adjustment that has been proposed doesn't reconnect the state's milk pricing to the marketplace but it is a step in the right direction. I hope that the Panel that the Secretary is putting into place will look -- will look further at these issues and the need to reconnect California to the marketplace. Because I think unless and until that is done w are going to continue to have problems as a state in terms of the pricing for milk and the relationships between the California farms and the processing entities downstream.

So I do think implementing these changes will be helpful stemming the loss of dairies and the loss of employment associated with dairy production in the state.

And certainly the changes being implemented, in my view, will not unduly disadvantage the cheese plants. And certainly we're talking about transferring some revenue from the cheese plants to the -- to the farmers. But the change that is being requested is still going to undervalue the whey production relative to its market value. The compensation to the farmer, even under these adjustments, will be below the market value. So cheese producing plants in California should still have a cost advantage relative to their competitors in other states.

That concludes my testimony and I thank you.

MR. EASTMAN: I have a few questions for you, Dr.Sexton. Earlier in your testimony you mentioned that you didn't feel that -- what did I write here? I thought you stated that California's share of the market is being lost.

DR. SEXTON: Yes.

MR. EASTMAN: What do you mean by that? Which market are you referring to, specifically?

DR. SEXTON: Our market share of milk production nationally has fallen by one percentage point. I don't remember the exact, exact numbers but we went from -- I'll throw a hypothetical number out that's not exactly right, 21.9 to 20.9. That's my best recollection of what the -- what the loss in share over this period since 2008 has been. But it has been one percentage point in market share.

MR. EASTMAN: Gotcha. And then on the slide that you showed up you had a slide that showed dairy margins by the different states and it showed Washington and California in the negative and other states in the positive.

DR. SEXTON: Yes.

MR. EASTMAN: And that was based on UCDA data. Do you have any sense of, besides just the outcome of the data or the actual data point, any reasons or explanations about why you would expect, say, the state of Washington to have a negative margin?

DR. SEXTON: Candidly, I didn't look into what was going on in the state of Washington. I'd be happy to follow up on that and I will do so and I'll provide that in the post-hearing brief that I'll submit.

MR. EASTMAN: And then one of the recommendations you make, the last one there is you feel that California cheese plants wouldn't be disadvantaged by the petition that has been submitted by the co-petitioners. Is that just based on the idea that you believe that if that petition were implemented that there would still be sufficient margin there for cheese manufacturers thereafter in order to sell their market to, say, distant US domestic markets say on the East Coast?

DR. SEXTON: Well, right. One thing to bear in mind is that whereas, you know, raw milk is difficult and expensive to transport, as is feed because it's a very bulky product. You know, once we process milk into the form of cheese it becomes a much more compact product and much more readily transportable. So, you know, the advantage obviously of processing on-site and shipping the finished products across the country or across the world, literally, is that the processed products are much cheaper to ship.

My point was specifically with respect to the cost of the raw milk input for the -- for the cheese plants. It will continue even if this -- even if this petition is granted by the Secretary. California milk prices will continue to be low relative to prices in most of the rest of the country. So that as it pertains to that facet of the cheese plant's cost, they will have a comparative advantage. I can't speak to the cheese plant's costs for the other aspects of their processing operation because we don't, we don't have those data, as you well know.

MR. EASTMAN: Okay. So you just -- so in essence you believe that there would still be some sort of margin that would account for the transportation cost of shipping the cheese to the appropriate market where it's being sold.

DR. SEXTON: I do think that but, you know, we're -- I guess I would have to echo Mr. Barcellos' testimony in that respect. When I don't have the hard data in my hands, as I don't in this case, I have to make inferences based upon things I know professionally and so forth.

And as I said to you, cheese is not -- cheese transportation costs are going to be certainly less relative to heavier and bulkier products. Obviously there is a cooling or refrigeration element that, that plays into account here so the transportation costs are just one facet of the cheese plant's cost, you have labor costs and energy costs in their own right.

And so, you know, all we can do in those -- in those cases since we don't have the actual data is, you know, is ask ourselves, you know, should labor costs be higher for our plants than plants in other states? Should energy costs be higher and so forth? You know, there may be testimony to the contrary in the afternoon, but I don't see from where I'm sitting that there should be those significant kinds of cost disparities for other inputs into cheese production that would obviate the advantage that will still remain in terms of being able to acquire relatively cheaply.

MR. EASTMAN: Great. And then you mentioned that -- were you going to submit all the slides that you presented here today in your post-hearing brief?

DR. SEXTON: Yes, I will do that.

MR. EASTMAN: Okay.

MR. MASUHARA: Similar to Hyrum's question I had a question on if your study showed or did you examine whether or not some of this California cheese that you characterized as being subsidized or having an extreme cost advantage, has it displaced or cannibalized any of the domestic markets and displaced cheese production, say, from other states due to this cost advantage?

DR. SEXTON: Well, the share of -- the share of cheese production for California has remained pretty stable over this period. I think we're probably dealing with plant capacity limitations and the difficulties of siting new plants as a reason why the cheese share of California milk production hasn't, hasn't risen considerably.

I did not do a study of the cheese marketplace as part of preparation for this testimony, but the fact that California's cheese share has remained very stable, very near to the 43 percent it is now over this whole period, and California's milk production has declined as a share relative to other states, then I think we can safely conclude that it has not displaced cheese production from Wisconsin or any other state. The arithmetic doesn't add up so I would have to say that it is has not.

MR. MASUHARA: And my other question is, you mentioned the disconnect from the market back in '07 with that decision. Did the scope of your study look at specifically the dry whey market conditions in California over the last five years?

DR. SEXTON: I did not examine California versus the market broadly. I mean, it is a misnomer or a mistake to say that there is -- that there is a California market isolated from the rest of the market. Again, dry whey is going to be a product that is transportable and shippable, you know, across regions so that -- that the different regions, to put the term in economics parlance, the different regions are going to be integrated, they're going to be, they're going to be connected.

That's not to say that the value is exactly the same in -- of whey in California as it is in other states but those values are all going to be interconnected due to the ability to arbitrage across geographic regions so those prices are all going to be connected, so I was looking at the broader whey value nationally. But the California value, it may not be the same but there is not going to be a significant disconnect just due to that integration of the markets.

MR. MASUHARA: That's all I had.

HEARING OFFICER SUTHER: No further questions. Thank you for your testimony, Dr. Sexton.

DR. SEXTON: Thank you.

HEARING OFFICER SUTHER: I would now like to call up Mr. Dryer.

Mr. Dryer, will you please state your full name and spell your last name for the record, please.

MR. DRYER: My name is Greg Dryer, D-R-Y-E-R.

Whereupon,

GREG DRYER

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements or things you would like entered into the record at this time?

MR. DRYER: Yes, my testimony that I passed out.

HEARING OFFICER SUTHER: Okay. It will be Exhibit number 50.

(Exhibit 50 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. DRYER: Mr. Hearing Officer and Members of the Hearing Panel:

My name is Greg Dryer. I am Senior Vice President of Industry and Government Relations for Saputo Cheese USA Inc. Our company, Saputo, operates seven facilities in the state of California. We employ nearly 1,500 people here and purchase a substantial portion of the state's milk production both directly from farmers and from farmer cooperatives. We are very familiar with conditions in other regions from our experience with the 16 facilities that we operate in 10 other states.

I am here to testify in opposition to any further changes to California's regulated milk prices until a viable long-term alternative can be developed by the Department in cooperation with the Secretary's Dairy Future Task Force. We acknowledge that producers' economic challenges have been real and believe that a national policy that would provide them a margin insurance option is desirable. Simply shifting a problem from one interdependent constituency onto another is not a solution. In fact, the continual threat of such an outcome creates uncertainty which inhibits decision-making and therefore potential growth to the detriment of all industry participants. Regarding the petition, conditions that led to the request for emergency relief have been steadily improving and are projected to continue to improve. In the Department's "California Dairy Landscape" document from the most recent hearing, California mailbox prices for the first two months of 2013 were reported to be $2.41 per cwt higher than the previous year. Updating that number with available data through May 2013 reveals that it has further increased to $2.62 per cwt over the same period in 2012. The 4b price through August is $1.70 higher than last year. Production costs according to CDFA for Q1 2013 are $1.06 higher than Q1 last year but did decline by $0.86 from Q4 of 2012. Most of the cost increase occurred between Q2 and Q3 2012 when feed costs spiked. Following is a quote from the Michigan State Dairy Market Update for August 2013: "Dairy producer margins are much better than this time last year, 27.8 percent higher Income-Over-Feed-Cost, encouraging dairy producers across the country to increase milk output. This upward trend in milk output may gain even more steam this fall as feed prices in December, using the USDA formula, are forecasted to drop 16 percent, or $2.02/cwt of 16 percent protein dairy feed, as compared with December 2012." On balance, conditions have improved since the last hearing and will likely continue to improve.

Further alterations to the 4b whey factor cannot be justified given the scarcity of relevant California data and the inherent unfairness of such a factor given the myriad of practices employed across the industry. Whey processing requires huge scale to be economic. Enormous capital is required, and once a specific plant configuration is chosen, it faces the risk of technological obsolescence, fickle markets and potential adverse environmental and energy cost impacts.

Relatively few industry participants are in a position to make that investment and take that risk. Many cheese plants in California receive no value or incur a cost to dispose of their whey.

Why cheese milk prices in California are lower than in many other regions around the country.

California dairy farms are big. On average, they produce over 25 million pounds of milk a year, 10 times the size of an average Wisconsin dairy farm and 8 times the national average outside of California. Why are they so big? Logic would suggest that there must be a cost advantage arising from the economy of scale. While the information substantiating that conclusion is somewhat limited, USDA conducted a cost survey by size of operation on 2005 data, which was subsequently updated each year through 2009. In it, they pegged the cost advantage of a farm with over 1,000 cows at approximately $7.50 over a farm of 100 to 199 cows. in 2012, California farms average 1,080 cows while Wisconsin averaged 111. USDA also publishes estimated monthly and annual costs of milk production by state. In that report, from 2005 through 2012, California has an average cost advantage over Wisconsin of $4.73/cwt. Milk prices in the long run tend to maintain a relationship to the cost of production for that region. Supply and demand will respond eventually to prices that land too far one way or the other from that benchmark.

How California's Dairy industry grew.

In the past 20 years, California nearly doubled its milk production. Farm sizes, in terms of output, increased nearly fivefold. The extra production over that time vastly exceeded local demand for milk. In 1992, California produced 15.4 billion pounds above Class 1 needs and Class 1 utilization was 30.3 percent.

By 2012, the surplus over Class 1 ballooned by 136 percent to 36.3 billion pounds. Class 1 utilization fell to 13.1 percent. That impacted average milk prices. Most of the surplus found its way into cheese. Much of California's exploding growth came at the expense of the Upper Midwest. High volume, bulk commodity customers were attracted to the California highly efficient cost model and largely abandoned the Upper Midwest en masse. Wisconsin lost over 60 percent of its farms over the last 20 years and 34 percent over the last 10. Twenty years ago, 14 Wisconsin butter plants produced 29 million pounds more butter than the state of

California. By 2012, less than 3 have survived and no longer meet USDA's criteria for reporting. California. on the other hand, doubled its production and now supplies more than a third of the national total. In 1992, Wisconsin produced 285 million pounds more mozzarella than California. In 2012, California produced 354 million pounds more than Wisconsin. The Midwest industry, to survive, had no choice but to develop specialty products and to build a market for specialty cheese. That was the only option that could afford them to pay the higher milk prices required to sustain their higher cost milk production infrastructure. California, on the other hand, largely pursued mega, bulk commodity-oriented plants better suited to handle the volumes of milk generated by their mega dairy farms. California: big efficient farms, big efficient plants. Wisconsin: small, inefficient farms, small inefficient plants. Apples and oranges. These are generalities, of course, with no shortage of exceptions. On balance, however, the facts are the facts. California farms continue to grow. Average cow numbers per farm were up 5.8 percent from 2011 to 2012.

The real source of California producer economic challenges.

They are not the result of a failed pricing system. They are the result of skyrocketing feed prices that challenged dairy producers all over the world. If the problems were attributable to the California system, would Wisconsin have lost 610 farms last year? Or would California rank 30th among the 50 states in percentage reduction in average dairy farm numbers from 2011 to 2012? An important fact to consider is that California prices have not fallen relative to USDA prices. Instead, USDA prices have risen relative to California because of recent high dry whey commodity prices.

California milk production has been relatively steady.

Year to year variations are likely more weather than economic related, and current local supply and demand conditions are relatively in balance. 2013 production through July is actually the second-highest of the past six years.

A federal order state that is comparable to California.

New Mexico is a far western state with a significant, large herd dairy industry. It enjoys a much higher Class 1 utilization percentage than California, which helps bolster its milk price, but for 2013 through May, California's average mailbox price is $0.14/cwt higher than that of New Mexico. Over the last twelve years -- twelve-plus years, the two states have averaged within $0.03/cwt of one another.

If California cheese milk were underpriced, there would be a surge in cheese processing investment in the state.

Instead, several in-state cheese processors have recently chosen to locate new facilities in other states. Cooperatives have, for the most part, elected to abandon the cheese business in the state and there have been a number of failures and closures in the cheese business in recent years.

The long term pool impact of Class 4b pricing.

If you look at just the past three years and half of this year, Class 4a has contributed more to the pool than Class 4b. Over the last ten and a half years, however, Class 4b has actually contributed 17.5 cents more per cwt to the pool than Class 4a has.

The most recent 4b price increases have already made a major impact on the state's cheese manufacturers.

To illustrate the point, assume that a hypothetical cheesemaker earns a 5 percent net profit on $1.70 cheese. That is $0.085/lb of cheese. The whey factor increased by as much as $0.40/cwt in September in 2011 and another $0.10 in August 2012. That, coupled with the temporary relief of $0.30 that ran from February through May of this year, amounted to about $0.80/cwt of milk or

$0.008/lb of cheese.

By raising the milk price by $0.80/cwt, 94 percent of this hypothetical cheesemaker's profit has been eliminated. Even at the current $0.15 relief the number falls but still eliminates 76 percent. While you may argue about a few pennies one way or another, the recent price increases granted may not seem significant to dairy farmers, but they are definitely significant to the state's cheesemakers.

The "overbase price" is not a fair barometer of dairy farm profitability.

The oft quoted overbase price is the price for milk containing 3.5 percent butterfat and 8.7 percent solids-not-fat. It contains no measure of milk premiums paid nor the average value of quota held. In reality, California milk averaged 3.73 percent butterfat and 8.87 solids-not-fat in 2012. Mailbox milk prices reflect actual total receipts less marketing costs and assessments and typically average $0.60 to $0.80 above the overbase price.

The mailbox price is a more appropriate measure of milk's value when evaluating producer profitability.

The California 4b price did not always contain a whey factor.

There was no whey factor in California prior to April 2003. The USDA Class III has had a whey factor since the inception of component pricing in April 1999. For four years, the two systems operated independently with full knowledge of that difference and without controversy.

The last CDFA Manufacturing Cost Exhibit that contained a dry whey manufacturing cost was published in September 2007 for 2006 data. The whey cost published in that report was $0.3099 per pound. The federal whey factor has a cost make allowance of just $0.1991 per pound. At $0.60 whey, if the California cost were applied to the federal whey factor it would reduce the Class III price by $0.65/cwt.

After the fixed whey value of $0.25 was introduced in California in December 2007, it resulted in a higher price for farmers than the previous factor for 17 of its first 19 months of existence.

End product pricing is no longer viable in California.

Not only are there insufficient whey manufacturers for surveying and publishing cost data, consolidation and closures have led to a scarcity of cheddar manufacturers as well. Dry whey is not the only product presenting challenges to this end product pricing system. For example, if one of the four cheddar manufacturers in the state were large enough to have a significant influence over cost data and that manufacturer were fortunate to have a substantial portion of its volume directed to one of a very limited number of large cheese buyers residing here, that would go a long way to explain an FOB adjuster of just 2.52 cents.

Unfortunately, many of the other cheese manufacturers in the state do not enjoy the luxury of a large in-state customer and are forced to export the majority of their production back across the country at costs ranging from 10 to 20 cents per pound of cheese. That transportation cost versus a 2.52 cent FOB adjuster represents $0.75 to $1.75/cwt of milk. End product pricing has outlived its usefulness and needs to be replaced. No further fiddling or fine tuning can be justified.

That concludes my testimony. Thank you for your attention and I appreciate the opportunity of filing a post-hearing brief if warranted.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

MR. DRYER: Thank you.

MR. EASTMAN: I have a few questions for you, Mr. Dryer. On page two of your testimony you cite a quote from the Michigan State Dairy market Update for August and they mention that dairy margins are improving. Is that some sort of national average, were they dealing with just Michigan? What exactly were they referring to?

MR. DRYER: It was in a published article and my presumption was it was a national number that they were referring to.

MR. EASTMAN: So they didn't necessarily refer to California specifically, I assume.

MR. DRYER: No, it definitely wasn't California specifically.

MR. EASTMAN: And then on page three you mentioned that many cheese plants in California don't receive any value for whey because they don't process it, however, Saputo does have whey processing capacities in California.

MR. DRYER: Correct.

MR. EASTMAN: So were you just referring to the other parts of the cheese industry here in California?

MR. DRYER: Yeah, my --

MR. EASTMAN: Is there a --

MR. DRYER: My understanding is the majority of plants do not enjoy the opportunity to have whey processing. You need a pretty significantly sized plant to be able to justify the investment.

MR. EASTMAN: Once that investment is made would that not then allow, though, a cheese plant to leverage whatever margin or the income versus positive, the whey stream products with the cheese manufacturing in order to use them?

MR. DRYER: My point here was that the investment is so large that the investment in whey processing is typically higher than the investment in the cheese processing facility itself. It's inherently risky because you're investing in a single product or narrow range of products that may fall out of favor in a relatively short period of time, so therefore you're taking an inordinate amount of risk. And so for one year or another you may make a significant profit but there's a lot of vagaries in those markets that go up and down.

MR. EASTMAN: On the page of your testimony after the one chart on milk production you mention that one thing that I think is fairly accepted is that there is not a lot of new cheese plants that's been constructed or have been built here in the state of California. You mentioned that if cheese milk were under-priced we would expect to see more cheese plants. But aren't there other factors also that sort of inhibit establishing cheese plants in the state, things like -- I think in the past there's been mention of frequent regulatory hearings, business climate, permitting, things of that nature. Wouldn't those things also contribute?

MR. DRYER: Absolutely.

MR. EASTMAN: Is there any way to disentangle the in-fact pricing as an impediment or a motivation to build a plant, compared to the other things that might impede it?

MR. DRYER: I don't know of a means of doing that. I just know that on balance, when you weigh all the factors combined, we are not seeing investment. And if the price, you know, if the price discount is purported to be significant enough you'd think that there would be an influx of investment in the state that would overcome those other factors.

MR. EASTMAN: I may have another question, I need to look here for a second.

MR. MASUHARA: Greg, I have a quick question. We have taken testimony today that referenced a deal or negotiation that happened between processors and producers that came up with the specific numbers that were put forth in the petition. Were you a part of that negotiation?

MR. DRYER: I was not a direct party. We're members of the Dairy Institute of California and therefore we were involved in the communications back and forth as to what was ongoing. What I was told was that the negotiations -- the offer that was presented was rejected by the producer community so it wasn't all agreed.

MR. MASUHARA: Okay. And then I am making the assumption that since you are in opposition to the petition then you are in opposition to the specific numbers that were contained in that petition.

MR. DRYER: Yeah, I think the offer that was made and the letter that has been presented talked about "if conditions warranted" which was an important element of the offer. And it is our opinion that conditions don't warrant the change.

MR. MASUHARA: Okay, thanks.

HEARING OFFICER SUTHER: With no further questions, thank you for your testimony, Mr. Dryer.

Mr. Lantz Adams. Mr. Adams, would you please state your full name and spell your last name for the record, please.

MR. L. ADAMS: Lantz Adams, A-D-A-M-S.

Whereupon,

LANTZ ADAMS

Was duly sworn.

HEARING OFFICER SUTHER: And do you have any written statements or other things you would like to add into the record at this time?

MR. L. ADAMS: Yes, but I'd like to give them to you after I've given you my testimony.

HEARING OFFICER SUTHER: That would be fine. You may proceed.

MR. L. ADAMS: First of all, thank you for allowing me to present my testimony to you today.

My name is Lantz Adams. I am 13 years old and I am in the 8th grade and I attend Woodrow Wilson Junior High

School in Hanford, California. My father is a third generation dairy farmer. I am writing to you because our dairy farm, like many others, is in dire financial straits and may not continue into a fourth generation. That thought makes me sick. As I think of my family's situation and understanding that you have the ability to raise the producer's pay price, I have thought of several issues that you may consider.

1. Dairymen are going out of business due to the low milk prices.

Many multi-generational family dairies are going out of business.

Over 90 percent of them are family owned.

All of the earlier generations' work is being sacrificed when a dairy exits the industry.

Please understand that losing dairies leads to a loss of many jobs.

2. Dairies going out of business cause a negative impact on society.

Unemployed become dependant on social programs.

And when dairies go out of business it negatively affects allied industries.

After a loss of a dairy it can cause catastrophic casualties to the family structure.

Please understand that the loss of dairies affects society in many ways.

Additional items regarding milk.

Dairy products from other countries could be of questionable quality if imported.

If less dairy are being produced -- if less dairy products are being produced, prices may go up. This could result in a less-healthy diet.

Please understand that the loss of dairies could result in an unhealthy diet.

Finally, I understand the importance of having milk processors in the state of California, but I also understand that the necessity of having dairy families willing to be able to profitably produce the milk to fill those plants. I know I'm only a kid but what I see in this industry is not good and is only getting worse. Thank you.

MR. EASTMAN: That was very articulately well-spoken. Normally we don't have people come and testify, I think your age is slightly below the average of some of our more distinguished witnesses, we'll say.

(Laughter.)

MR. EASTMAN: I do have a couple of questions for you. Since you're on the farm do you actually fulfill some of the duties or some of the work that is done on your farm?

MR. L. ADAMS: Yes. On our worker's day off I feed calves and I help milk. And whenever it's needed I milk with my dad or whenever he has to do something I milk the cows.

MR. EASTMAN: Great. One day do you hope to possibly take over your parents' dairy? Do you hope to be a dairyman yourself?

MR. L. ADAMS: Yes, possibly. If we can have a fourth generation I do want to take over the dairy.

MR. EASTMAN: What would be some of the reasons why you would want to be a dairyman?

MR. L. ADAMS: I think it's important that kids know what actual work is, because some don't. And it's important to keep the fourth generation going. I think it would be good to have a fourth generation continue on.

MR. EASTMAN: That sounds good. I just have one more question. I've noticed you've been here for quite a while, right? Were you here since the beginning?

MR. L. ADAMS: Pretty close, yes.

MR. EASTMAN: Pretty close. And so you mentioned that -- obviously you attend middle school so you're not in school today. Normally it would be a school day, right?

MR. L. ADAMS: Yes.

MR. EASTMAN: So the question I have is, based on what you've heard would you have rather have been in school or would you have rather been here listening to what we have been talking about?

(Laughter.)

MR. L. ADAMS: I think either way it's a learning experience and I enjoy it here.

MR. EASTMAN: Well said, very good.

MS. GATES: I just wanted to say thank you very much for coming up and testifying, we really appreciate it.

MR. L. ADAMS: Thank you.

HEARING OFFICER SUTHER: Well thank you for your testimony, Mr. Adams. And you're going to bring that exhibit up?

MR. L. ADAMS: Yes.

HEARING OFFICER SUTHER: Okay, please bring that forward. It will be Exhibit 51.

(Exhibit 51 was entered into the record.)

HEARING OFFICER SUTHER: Mr. Rick Adams.

MR. R. ADAMS: Good morning.

HEARING OFFICER SUTHER: Good morning. Mr. Adams, will you state your full name an spell your last name for the record, please.

MR. R. ADAMS: My name is Rick Adams, the last name is A-D-A-M-S.

Whereupon,

RICK ADAMS

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements you would like to enter into the record at this time?

MR. R. ADAMS: No, but I can give you what I wrote at a later date after you hear what I have to say, you want a copy.

HEARING OFFICER SUTHER: So are you -- you want to submit a post-hearing brief?

MR. R. ADAMS: Yeah, I can send this to you if you want me to, yeah.

HEARING OFFICER SUTHER: Okay, all right, thank you.

MR. R. ADAMS: Are you ready?

HEARING OFFICER SUTHER: You may proceed, yes.

MR. R. ADAMS: Okay, thank you. First of all, that was my son and I am very proud of him. He understated his contributions on the farm. We are a very old farm, we are very family-oriented. We actually, typically would probably belong in Wisconsin and not California. But he has many jobs other than the ones he just stated, he was just trying to be smug about it.

Actually I did not come here originally intending to testify but on the way here I decided it was probably a good idea and I started thinking about things. So I'm going to read you what I wrote and sorry if it's less than, less than perfect.

Thank you for your time and for holding this hearing. I originally was just going to bring my son Lantz to testify but on the ride here I thought maybe I should testify myself and now here I am. Please excuse me if my testimony is a bit choppy, I typed it here on my iPhone today.

What changed my mind about testifying was the recognition that three co-ops handling over 70 percent of California's milk not only recognize our plight as an industry but they are actively testifying on behalf of their member-owners. They recognize that the demise of additional member dairy farms is not in their interest as processors, nor in the best interest of the industry as a whole.

About us and our farm. We are a small dairy milking 65 cows with many inefficiencies but operate as a small family farm that produces all of our forages with family labor, doing most of the milking, feeding and farming operations.

I understand and agree that the California model of dairying, which is having a large dairy and buying all or most of your feeds, is no longer as effective as it used to be. Though we recognize the inefficiencies of our older, small dairy farm we do everything we can to cut expenses, including eliminating all custom operating as possible. In fact, when we chop our stillage my son Lantz drives his own stillage truck.

We struggle to survive without bank loans because we as a family dairy farm refuse to lose what my grandfather and my father himself worked so hard for. So my wife's teaching income is, in the short-run, continually being used to keep our dairy in operation. That is not a planned business strategy and one we cannot maintain long term.

I also understand the Department's desire to ensure that the small cheese operators can continue to operate without the efficiencies that come with the ability to further process whey into a higher value whey product. Those efficiencies are similar to the ones that our small family dairy operates under.

Having said that, I am not asking you today to raise your milk price to reflect -- okay, I'm going to start over. Having said that, I am not asking you today to raise our milk price to reflect the full value of whey to selfishly protect me and my inefficiencies, but rather to support all of my fellow dairy farmers. By paying us full whey value, it will not save all of us. Some of our dairies are already beyond being saved, their fate is already sealed.

I guess one of my biggest frustrations is the fact that the Department's own cost of production studies correctly illustrate our reality. Realizing that the

Department recognizes our milk income does not cover our cost of production and then continuing to drag its feet instead of rectifying the situation that's a problem -- the Department has been tasked with, which is balancing the needs of the producers, the processors and the public.

In conclusion I would like to thank you for your time and implore the Department to raise our milk price to reflect the full value of the whey price. As I said earlier, I am not asking this to be selfish but rather because this is an emergency and we need it immediately to save our industry. Thank you.

MS. GATES: I just have one quick question.

MR. R. ADAMS: Yes.

MS. GATES: Where do you ship your milk to?

MR. R. ADAMS: Land O'Lakes.

MS. GATES: Thank you.

MR. R. ADAMS: Thank you.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Adams.

MR. R. ADAMS: Would you like me to submit what I -- what I said.

MR. R. ADAMS: Yes, a post-hearing brief.

MR. R. ADAMS: Okay, thank you very much.

MS. GATES: Great, thank you.

HEARING OFFICER SUTHER: Thank you.

Ms. Peets. Ms. Peets, would you please state your full name and spell your last name.

MS. PEETS: Sure. Renee Peets, P-E-E-T-S.

HEARING OFFICER SUTHER: And state your affiliation for the record.

MS. PEETS: I am here on behalf of Kraft Foods North America.

Whereupon,

RENEE PEETS

Was duly sworn.

HEARING OFFICER SUTHER: And would you like this testimony marked as an exhibit?

MS. PEETS: Yes, please.

HEARING OFFICER SUTHER: Okay. It will be Exhibit number 52.

(Exhibit 52 was entered into the record.)

MS. PEETS: Thank you.

HEARING OFFICER SUTHER: You may proceed.

MS. PEETS: Mr. Hearing Officer and members of the Hearing Panel:

My name is Renee Peets. I am the Senior Director of Cheese and Dairy Procurement for Kraft Foods North America. Kraft operates a dairy plant in Tulare, California, where we manufacture Parmesan and other hard Italian cheeses as well as cultured products including sour cream and cottage cheese under the Knudsen brand. This facility also produces dry whey powder. We employ 265 people at this facility and process several million pounds of milk a day; this milk is purchased from farmer cooperatives in California. The Tulare plant is one of Kraft's 40 manufacturing facilities in North America, 11 of which are cheese plants.

I am here today to testify in opposition to any increase in California milk prices, whether in the form of the proposed changes to the temporary price relief that was implemented July 1, 2013, or the proposed change to the sliding scale whey factor that is part of the Class 4b formula. While we agree that the financial struggles related to the drought of 2012 had an unfavorable impact in farm economics, this year's crops are reported to be in much better condition and are predicted to be available in much larger quantities than last year, thereby providing ongoing relief to farm input costs and a corresponding improvement of farm economics.

With improved grain harvest conditions and reduced price pressures related to feed, California farm economics are expected to improve significantly during 2013. Recent cost of production total feed cost data published by CDFA paints a compelling picture of improving conditions in California. The cost of feed is over one-half the total cost of producing milk, and corn is a large component of feed, so it stands to reason that movements in the corn market can impact on-farm economics. With higher grain markets beginning mid-2012, feed costs not surprisingly climbed to very high levels. However, these costs have already started to ease, probably due both to lower grain markets and changing rations at the producer level, with more downside likely as a function of the new corn and soybean crops which are beginning to be harvested. Of course, it's difficult to say whether year-over-year milk production changes have been just a function of weather conditions or the result of deeper, more fundamental on-farm cost struggles. However, drawing conclusions regarding the favorable economic impacts of corn prices and their relation to feed costs is certainly warranted.

From mid-2011 to mid-2012, corn prices averaged about $5.50/bushel and average total feed costs rose by less than $0.30/cwt of milk. Then, from the mid-2012 to early 2013 period, corn prices averaged about $6.00-$6.50/bushel. During this period average total feed costs rose by $0.93/cwt. The late 2013 and early 2014 corn futures as of today would suggest that corn pries are predicted to be below $5.00 through September of 2014, and this price level should lead to corresponding decreases and result in average total feed costs that are comparable to or even less than those of the 2011 crop year. Additionally, the 4b price through August of 2013 is $1.70/cwt higher than 2012.

Therefore, in light of this improving situation in feed costs, and coupled with the $0.15/cwt of temporary price relief that began July 1, and the $0.30/cwt temporary price relief that spanned February through May of 2013, there is no need to further temporary price relief. Declining feed costs should be providing additional income to farmers, versus adding on to the prices paid for milk by cheese manufacturers. The duration of the current temporary price relief of $0.15/cwt on 4b should allow time for the Secretary's Dairy Future Task Force to fulfill the purpose for which it was created, namely to create a pricing system in California that is viable for the long-term and allows producers and processors to maintain and grow their businesses, while securing the California dairy industry's position as a leader within both the United States and the expanding global dairy marketplace.

Regarding the proposal to increase the whey factor, we do not feel that this request is supportable. Efficient whey processing requires the manufacturer to have enough scale to justify making a large investment in the asset base required to further process whey into a commodity dry whey product. Many of the California cheesemakers either can't afford the tens of millions of dollars required to buy and outfit a drying operation, or they don't have the floor space in their manufacturing facilities to support a drying operation, or they simply don't generate enough whey to process in order to have a reasonable return on invested capital. In the case of value-added whey products like whey protein concentrate or whey protein isolate, lack of scale becomes an even bigger impediment as the cost of assets to manufacture these value-added ingredients are even higher than for the assets used to process commodity dry whey. As a result, many California cheesemakers are forced to dispose of their whey, often incurring a cost for doing so.

Any increase in the whey factor will have a negative impact on Kraft's operations and business decision making. Cheese processor margins are small, as retail cheese is a commodity business. And by this statement I mean that on-shelf prices for branded products need to be close to prices for store brand products in order to be attractive to consumers and drive them to choose the branded product. The cost of manufacturing, storage, transportation, sales and marketing are inflationary, and when combined with the increasing costs of raw materials like milk in California, there's only one place that additional costs like temporary price relief and adjustments to the whey factor in the 4b formula can come from: the margin. Our shelf prices are based on our input costs. We can't charge the customer more just become some percentage of our cheese is made in a particular region, like California, for a higher cost. We also can't just pull back on trade spending because some percentage of our cheese is made in a particular region for a higher cost. If we did that, retailers would choose to promote private label products over our branded products because private label products don't carry the heavy marketing expenses that branded products do. We would lose volume and share and eventually become delisted from retailers' refrigerated cases. After that, the business would eventually have a lack of viability. The continued squeeze on margins that will be caused by recurrent temporary price relief and other short-term fixes instead of addressing the issue of the current California dairy pricing system will eventually result in cheese manufacturers leaving California for other regions. California's labor rates are higher than other regions and the cost of transportation to other areas in the US of product produced in California is prohibitive - therefore something has to give to return the California milk industry's balance to equilibrium.

The California Milk Advisory Board's website say that "cheese is California's fastest growing dairy product and 43 percent of the state's milk supply goes to cheese production. In the period between 1990 and 2012, California cheese production grew from 702 million pounds to 2.25 billion pounds. California's more than 50 cheesemakers make 250 different varieties and styles of cheese. Operations range from small producers famous for their handmade cheeses, to some of the country's largest cheese plants." That mix of growing manufacturing scale and the ability of the California cheese manufacturers to utilize 43 percent of the state's milk supply provides a mechanism that California dairy farmers can leverage to grow their businesses and make more money through volume and efficiency; but without this infrastructure, farmers will struggle to find economically feasible outlets for their milk.

The current California milk pricing system is no longer useful. The purpose of the Dairy Future Task Force is to create a pricing system in California to replace the current pricing system. The Task Force must create a pricing system that is viable for the long-term and allow producers and processors to maintain and grow their businesses, while securing the California dairy industry's position as a leading source of supply both within the United States and within the expanding global marketplace.

The impacts of the 2012 drought were real and California farmers weathered the storm. Milk production is improving, grain prices have fallen and on-farm economics are improving. This should continue to be the case going forward into 2014 and therefore additional increases to California milk prices are not required for farmers to thrive and be profitable.

The California dairy pricing system has outlived its useful life and it needs to be replaced with a system that provides a sustainable and fair economic state that can withstand good and bad production years, years with droughts and others with floods, years with large margins and years with much smaller margins. The way to resolve the current pricing situation is to let the Dairy Future Task Force fulfill its purpose and bring all the parties together to construct a system that works for producers and processors alike.

Kraft is supportive of the work of the Dairy Future Task Force and we are hopeful that 2013 will continue to enjoy lower feed costs, better year-over-year weather conditions, improved farmer profitability and an opportunity for the Dairy Future Task Force to create a pricing system that works for all parties, and most of all provides a long-term benefit to the California dairy industry. We look forward to a more permanent solution to the current pricing situation versus continued attempts to tweak the formulas to result in more income to farmers and more cost creep to cheese manufacturers.

This concludes my testimony. Thank you for your time. I would like to have the opportunity to file a post-hearing brief if necessary.

HEARING OFFICER SUTHER: Your request is granted for a post-hearing brief.

MS. PEETS: Thank you.

HEARING OFFICER SUTHER: Any questions?

MR. EASTMAN: I do have a couple of questions.

Earlier today we heard testimony by some witnesses that have stated that if the Department were to implement the co-petitioners' proposal it would still allow a margin between the California Class 4b and the price of milk in other areas of the country so that margin would still exist. Do you agree with that?

MS. PEETS: I do not.

MR. EASTMAN: And why not?

MS. PEETS: Because our pricing systems with retailers, which is our predominant channel that we sell into, is very static. In order to change those you would need a significant -- you would incur a significant expense as well as push-back from the retailers on the amount of promotion that they'll do with your business. I would say that our shelf prices can't budget. So when our input costs go up it comes out of the margin, period.

MR. EASTMAN: So would that apply only to your in-state competitors compared to those that are outside of the state of California?

MS. PEETS: No, I wouldn't say that. California is our only manufacturing facility of Parmesan and hard Italian cheeses, so we have to take that product and get it to all of the other regions of the country.

MR. EASTMAN: And the other question I have is, in California, Kraft is one of the few plants that actually manufactures dry whey powder.

MS. PEETS: Yes.

MR. EASTMAN: And as we know, dry whey is one of the commodity prices that determine Class 4b prices, it's also one of the commodities that determine Federal Order Class III prices. So because of the fact that you actually manufacture and sell the product that the formula is based on, doesn't that give you an advantage because your operation more closely reflects the formula itself?

MS. PEETS: I would say it might give us an advantage over folks who don't process their own whey and who actually pay to dispose of it. But I would also say that whey processing itself, particularly just dry whey powder and not some of the more value-added whey protein concentrates and isolates, is a very challenging business. The assets are super-expensive and the amount of product that you make that is food grade versus feed grade sells for a very different price as well as you have to pay somebody to market it. So I would say that it's a penny margin business for whatever advantage that is.

MR. EASTMAN: And then you mentioned how you support the Dairy Future Task Force and finding some other pricing system. Do you then -- are you not supportive of the current system of end product pricing and structure?

MS. PEETS: No.

MR. EASTMAN: Although it seems that that has served the industry for a number of years and in California for quite a few years, what has changed over the years that would lead you to feel that the system of pricing needs to be changed to something different?

MS. PEETS: Because I -- my own personal opinion, I feel that we're constantly searching for short-term fixes. And pulling out pieces of the pricing formulas to change, increase in this case, doesn't help the overall situation. If we need to create a new pricing system we should create one. We should go back to the grassroots and determine what each party's needs are and then create a system that can work for everyone. Forty-three percent of the state's milk goes to making cheese. If both parties were at the table together I'm sure we could come up with a way that pricing could work for everybody, versus having these hearings every few months and coming up with a piece of a temporary price increase that goes into effect for three months or one month or six months. It doesn't fix the overall problem.

MS. GATES: I just have a quick follow-up question to one that Hyrum asked because you are one of the dry whey processors. You were talking about the difference between animal grade and food grade and I'm sure there is a difference in price there. What percentage maybe of your production kind of goes either way or is it just the heat issue that dumps it over?

MS. PEETS: Honestly, it depends. We have a party who markets all of our whey for us because we are not in the ingredients business so we have a contract with that person that says that we will produce a set percentage of food grade whey and feed grade whey. And when our system doesn't cooperate and we produce more feed grade, that party takes a loss on that product and it then gets charged back to us. So we have to live up to our contract and when our equipment doesn't cooperate we have to make up that difference.

MS. GATES: Thank you.

MS. PEETS: Sure.

MR. MASUHARA: Ms. Peets, similar to what I asked Mr. Dryer. Were you part of any of the negotiations that have been spoken about today?

MS. PEETS: Like Mr. Dryer I was not directly involved but we are members of the Dairy Institute, they acted on our behalf.

MR. MASUHARA: And I didn't ask Mr. Dryer this but I'll ask you and I'll assume that you speak similarly for all the other processors. Was there any other level that is not represented in the numbers that have been presented by the co-petitioners that you feel economic conditions do warrant at this time? I know it's kind of a complicated question to try to answer on the fly.

MS. PEETS: It is complicated to answer on the fly. I am not sure I could answer that right now. I don't think so.

MR. MASUHARA: Okay.

MS. PEETS: From what I understood the negotiations broke down, the proposal was not accepted by the other side.

MR. MASUHARA: Okay, thank you.

HEARING OFFICER SUTHER: Thank you for your testimony, Ms. Peets.

MS. PEETS: Thank you.

HEARING OFFICER SUTHER: Before we adjourn for lunch for one hour is there anybody that is going to testify this afternoon that has a computer-aided program that they want to present?

All right, thank you, I'll see you at one o'clock.

(Off the record at 12:00 p.m.)

(On the record at 1:02 p.m.)

A F T E R N O O N S E S S I O N

HEARING OFFICER SUTHER: Okay, ladies and gentlemen, we will now go back on the record.

Ms. Duarte. Ms. Duarte.

Mr. Paris. Mr. Paris, could you please state your full name and spell your last name.

MR. PARIS: My name is Joe E. Paris, the last name P-A-R-I-S

Whereupon,

JOE E. PARIS

Was duly sworn.

HEARING OFFICER SUTHER: And would you like your written statement marked as an exhibit?

MR. PARIS: Yes, sir.

HEARING OFFICER SUTHER: It will be Exhibit number 53.

(Exhibit 53 was entered into the record.)

MR. PARIS: Thank you.

HEARING OFFICER SUTHER: You may proceed.

MR. PARIS: Mr. Hearing Officer and Members of the Hearing Panel:

My name is Joe E. Paris and I am a consultant representing Gallo Cattle Company LP, d.b.a. Joseph Gallo Farms. We are grateful for this opportunity given to us by the Secretary and the hearing panel to express our position on the proposal that is being heard today. This testimony is based on discussions that I have had with Mr. Michael D. Gallo, CEO of Joseph Gallo Farms and Mr. Gallo fully endorses this testimony. Michael D. Gallo has been a leader in his community as well as agriculture and the dairy industry. Mr. Gallo currently serves on the California State Board of Agriculture and is a member of the dairy task force created by Secretary Karen Ross.

Joseph Gallo Farms is a family-owned dairy and cheese plant with its principal offices located at 10561 West Highway 140, Atwater, California. Joseph Gallo Farms has approximately 10,000 milk cows. We currently operate two milking facilities in Merced County and most of our milk goes into our family-owned cheese plant. The Gallo cheese plant also purchases milk from two local cooperatives and processes almost 45,000,000 pounds of milk per month into a variety of different cheeses.

Joseph Gallo Farms supports the current whey factors and the current temporary price relief as outlined in Section 300.00 of the Northern and Southern Milk Stabilization Plans under order numbers 59 and 74. Gallo specifically supports the language found in Section 300.0, Paragraph E(1)(c) and Paragraph H(1-8).

The petitioners have requested that the current whey factor be capped at $1.00 rather than at the current

$0.75. The petitioners have requested that the current temporary price increases on all classes of milk be eliminated except for the 4b price which they propose to increase to $0.0528 per pound of solids-not-fat or a little over $0.46 per hundredweight. That increase will result in an increase in the cheese price of over $0.045 per pound in a very competitive market. Joseph Gallo Farms opposes these proposed changes.

We continue to hear that the 4b price needs to mimic the Federal Order Class III price. California cheese plants do not compete with Midwest plants as much but from unregulated plants in Idaho and Utah. We also compete with a plant in the West Texas-New Mexico area. New Mexico mailbox prices run very close to California prices. It is difficult to get verifiable producer information from the Idaho-Northern Utah area, but anecdotal information reports that the producer prices run much below the federal order prices.

The idea of having only one class of milk, 4b, pay for a temporary price relief to California dairymen is arbitrary, capricious and is patently unfair. Joseph Gallo Farms would support a continuation of the current temporary prices as currently outlined in the Milk Stabilization and Marketing plans until the California dairy task force has completed its work and published a plan to change dairy pricing in the state of California. We adamantly oppose the petition being heard today.

Again, I thank the Secretary and the hearing panel for allowing us to give this testimony and we also request the right to submit a post-hearing brief.

HEARING OFFICER SUTHER: Your request to submit a brief is accepted.

MR. PARIS: Thank you.

MR. EASTMAN: I have a question. You mentioned that it's difficult to find published information in the unregulated area of Idaho and Utah but you do mention that there is anecdotal information reports. Is that some sort of written report or market commentary by analysts?

MR. PARIS: No.

MR. EASTMAN: What do you mean by that?

MR. PARIS: I have a client in Utah, a small dairy co-op that I work with. And where I have that information is from them who are in that marketplace and work in that marketplace. And I have been in that marketplace. But I can't get any flat numbers that tell me what it is.

Now I have heard that -- and it's an unregulated area. Since they have had a couple of powder plants go in up there, unregulated and the price of nonfat has come up, that there has been more competition in the cheese places for milk in that area and that some of those prices have come up. At one time they were -- most of that milk was bought on some type of a cheese-yield formula that actually set the price somewhere below the Class III price.

MR. EASTMAN: Okay, so that is based more on sort of the sense of -- sort of economic conditions, what you could sort of observe, they are not going to necessarily be verifiable.

MR. PARIS: If I could have found the numbers they'd have been in the testimony.

MR. EASTMAN: Sure. No, that's understandable.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Paris.

Ms. Duarte?

Mr. Sanchez. Mr. Sanchez, could you please state your full name and spell your last name for the record.

MR. SANCHEZ: Adolfo Sanchez, S-A-N-C-H-E-Z.

Whereupon,

ADOLFO SANCHEZ

Was duly sworn.

HEARING OFFICER SUTHER: Would you like your written testimony here to be marked as an exhibit?

MR. SANCHEZ: Yes.

HEARING OFFICER SUTHER: It will be Exhibit number 54.

(Exhibit 54 was entered into the record.)

MR. SANCHEZ: I just have a brief statement.

I represent Los Altos Foods, which is a very small family-owned business just like many of the dairy farmers say they are. We employ about 200 employees. That's the total company including salesmen and drivers, everybody.

We are also being hurt by the economic structure in today's country, today's facilities. Our pricing for not only milk but freight, packaging, ingredients, energy have all gone up. Our margins have greatly been reduced to where they were almost non-existent last year.

If we don't continue -- if we continue with higher prices maybe the 200 employees, which represent 200 families, they are also in danger of losing their jobs.

The additional cost of whey would be prohibitive for us. We do not process dry whey, we don't have the capacity or the volume to process it or to buy the highly expensive equipment that is required. It costs us about $288,000 a year to ship our whey out of the plant to dispose of it and it looks like this year is going to be a little higher.

The only thing I can say is that maybe a more reasonable approach to what the farmers are suffering, and we are all suffering the same, is to maybe alleviate the regulatory burden that is placed on all of us. Thank you.

MR. EASTMAN: I do have a question. Your verbal testimony today mostly looks like it has deviated somewhat from the text of your exhibit.

MR. SANCHEZ: Right, right.

MR. EASTMAN: Is there any emphasis or any focus or points you would like to make regarding any of the points that are found in your written testimony or are you just -- they are part of the record.

MR. SANCHEZ: They are part of the record.

MR. EASTMAN: Okay.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr.Sanchez.

MR. SANCHEZ: You're welcome.

HEARING OFFICER SUTHER: Ms. Duarte.

MS. DUARTE: Thank you.

HEARING OFFICER SUTHER: Ms. Duarte, could you please state your full name and spell your last name for the record, please.

MS. DUARTE: Antoinette Duarte, A-N-T-O-I-N-E-T-T-E, D-U-A-R-T-E.

Whereupon,

ANTOINETTE DUARTE

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements or anything else you would like to be entered into the record?

MS. DUARTE: Yes, and I will do it after, thank you.

HEARING OFFICER SUTHER: Go ahead.

MS. DUARTE: Good afternoon, Hearing Officer, my name is Antoinette Duarte. My son, who will turn 40 next week, and I operate our dairy in Elk Grove. Our dairy is in its forty-sixth year of operation.

I have had the opportunity to attend many of these hearings and have given testimony of what has happened in the last three and a half years. I was honored to present testimony to the Ag Assembly Committee on May the 1st, 2013.

The financial devastation since then has gotten worse and has caused many of the dairies to close or be forced to be sold by the creditors and in many cases leaving no monies to buy a home and then no place to find a job. The qualifications of running a dairy do not guarantee a job in the job market.

The question I would like to ask of this hearing panel is, have you asked the men and women who visit the dairies that participate in the Cost Analysis Program about how the dairymen and -women are doing? How the cost production and lack of dairy income to cover the costs is affecting the dairies. I am confident that the response you are going to get is that it is very difficult, each and every time they visit the dairies. Many of the cost analysis people have gone to participate on these dairies for years and they see the stress that we are going through. To try to keep our operations going is causing health issues and difficult family situations. The inadequate milk income to the California dairies in the three and a half years has cost us millions of dollars in equity that is lost forever.

Yesterday my son and I met with our loan officer for our biannual review. Each and every time we do this it is difficult to stay positive about our industry. We do not know what the feed prices will be this year until the grains are in, the grains are harvested. Our corn stillage is about to be harvested and the cost of having it chopped and put in the pit is rising due to the fuel costs.

Where is all this money going to come from to pay for the feeds that we desperately need for our cows? As we were talking to our loan officer she went on to tell us 80 percent of the dairies that they financially carry are feeding their cows with hay month to month, nobody is stocking any hay this fall.

Our priority in operations is to keep the cows and livestock well-fed, maintain our trucks, tractors and of course the milk barn, so that we have no major breakdowns. Anything else that has to be fixed or replaced is put on a list. When it breaks we hope that it can be fixed without having to be replacing. There is no monies available after the feeds, labors and utilities, insurance and supplies are paid. In our operation we can no longer afford any major breakdowns.

My husband and I have always worked and saved to try to make the right decisions so that we can pass on the dairy to our son. Yes, we experienced the volatility like so many others and, again, the last three years have been brutal. Never did I ever think that we would be in so much debt after all these years.

As I stated in the beginning of my testimony that my son is going to be 40 years old next week. At one and a half years old he was out helping me feed the calves. He has chosen to work 16 hours a day now because he does not want to hire any hired help. He is inheriting a larger debt than when we started 46 years ago. The size of our operation is the same. Yes, we are milking more cows but what we have is all homegrown.

Each month I ask my son, well, are you ready to put up the "for sale" sign? And his response is, not yet, mom, let's keep going. I can manage the monthly decisions of who is getting paid and how much. But the stress and the toll that I see on my son every month is very difficult.

In our area three dairies have been sold since March and those dairies are being torn down as of today and grapes are being put in. We will not see any cows on those operations ever.

I want to thank you very much for allowing me the opportunity to give my personal testimony of our operation and I believe I am speaking on behalf of many dairymen and -women who have not taken the time to come today, not because they -- because don't have the time, they have to stay home and maintain their operations. Thank you.

MR. EASTMAN: I just have a couple of questions regarding the dairy itself. About how many cows do you milk and who do you ship to?

MS. DUARTE: We are now feeding 560 cows and we're shipping to DFA.

HEARING OFFICER SUTHER: Thank you, Ms. Duarte.

MS. DUARTE: Thank you.

HEARING OFFICER SUTHER: Ms. Duarte, do you have that exhibit you'd like entered into the record?

MS. DUARTE: Post, I'll submit it post.

HEARING OFFICER SUTHER: Okay, thank you.

Mr. Hofferber. Mr. Hofferber, could you please state your full name and spell your last name for the record.

MR. HOFFERBER: Yes, I am Scott Hofferber, H-O-F-F-E-R-B-E-R.

Whereupon,

SCOTT HOFFERBER

Was duly sworn.

HEARING OFFICER SUTHER: And do you have any written statements or anything else you would like entered into the record?

MR. HOFFERBER: Nothing else, just that.

HEARING OFFICER SUTHER: This will be marked as Exhibit 55.

(Exhibit 55 was entered into the record.)

MR. HOFFERBER: Good morning, Hearing Officer and members of the Hearing Panel. I am Scott Hofferber, the Chief Financial Officer at Farmdale Creamery, and I am here at the direction and on the authority of our Board of Directors. Farmdale is a third-generation family-owned and operated dairy processing facility in Southern California. With about 86 employees, Farmdale is processing an average 24.2 million pounds of milk and cream per month, that's about 100 loads a week, into cheese, sour cream, whey protein concentrate-80 percent powder and buttermilk. We are grateful for this opportunity to provide Farmdale's perspective on the matters before the panel.

In accordance with the call of the hearing, I will provide our testimony in response to each of the three proposed amendments.

With respect to temporary price adjustment. Article III, Section 300, Paragraph H, in its current form, resulted from a hearing held just four months ago on May 20th. In the letter announcing the Department's decision, Secretary Ross explained that, quote: "While the testimony on the hearing record failed to provide economic data to justify the industry's positions, the uncertainty of the 2013 corn crop, and questions about the stability of the market recovery indicate this adjustment is appropriate."

Well the "uncertainty of the 2013 corn crop" has certainly been alleviated with current and future corn prices down to under $5.00 a bushel. The market recovery questions are also answered. Removal of Paragraph H is appropriate and we support such action by the Department. To leave Paragraph H in effect shifts its purpose away from "emergency price relief" toward a recapitalization effect, which we do not support.

Whey Valuation

We oppose the petition's adjustments to the whey factor. The resulting increase in raw product costs will cripple our ability to meet the covenants under the financing arrangement developed to facilitate creation of our WPC-80 powder plant.

With respect to Article III, Section 300, Paragraphs E(1)(c), E(6) and E(9) of the Plans: What more can we provide with respect to this topic that isn't already included in our cumulative testimony to date, which we incorporate herein by reference. And I mean cumulative, in the last, say, eight hearings. At least certainly back to 2007. The petition takes yet another stab at unreasonably extracting revenue from higher-valued-whey processing plants without concern or regard for the consequences of this approach on the smaller cheese plants in California, which represent about 80 percent of all cheese plants and about 15 percent of the cheese milk.

The annual results of Farmdale's animal feed popcorn whey processing over the last three years has gone from break-even to a loss of nearly half a million dollars; almost entirely resulting form the ever-increasing cost of whey in cheese milk. It is unreasonable to expect small cheese plants, unable to justify the investment in a higher-valued whey processing facility, to suffer the consequences of a perverted end-product pricing model that is based on a higher-valued product.

Additionally, as a processor who has now risked investment in a higher-valued-whey processing plant, we cannot understand how producers imagine they're entitled to extract most of the profit from such an enterprise, one for which they have done nothing different than what they have always been doing as long as cows' milk has been on the menu.

A sliding scale construct would infer that the strata of the scale would be represented over time, all strata of the scale would be represented over time. But only the top two tiers have been represented in the last three years. If you're going to talk about the sliding scale, which I don't think should be in there at all anyway, it seems to me you need to extend the top of it instead of just changing it to $1.00 at the $0.60 level. You need to go up to $1.00 instead of $0.60 and put the $1.00 in there. I don't know, you need to expand the scale such that you're representing an average tier rather than the top tiers all the time. That's not in my written testimony but there you have it.

We suggest the whey factor be restored to the $0.25/cwt as was implemented on December 1st, 2007 and let negotiations between individual plants and their shippers determine a price reflective of that plant's ability to move the whey stream someplace; maybe into a marketplace or maybe to a landfill.

And then we saw -- let's see. We heard testimony earlier that the $0.25 factor disconnected the price from the market. I would suggest that a minimum price is never disconnected from a market when a premium can be charged for the milk. Sellers must take up this responsibility, not expect the Department to do it for them.

Evidentiary Support and Legal Compliance

Smarter minds than ours will have to tackle the issue relating to the legality of the whey factor. However, it seems intuitively obvious that, with as many end-products that exist in the whey processing arena, no cost study or make allowance analysis can result in a fair and equitable methodology.

And then the Task Force

Meanwhile, back at the ranch, the Dairy Future Task Force continues to be our best hope for true reform to our now ridiculously contentious business partnership. We remain committed to the DFTF and encourage all stakeholders to get on board with this process as soon as possible.

And then I had just a couple more comments. We saw a slide earlier of the 2012 profitability indicating Idaho being probably twice as profitable as any other market in that presentation. It's worthy of note that Idaho is unregulated.

And then last, the question came up earlier, aren't there a lot of factors causing plant expansion not to occur in California right now? And I liked the answer that was given but I'll kind of restate it. And that is, if 4b is sufficiently profitable, plants would be built. So to negatively impact 4b now certainly cannot be an encouragement to growth.

And that, with a request for a post-hearing brief, if necessary.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

MR. HOFFERBER: Thank you. Yes, Hyrum?

MR. EASTMAN: I don't think I looked your way.

(Laughter.)

MR. HOFFERBER: That was a dead giveaway.

MR. EASTMAN: Oh I see, okay. In that case I'll guess I'll ask you a question so you feel --

MR. HOFFERBER: So I feel --

MR. EASTMAN: -- like everybody else.

MR. HOFFERBER: So I feel complete.

MR. EASTMAN: Yeah, exactly. What do you -- I was going to ask you to clarify your statement with regards to -- I suppose you're making a statement about the construct of the 4b formula. You mentioned that when it comes to whey processing, no cost study or make allowance analysis would be fair and equitable. Can you expand on that? What exactly do you mean by that?

MR. HOFFERBER: Well, currently we've picked dry -- dry sweet whey as the base product. But there's lots of base products, including just taking it to the dump, that exist, that don't return any value to the cheesemaker. So what's saying that here with these kinds of increases in the 4b formula is they are actually trying to elevate it to, say, the 80 powder product that we are now making. Or if you make that the reference price it's going to even make life much worse for the people who aren't making that.

We have long testified at these hearings that we are like the biggest of the smalls, kind of a notion. Where we have been forced into making the decision to do an 80 powder plant now just to stay in the cheese business. That's my comment earlier about the loss on the animal feed. The popcorn whey business going from a basically break even in the year that we went from the $0.25 factor to the $0.65 factor, which was an average that year for us of about $0.39. Then we went to the $0.65 cap to the $0.75 cap. In 2013 we would lose $477,000 if we continued into that -- in that popcorn whey mode.

Seeing that coming we made the decision last August to build this plant and try to stay in the cheese business. And so then you get to my comment, now you're going to -- with this you're going to suck everything out of that and we're going to have to go to the bank now and say, well, the rules changed. Now we get the 10 year payback or a 12 year payback, whatever the numbers turn out to be. You know, too bad. I mean, it's a business decision and we're willing to live with it but we are certainly going to advocate, you know, for something that stratifies the cost of whey to more fit the product that's being made.

MR. MASUHARA: Scott, similar to the questions I asked of a couple of the other processors. As far as the negotiated agreement, did you actively participate?

MR. HOFFERBER: Only in receiving output. We never directly spoke with producer lobbyists or representatives or whatever. We, of course, testified at the May 1 hearing with respect to the legislation that went through. We were kept abreast all through time as to how the progress was going. And what we understood at the end of that was we had reached an agreeable set of language but there was a piece of that language that dealt with economic justification that the producer representatives removed from the language and walked away from the negotiation.

MR. MASUHARA: So you never worked up a set of numbers that you considered a range of numbers that --

MR. HOFFERBER: This was strictly a political negotiation, as far as I was concerned. I wasn't part of any kind of number crunching.

MR. MASUHARA: Okay, that's all I had.

MR. HOFFERBER: All right.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Hofferber.

Mr. Ahlem. Mr. Ahlem, will you please state your full name, and spell your last name for the record.

MR. AHLEM: David Ahlem, A-H-L-E-M.

Whereupon,

DAVID AHLEM

Was duly sworn.

HEARING OFFICER SUTHER: Do you have anything else other than this written testimony you would like --

MR. AHLEM: That's plenty.

HEARING OFFICER SUTHER: Yours will be Exhibit number 56.

(Exhibit 56 was received into evidence.)

HEARING OFFICER SUTHER: You may proceed.

MR. AHLEM: Thank you. Mr. Hearing Officer and Members of the Panel.

My name is David Ahlem. I am the Vice President and, General Manager for Hilmar Cheese Company. Hilmar Cheese Company is a cheese and whey products manufacturer with locations in California and Texas. In California, Hilmar Cheese Company processes over 12 million pounds of milk per day, more than 10 percent of the milk produced in California, and purchases milk directly from over 200 dairies. Finished products are sold to over 50 countries around the world.

Hilmar Cheese Company was formed by an innovative, market-oriented group of Jersey dairymen who sought to capture the full value of their high quality milk. They founded the company on the ideal that producers should receive a competitive market-driven price for their milk.

I am here today to represent Hilmar Cheese Company and our dairy producer owners. Hilmar Cheese Company opposes the petition from California Dairies, California Dairy Campaign, Milk Producers Council and Western United Dairymen. Hilmar Cheese Company supports a low regulated minimum price that allows the market to efficiently set high market-driven prices.

Economic Conditions Do Not Support Further Emergency Price Relief

California milk supply and demand appear to be in balance. Milk production has seasonally exceeded the state's processing capacity the past several years. When capacity was not available milk had to be shipped out of state, sold to calf ranches or dumped. Milk buyers imposed caps and base programs to help throttle supply. Recently, milk production reports indicate that milk supply has decreased 2.6 percent year over year. this decline has brought us into better balance with the state's processing capacity.

Our experience, as a company that pays producers significant premiums over the regulated price, is that the milk supply is reasonably stable and additional supplies are available to those who are looking to grow and pay premiums. Year-to-date, our same farm production is up more than one percent year-over-year. We continue to have many more producers on a wait list for permanent growth, and some milk has been available on the spot market even through the warm summer months.

The story in California and much of the country the past several years is about consolidation, not contraction. Although undoubtedly painful for those affected, milk supply is transferring ownership with no significant loss in production and cow numbers. This trend is not unique in California. According to the Wisconsin State Farmer, Wisconsin lost well over 600 operations in the last year and typically loses an average of 400 farms annually. Unfortunately, high feed costs have accelerated the rate of consolidation across the nation in recent years.

Milk supply is expected to grow as producer margins improve further. Crippling high feed costs are finally on the decline, as indicated by corn's current and futures market trends. Corn prices have fallen several dollars a bushel and forecast to continue around the $5.00/bushel mark into 2014. As feed costs fall, producer economics are improving; CDFA data shows income over feed margins trending upwards, with the first quarter of 2013 at $6.17. Producer margins are expected to strengthen further in the fourth quarter of 2013 and into 2014.

Unfortunately, California plant capacity has not kept pace with supply. Although demand for cheese is growing domestically and abroad, processing capacity in California continues to decline amidst stable milk supplies. California's latest plant closure is slated for this month as Lactalis American Group relocates production from Mozzarella Fresca in Tipton to their plant in the unregulated state of Idaho. Lactalis has testified in past years that future investment in California was unlikely due to the state's regulatory atmosphere. This sentiment has been echoed by may processor representatives over the past several CDFA pricing hearings. California does not have additional production capacity available to handle any surplus milk. It is imperative that minimum regulated prices are not set above market prices such that they artificially encourage increases in supply.

Emergency Price Relief is Not Required to Address Changes in Market Conditions.

The market can and will respond to changing market conditions much more effectively than any intrusive increases in the minimum regulated price. Nothing prevents milk buyers from increasing their pay price when supplies tighten. There have been several examples of milk buyers increasing their pay price in the past year as a response to changing market conditions. In October of 2012, Hilmar Cheese Company increased our pay prices in anticipation of the milk supply tightening. We have also heard of another cheese processor doing the same. This summer there were reports of one large cooperative offering significant over order premiums for milk to fill seasonal gaps in supply. These illustrations demonstrate that the market can and will change if supply conditions are threatened. Price corrections through market-driven premiums are more effective than regulated price increases because they are supported by market demand and therefore sustainable.

Eighty percent of the milk in California is controlled by cooperatives that regularly negotiate supply agreements with buyers of 4b milk. This is the proper place for price discussions to take place. Instead of going to the marketplace and asking their customers, cheese processors and others, for a higher price, these cooperatives have chosen to delegate this responsibility to the California Department of Food and Agriculture. This is not the intended function of the regulatory system. The regulated minimum price should be a market clearing price, not a market making price. If allowed to function, the marketplace will drive premiums and establish a value for milk above and beyond the regulated price.

Minimum Price Increases Redistribute Revenue and Disconnect Producers from the Marketplace

Not all dairy producers benefit when the minimum price is increased. Increases in the minimum price do not mean increases in take-home pay for all dairy processors -- dairy producers, excuse me. In fact, those who received over order premiums will actually see a decrease in their pay when minimum price increases as the premiums are redistributed through the pool. Increases in the minimum price redistribute revenue and disconnect producers from the marketplace. So that is our example, as the minimum price goes up the premiums that we have paid, which we have paid significant premiums since our inception, become redistributed through the pool.

Comparing Class III to 4b Is Like Comparing Apples to Oranges

For over seven years, California has debated the whey valuation in the 4b formula. At the heart of this debate is an inappropriate 4b/Class III comparison. Producer organizations have led their constituents to believe that these two pricing mechanisms should be equal. As a processor that operates in both California and federal order environments, I can tell you that they are wrong. Class 4b and Class III are not the same, nor should they be the same.

First, California market conditions are different. Our supply and demand structure is such that California is chasing plant capacity while Wisconsin plants are chasing milk. This fundamental economic situation contributes greatly to the premiums paid to Midwest producers.

Secondly, California processors' costs are greater and must move product further to market. California plants cost more to build and operate. We are also at a cost disadvantage to our Midwestern competitors as it relates to proximity to domestic markets. Hilmar Cheese Company regularly moves -- moves the majority of our cheese production east. It currently costs about $0.08-$0.11/lb cheese to move it into the Midwest. That equates to about -- around $1/cwt. It's really $0.80 to $1.00/cwt. We must be able to price this cheese competitively to remain in these markets.

The third and most significant difference is that paying the regulated minimum price is optional for cheesemakers in Federal Milk Marketing Orders. The Federal Milk Marketing Orders have a mechanism for pricing pool milk below regulated minimums to clear the market when needed. Through diversions to non-pool plants, all of our primary competitors either operate outside of the regulated environment, Idaho/Oceania, or have the opportunity to opt out of the pool, like New Mexico and Wisconsin. This means that cheese milk is oftentimes sold for less or purchased for less than Class III in order to move milk during periods of oversupply. Hilmar Cheese Company regularly buys milk at below Class III prices.

Fourth, the debate assumes that Class III is a good, sound way to value cheese milk and value whey. But processors in Federal Orders have also expressed concern with the nature of the Class III formula. As evidenced by the recent closing of Penn Cheese Corporation in Pennsylvania, cheese plants in regulated systems without whey concentration equipment struggle regardless of the state in which they operate. This is also true in Wisconsin, where several years ago it was said that one-third of the cheese plants were swimming in red ink on the other solids price. That was a statement by John Umhoefer of the Wisconsin Cheese Makers Association.

In the end, formulas do not generate revenue. They simply determine how revenue is divided up. The solution to our problems is not to move to Class III or to the Federal Order because the Federal Order does not guarantee producers additional revenue. One only has to compare the California mailbox price with mailbox prices in other regions with Federal Orders. There are regions of the country like New Mexico, which have a much higher percentage of Class 1 milk than California, where mailbox prices are very similar to California. At the end of the day, supply and demand conditions drive mailbox milk values even in Federal Orders. Quite frankly, our industry is asking the wrong question. Instead of asking which of the two existing regulatory systems are best, we should ask what environment creates the most opportunity for all industry participants to thrive. Our industry needs to focus on answering that question. Until we do this we will continue to get the same poor results.

The Current Construct of the 4b Whey Formula is Insufficient and unsustainable

While there are many differences between the Federal Order Class III and the California Class 4b prices, there is one major defect they share, they both have deficient means for valuing dry whey. Dry whey does not have a liquid cash market for price discovery. Its quoted market is based on a phone survey, which lacks transparency and tends to lend itself to the potential for misreporting.

Whey valuation is problematic because the cost of production information is not available and auditable. As the industry continues to consolidate and diversify, there are not a sufficient number of plants that cost of production can be publicly reported without reaching -- without risking breaches in confidentiality. Out of the dozens of whey plants in California, we believe only two actually produce dry whey and their costs are not available. The state, therefore, does not have adequate information to properly construct end-product pricing formulas.

Further, a disparity exists for most processors because they do not make dry whey. There are multiple categories of value-added whey and valuing based upon dry whey is inapplicable to most processors. For example, a comparison of whey markets over the past five years shows that the income stream for whey protein concentrate based products is not keeping up with the benchmark milk fueled by escalating dry whey markets. Whey products are not all the same and do not move in tandem. Processors are required to pay a minimum price that is not tied to the products which they produce.

Processors agree that the data available for dry whey is lacking, but selecting another whey product is not without flaws. Hilmar Cheese Company produces over half s dozen different whey products. In addition, we make specific products for specific customers, which require large investments in equipment and personnel. But even the most basic form of processed whey requires considerable funds that some smaller processors cannot afford.

Moreover, the use of value-added products should not be attempted in minimum pricing formulas. As John Umhoefer described in his Cheese Market editorial on January 6, 2012. The baseline product we should be using is skimmed wet whey. "Whey that has been skimmed, cooled, transported and run through a million-dollar dryer is not a base commodity and has no place in a basic milk price formula."

Pooling and End Product Pricing Do Not Benefit Dairy Producers

Pooling and end product pricing formulas disconnect producers from the marketplace signals. Increasing the regulated price will effectively pool premium dollars being paid by handlers, putting further distance between the marketplace and the price signals a producer receives. This inhibits our ability to send price signals directly to dairymen to produce the type of milk the marketplace demands. It also slows down a producer's response to demand changes, thereby increasing periods of low prices. At its extreme, over-inflated minimum prices could tell a Jersey dairyman there is no difference in shipping his milk to a bottler or a powder plant or a cheese plant, yet we all know the best and highest use for this type of milk is in cheese.

End product pricing formulas force producers to bear all the market risk while making it more difficult to hedge that risk. With make allowances imbedded in pricing formulas generating high minimum prices, risk-averse processors have learned to operate within that set margin, regardless of market direction. Producers are not afforded that same luxury and are vulnerable to price volatility.

End product pricing formulas are already a hindrance to innovation and new product development. Increasing minimum prices will stifle innovation and new product development even further, resulting in missed opportunities for demand growth. These formulas discourage processors from producing new products by introducing considerable risk when the price of the products a processor makes deviate from the products used to set the regulated price.

End-product prices are unable to keep up with our ever-changing global marketplace. As soon as these formulas are put into place they are outdated. Export customers expect to negotiate contracts for set periods into the future. By the time prices are calculated using historical numbers, they are no longer applicable and this can be extremely detrimental.

End-product price formulas also lead to contentious debates over value sharing that do not contribute to sustainable increases in the value of milk. Any change creates winners and losers. It directs the industry's focus to formulas, not customers. In the end we simply fight about how to divide up the pie, rather than grow the pie for all.

Pooling subsidizes the purchase of milk for low value dairy products and does not force all market participants to compete. As long as we have pooling and classified pricing in California those who process milk will not have to compete for milk based on the value they create, they can use the revenue from others via the pool to pay for their milk. And that is bad for dairymen. The solution is not to make others pay more into the pool, the solution is to deconstruct the system and force all processors or buyers of milk to compete for that milk.

Hilmar Cheese Company is not asking the system for financial support, as some are. We are ready and willing to compete for milk in a market-driven environment, but today that is not an option in California. In the end, the dairy industry needs to reform our pricing system and force all milk buyers to focus on growing the value of milk, not work the system. This is the only way to sustainably grow the value of milk and increase producer pay prices.

Regulatory Uncertainty Impedes Investment

In the past ten years, we have had 20 milk price hearings, not including the hearing we are in the middle of today. Each of those hearings have significantly impacted the margins and the returns for all processors and producers. As individual companies consider long-term investments that require massive amounts of capital, these frequently changing regulatory environments discourage investment by creating uncertainty. I would say this for both parties, producers and processors. This regulatory uncertainty paralyzes the industry and increases the risk of new investment and continues to drive investment to other regions. It's time we introduce some stability into our pricing environment and allow market signals to drive investment decisions.

The Solution

As a producer-owned company, Hilmar Cheese Company supports the efforts to increase the value of milk. We believe this requires moving to a more market-oriented approach. This strategy has also been suggested by producer funded, third-party studies. Both the McKinsey Report and the Innovation Center Report on Globalization concluded that there is tremendous opportunity for California and the US in the global marketplace. However, they both suggested that the industry adopt market-oriented policy initiatives and pricing reform. Both warned that failure to do so might compromise our competitive position long-term.

Our problem is not that our industry has been focused -- our problem is that our industry has been focused on the system, not the customer. As a result, many of the state's production assets are not configured to take advantage of high value global opportunities that exist. We must turn our focus away from the system and focus on the customer. If we do not, we will get more of the same poor results. The whey factor debate is a symptom of a much larger problem and a simple adjustment in the whey factor will not solve our problems long-term. As long as we remain entrenched in formula pricing, we will continue to have contentious debates around value sharing, producers will continue to bear all the market risk and our industry focus will be on the system, not the customer. Let us redirect our efforts in support of the California dairy task force as they collaborate towards long-term, sustainable solutions.

Our global competitors are moving in that direction. In order to take advantage of international growth opportunities we must follow the lead of other countries such as New Zealand and the European Union. Dairymen in New Zealand operate in an unregulated market, yet they are often paid more than those in regulated areas. Just last month, Fonterra announced another increase to its Forecast Farmgate Milk Prices for the 2014 season in response to strong international dairy prices. In the European Union, processors are expanding capacity in lower cost regions in expectations of increased milk production when the restrictive quota system is eliminated. These processors are likely to emerge as formidable international competitors, according to USCED. We too must change or risk being left behind.

On behalf of Hilmar Cheese and its producer-owners I urge the state to reject the petition from California

Dairies, Inc., California Dairy Campaign, Milk Producers Council and Western United Dairymen. In view of the very recent changes to the whey factor, the misplaced comparison of 4b with Class III, and the serious insufficiencies in the whey calculation, and improving economic conditions, now is not the time to further distort market signals by increasing the minimum regulated price. The proposed increase in the regulated minimum 4b price is a step in the wrong direction for both processors and producers. Now is the time to embrace a more market-oriented approach and work together to capture the opportunity that exists in our global marketplace.

Thank you for your time and consideration and I would like to request the opportunity to file a post-hearing brief, if necessary. I would be happy to answer questions.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

We'll take questions from the panel.

MR. EASTMAN: I have a couple of questions on the appendices of your testimony.

MR. AHLEM: Yes. Yes.

MR. EASTMAN: Graph number 2, I assume the source of that information, is that the CDFA Cost of Production Survey or is that some other source?

MR. AHLEM: No, that's the CDFA, yes.

MR. EASTMAN: When it comes to Graph 3.

MR. AHLEM: Yes, the capacity.

MR. EASTMAN: I see that the milk production is pretty straightforward. How did -- I'm sorry.

How did you construct the effective plant capacity type line there?

MR. AHLEM: That's been -- that's been a -- this is a chart we've used and it's been used in past testimony, actually between both us and Dairy Institute, and Bill Schiek can speak to this as well when he's here. But generally at a point in time where there was kind of a known balance in the state of capacity and milk supply, we kind of tracked all the closures from there. So it is our estimation of where the effective capacity is that we have been tracking over the years, compared against daily milk production as reported by the state.

MR. EASTMAN: So in essence its just a comparison of the amount of milk at one point in time the state was able to handle.

MR. AHLEM: That is correct.

MR. EASTMAN: From there it either went up or down based on closures.

MR. AHLEM: And it's our best guess at a reflection of capacity based on what has been publicly reported in terms of plant closures or openings.

MR. EASTMAN: I may have another question, I need to look here for a second.

MR. MASUHARA: David, much as I have asked everybody before, as far as any negotiated numbers that came up with -- the petitioners' numbers, did you participate in that? And if you did, was there any analysis on your part to support those numbers or any level other than those numbers?

MR. AHLEM: Like some of the others have said, I'm a Dairy Institute member. I wasn't directly involved in the negotiation. There was a negotiation but there was no deal. But there was -- I wouldn't say, to my knowledge, any quantitative analysis or rationale behind some of the formulations, I think it was -- it was in a political context.

MR. MASUHARA: Okay. And I had another question. On page four you make mention of a comparison to the difference in increases fueled by dry whey markets versus WPC. Do you know of any reliable source of WPC sales information that's traded widely enough to be reportable or is it purely anecdotal?

MR. AHLEM: That was just -- that was gathering data from the survey prices reported by the USDA.

MR. MASUHARA: That's the USDA survey price?

MR. AHLEM: Yes, yes.

MR. MASUHARA: So it captures --

MR. AHLEM: They have a broad category. I think it's 34 to 79 percent or 34 to 50. Some others could probably correct me on that.

MR. MASUHARA: Okay. But it reflects sales in that category fairly accurately then?

MR. AHLEM: It's a survey.

MR. MASUHARA: Well, I mean, as accurately as a survey can capture it then, leave it at that.

MR. AHLEM: It's probably the only public number I'm aware of, but that's where that data was driven.

MR. MASUHARA: Okay, thanks. That's all I have.

MS. GATES: David, I just have one question. On page four of your testimony you had spoken to at your Texas plant you, on a regular basis, purchase milk below minimum Class III prices. Could you kind of further define what regular basis means.

MR. AHLEM: I mean, that could be ongoing. There's been -- at times there have been annual agreements that are on that basis, sometimes a spot. There are years and market conditions where it could be above and it can be below, it can be both, but it's not unheard of. So it can -- and it can transpire on more than just a spot basis.

MS. GATES: Okay, thank you.

MR. EASTMAN: I have a couple of other questions, piggy-backing on what Candace just asked. Are there other handlers or plants around your Texas plant that also operate in a similar fashion where they're taking in minimum price milk?

MR. AHLEM: I wouldn't know what they're purchasing milk for.

MR. EASTMAN: Say that again.

MR. AHLEM: There are other handlers and buyers of milk but I am not aware of what they are buying milk for.

MR. EASTMAN: And then on page three of your testimony you talk about transportation costs to move cheese to the Midwest.

MR. AHLEM: Yes.

MR. EASTMAN: That can vary, I assume, The range in cost, is that based on diesel prices or is it based on the location where you're shipping?

MR. AHLEM: Correct.

MR. EASTMAN: We know you have a plant in California and one in Texas.

MR. AHLEM: That's based on -- so that's a current snapshot of reflective diesel costs of transportation to get cheese from Hilmar to the Midwest specifically. So it's more -- if we go east to the East Coast it's a larger number, if we go, you know, to the mountain range that's a smaller number. And that number has grown over time. I probably -- if I were to report that seven or eight years ago it was probably half of that. The transportation numbers have grown over time.

MR. EASTMAN: And so the shipping point, though, is that in California, is it in Texas --

MR. AHLEM: No.

MR. EASTMAN: -- is it a storage facility?

MR. AHLEM: The number I used here was in California. So it's less shipping from Texas to the Midwest, which means we have more available milk.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Ahlem.

MR. AHLEM: Thank you.

HEARING OFFICER SUTHER: We are going to now deviate off our normal script. Senator Galgiani is here to make a statement.

SENATOR GALGIANI: Thank you, Mr. Chair, and members; I am here as the Chair of the Senate Agriculture Committee. And I wanted to make clear that after months and months of discussion between dairy farmers and milk processors they reached a historic agreement on the last day before we were leaving for break.

I called an emergency hearing of the Senate Agriculture Committee. That emergency hearing required rule waivers from the entire body to be able to hold the hearing after the deadline; and we did so because of the agreement that was reached between the producers and the processors. We had that bill held in our Agriculture Committee that day. I had two members from the Agriculture Committee flown back from Southern California to be present to vote on the deal, which was contained in AB 1038.

As part of this deal there was a short-term fix that included $110 million in new money that cheese processors would pay into the milk pool to be shared by dairy farmers. This additional money would come from increasing the price of 4b milk by $0.46 cents and by modification of the whey formula.

Furthermore, in the legislation there was contained an element that allowed for the task force to continue working. Being sensitive to this issue and both sides of the issue it was important, in our view, that the agreement that was reached be a temporary agreement and that both sides be allowed to continue with the Secretary and others within this task force process to come up with recommendations to be given to the Legislature for further consideration for some permanent future changes to the milk pricing structure.

I will be submitting my comments in writing to this body and I thank you for considering this. And once again, the purpose of my being here today is to set the record straight and make it clear that the purpose of our hearing and the purpose of the legislation was to codify the fact that a deal had been reached. Thank you.

HEARING OFFICER SUTHER: Thank you.

Now folks from the Dairy Institute. Mr. Schiek, could you please state your full name and spell your last name for the record.

DR. SCHIEK: Yes, my name is William Schiek, S-C-H-I-E-K.

Whereupon,

WILLIAM SCHIEK

Was duly sworn.

HEARING OFFICER SUTHER: You have six documents here that we will mark as Exhibit 57.

(Exhibit 57 was entered into the record.)

MR. SCHIEK: Okay.

HEARING OFFICER SUTHER: Mr. Lemmon.

MR. LEMMON: Yes.

HEARING OFFICER SUTHER: Could you state your full name and spell your last name for the record.

MR. LEMMON: Sure. John Lemmon, the last name is L-E-M-M-O-N.

Whereupon,

JOHN LEMMON

Was duly sworn.

HEARING OFFICER SUTHER: And you have one document that will be marked as Exhibit number 58.

(Exhibit 58 was entered into the record.)

HEARING OFFICER SUTHER: Mr. Schiek, you may proceed.

DR. SCHIEK: Mr. Hearing Officer and members of the Hearing Panel:

My name is William Schiek and I am Economist for Dairy Institute of California and I am testifying on the Institute's behalf. With me today is John Lemmon, General Counsel for Dairy Institute, who will address the legal foundation for the whey factor as noticed in the call of the hearing.

Dairy Institute is a trade association representing 30 dairy companies which process approximately 75 percent of the fluid milk, cultured and frozen dairy products, over 85 percent of the cheese products and a small percentage of the butter in the state. Member firms operate in both marketing areas and the position presented at this hearing was approved and adopted unanimously by Dairy Institute's Board of Directors.

Dairy Institute appreciates the opportunity to testify at this hearing where proposed changes to both the temporary price increases that were implemented on January (sic) 1st, 2013 and the sliding scale whey factor that is a part of the Class 4b formula will be considered. While prices for milk and some dairy commodities have decreased from their spring highs seen in April and May, they are now rebounding. And in the first seven months of 2013, dairymen received $420 million more in the pool than last year. At the same time the price of corn is beginning to decline from levels seen last year and earlier in 2013, and this trend is expected to continue and intensify in the coming months. As a result of these changes, dairy farm margins are expected to improve substantially. At present, the state's milk supply is in fairly good balance relative to demand. During this summer's heat spells, there have been periods where one or more buyers have been short of procuring all the milk components that they would like and have responded by going into the market and offering premiums to secure additional supplies. However, as the heat abated, no chronic shortage of milk or milk components has been reported. Milk processing capacity is not being stressed at present and milk supplies are being handled adequately within the state, a far cry from the situation seen during the first half of 2012. Based on the current economic conditions in the dairy industry, and the prospect for continued improvement in dairy farm margins, we do not believe additional price increases or changes to temporary price relief such as those proposed by the petitioners are warranted.

In the state's Food and Agricultural Code, the legislature has declared that the production and marketing of milk is a business affected with a public interest. In defining how the public interest is to be served, the legislature has made numerous declarations as to its intent. Section 61802(e) of the Food and Ag Code reads: "It is the policy of the state to foster the intelligent production and orderly marketing of milk." Therefore, pricing decisions by the Secretary that seek to discourage disorder marketing are reasonable, even if they result in prices for milk used in manufactured products that appear to be out of synch with regulated prices that exist in other parts of the country.

The bottom line here is that regulated prices must be set low enough to ensure that markets clear in order to maintain orderly marketing for milk. Setting regulated prices in the state at levels that are too high for California markets to clear locally, that is within the state, are contrary to the legislature's stated policy of fostering intelligent production and orderly marketing. A more detailed discussion of these issues is presented in Appendix A.

Additional Price Increases are Not Warranted by Economic Conditions

The producers' petition would result in a net increase in pool prices from levels generated by the current formulas. Economic conditions simply do not support additional price increases at this time. Futures prices suggest that dairy farm margins will be better than those seen in the first half of 2013 for at lest the next six months. For this reason, it is not advisable for CDFA to raise minimum price levels further. Stronger farm level margins are expected to lead to increased milk output and some testing of the state's plant capacity limitations. Current marketing conditions are discussed in more detail in our Appendix B.

Redirecting Temporary Price Relief Solely to Class 4b is Without Economic Justification

The Petitioners' proposal to place all temporary price relief solely on Class 4b is without justifiable economic foundation and is not warranted by current economic conditions. The rationale for the petitioners' proposal is built on the notion that Class 4b is underpaying relative to other classes or in comparison to other regions of the country. This notion is incorrect. Class 4b prices are lower than Class III prices for the reason that milk for making cheese has an inherent lower economic value in California than milk on other areas. This topic is discussed in more detail in Appendix C.

But the factors that lead to a lower California cheese milk value are as follows:

First, milk for cheese making has a lower location value in California when compared to other regions. In order to market all of the products made from the milk that dairymen produce, products must be sold in markets that are increasingly more distant from the state. To be competitive, California plants must ship product across the country at a landed cost that is competitive with the order prices that are paid by plants in the distant market. When the cost of moving product to more distant markets is considered, the current 4b pricing formula does not appear to be undervaluing milk for cheese making.

California is a more expensive place to do business than other states. This business cost difference lowers what a plant is willing to pay for milk in order to profitably make and market dairy products.

Third, farm level costs of production are generally lower in California than the rest of the country. And lower milk production cost leads to dairy farm expansions and more abundant supplies, which lowers the value of milk in the state over time.

California's expanding milk supply has collided with inadequate processing capacity in the state on numerous occasions, leading to disorderly marketing conditions and diminishing the value of milk even further.

Differences in the applicability of minimum pricing between California and the Federal Milk Marketing Orders necessitate that the California regulated prices be true minimum prices, while the same is not as crucial under federal regulations. In the federal orders, milk that is not pooled is not subject to minimum pricing under -- in other words, under the Order. In other words, the regulated price is optional. In California, on the other hand, all Grade A milk must be paid the established state minimum price regardless of its pool status. In other words, the regulated price is mandatory. If the price is set too high, plants will be put out of business and dairymen lose markets for their milk. When milk supply exceeds demand, milk must move out of the state to find processing homes instead of being able to clear locally. To ensure orderly marketing, California regulated prices for manufactured milk must be set at levels that clear the market.

Additional Changes to the Whey Scale Are Not Supportable

The inclusion of the whey factor in the Class 4b price formula has been problematic from its inception. These problems stem chiefly from the inherent difficulty, even the impossibility, of fairly attributing whey revenue and margins that are representative of what is achieved by all cheesemakers. It has been noted at prior hearings that the variety of whey products produced, the lack of a reference product that accurately represents whey revenues and costs achieved by all plants in the state, and the stubborn fact that the majority of cheese plants in the state do not have the ability to process their whey into revenue-generating products creates an intractable policy dilemma with respect to whey. This issue is discussed in full detail in Appendix D.

At past hearings, some have tried to argue that the dry whey price represents a minimum that is achievable by cheese plants and therefore it can be used in the pricing formula as plants making other products are undoubtedly earning even more than for dry whey. The problem with this argument is that it has been unsupported by any credible evidence and was actually refuted by an analysis done by CDFA as part of the Whey Review Committee in 2008 that examined the relative values of dry and whey protein concentrate-34 percent over time. The problem of representing whey in a milk pricing formula is further compounded by the large number of products that are produced. One California cheesemaker notes that it has over 150 whey protein formulations available for customers, illustrating that trying to capture the value of whey to a cheesemaker in a pricing formula is a practical impossibility.

The preceding discussion, of course, fails to identify the obvious problem that no reference product can accurately represent whey revenues to cheesemakers that do not process their whey. According to CDFA data presented at the prehearing workshop in advance of the May 31-June 1, 2012 hearing, only 11 of the state's 57 cheese plants actually process whey. The other 46 plants do not process whey and that number includes some of the state's larger plants. For plants that do not obtain revenue from the whey they produce as a byproduct of cheesemaking, any product that imputes a positive revenue contribution from whey would not accurately represent the situation of those plants.

But what are the policy implications? First, if regulators impose a whey end-product formula on cheese plants, it will over-value milk to some cheesemakers, drive them out of business and lead to disorderly marketing conditions, especially if there is inadequate plant capacity. Second, even in federal orders where the ability exists for plants to pay less than the minimum price, overvaluation leads to financial stress on plants. Finally, any valuation of whey in a regulated milk pricing formula runs the risk of overvaluing milk in the market and leading to disorderly marketing conditions if it results in cheese plants being unable to operate profitably. Ad hoc formulas, such as the whey scale currently employed, are as flawed as end-product ones because they are constructed arbitrarily without reference to the revenues that regulated plants actually achieve from whey.

Consolidation of plants has led to less publicly available data with which to design or amend end-product pricing formulas under the current system. In 2003 there were four dry whey plants in the state that CDFA could use in its dry whey manufacturing cost survey. Today there is only one plant in the state that consistently produces dry whey and the data cannot be reported for confidentiality reasons. From the perspective of generating representative information, the Department currently has no rational basis for determining manufacturing cots for dry whey in California or for relating them to the broader spectrum of whey processing in the state.

The same problem plagues the determination of whey revenues. The Department does not have an ongoing, public, California-based whey price series. It is not known how closely the Dairy Market News western dry whey prices that are currently used relate to prices received for dry whey by California cheese plants. A similar problem would exist when attempting to use data for other whey products in light of the diversity of the industry's product mix, the lack of a representative reference product and the dearth of public price and cost data. CDFA would be unable to establish a rational basis for a whey factor derived from alternative whey products.

The lack of California data might led some to suggest that CDFA simply adapt or modify cost, price and yield data or other factors from the federal formulas or from federal plants as a substitute. In order for such an approach to even be considered there would need to be substantive evidence to show that the federal data is or can reasonably be adapted so that it is broadly representative of plant operations and product prices in California. The Department's attempts in the past to use federal Class III prices as a basis from which to extrapolate the whey factor and incorporate it into the California 4b prices has been both inaccurate and unreliable.

In 2003, the Department added a whey factor to the Class 4b price formula. Since an audited manufacturing cost study for whey powder was not available at the time, CDFA relied on testimony from the hearing in 2003 to set manufacturing cost allowances. The evidence and testimony presented at the hearing was largely based on materials presented during previous federal hearings or drawn from budgeted financial information. Though the use of such data caused the hearing panel great concern, the Department nevertheless set the dry whey manufacturing cost allowance at $0.02 higher than the allowance for nonfat dry milk. This was the methodology employed initially by USDA in establishing the dry whey make allowance used in the federal orders. In 2004, when the results of CDFA's skim whey powder processing cost survey became available, they showed that the 2003 manufacturing cost allowance was actually $0.09 below the average costs incurred by California plants that were processing dry skim whey. California handlers were massively overpaying for Class 4b milk.

Due to the lack of credible and representative means to accurately represent the value of whey to cheesemakers across the state, and for all the other aforementioned reasons in this testimony, Dairy Institute does not believe that additional changes to the whey scale as proposed by the petitioners are advisable or warranted by current industry or economic and structural conditions. We do not support their adoption.

Rather, in our view, it is essential that the California dairy industry transition to a new method of determining milk prices that will enable both processors and producers to realize greater profitability. Dairy Institute believes that the work of the Dairy Future Task Force is crucial and we continue to support its efforts. Finally, there have been several newspaper articles in statements today about the industry negotiations surround AB 1038. We have set forth the facts surrounding those negotiations in Appendix E. Thank you for the opportunity to testify.

Mr. John Lemmon will now address the legal foundation of the whey factor in the Class 4b formula. After his testimony we will be happy to answer questions from the panel and we will also be requesting an opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Mr. Lemmon, will you continue.

MR. LEMMON: Yes, thank you. Good afternoon, Mr. Hearing Officer and members of the Hearing Panel.

My name is John Lemmon, I serve as General Counsel to Dairy Institute of California.

As the testimony by Dr. Schiek has shown, the evidentiary record in this hearing will not support an increase in Class 4b milk pricing based on an adjustment to the whey factor. As a matter of both law and common sense, the record fails to support even the continuation of the current whey factor in Class 4b pricing.

Dr. Schiek's testimony highlights five important issues:

First, the adoption of a whey factor based on the pricing, make allowance and yield of dry skimmed whey is irrational in light of the many other end uses for whey in today's market.

Second, the inclusion of a whey factor in the price paid by all handlers purchasing Class 4b milk is irrational in light of the fact that the majority of handlers in California do not produce whey products for sale as a byproduct of cheese manufacturing.

Third, there is no evidence in the record of this hearing reflecting current pricing, make allowance and yield in California for what appears to be the sole California handler that consistently produces dry skimmed whey for sale, nor will there be any such evidence. That information is proprietary, and because there is only one such California handler, it cannot be aggregated with information from other California handlers to preserve its confidentiality.

Next, the adoption of a Class 4b price based only on the Federal Milk Marketing Order Class III price is irrational owing to several key differences between California market conditions and out-of-state market conditions. These include the fact that, in the federal system, non-pooled milk is not subject to the minimum price, while in California the established 4b price is a true minimum; secondly, manufacturing and business costs in California are higher; and thirdly, producer costs in California are lower.

The last point in Dr. Schiek's testimony is that the last time the Secretary implemented a whey factor in

California based on data relating to the Federal Milk Marketing Orders that effort misfired badly resulting in overpriced Class 4b milk.

The Secretary appears to have anticipated these issues in the Notice of Hearing regarding this hearing. With that as a background I want to make four points:

First, the Notice of Hearings shows the Secretary's justified concern that any adjustment to the whey factor with resulting changes in the Class 4b prices be supported by evidence relating specifically to California handlers.

The notice of this hearing specifies the legally appropriate framework for analyzing whether there is any role for the use of the whey factor in setting the Class 4b milk price. That notice asked the petitioners to address the sufficiency of the calculation of the whey factor by reference to quantifiable economic data and methodologies, such as but not limited to manufacturing cost data, market and sales data and the whey stream valuation directly applicable to California plants.

The notice also describes the Department's concerns about the lack of transparent data that is readily available, data that cannot be published due to confidentiality, and data that are directly related to the manufacturing and marketing of California whey products.

Lastly, the notice asks witnesses to address the extent to which the factor can be transparently calculated as a component of the Class 4b price and fairly imposed on processors.

So far as any adjustment to the whey factor and resulting increases in Class 4b milk price is concerned, then, the Department is obviously concerned with transparency, as it should be. But as the record in this hearing today has shown, the whey factor in California cannot be transparently calculated and it would therefore be unfair to impose it on processors.

The Secretary's Decision must be supported by evidence specifically related to California handlers and included in the record of these hearings.

Transparency is not merely desirable, it is a legal requirement. Under the law established by several California cases cited in the written version of this testimony, it is axiomatic that any pricing decision made by the Secretary in connection with this hearing must be based on evidence in the record. As the Court in the Golden Cheese case has stated: "Factual matters are reviewed to determine if the director's action was arbitrary, capricious, or entirely lacking in evidentiary support." That evidence must be included in the record of the hearings out of consideration for fairness and the law.

These cases also establish that, as a matter of fairness, all parties are entitled to review, comment on and rebut any evidence on which the Department may rely for its decision to set prices. As one appellate court has already noted, an administrative agency directed to fix prices or price levels after a hearing, may not base its decision on evidence outside the record and not made available for rebuttal by the affected parties.

As a matter of law, therefore, the Department must create an evidentiary record on which a reviewing court can rely to determine whether the Department's action is arbitrary, capricious or lacking in evidentiary support. A court reviewing order by the Secretary in this proceeding will scrutinize the record and determine that the order lacks evidentiary support if there is no reasonable basis to support the decision. The California Supreme Court has delineated the scope of the reviewing court's inquiry into whether there was a "reasonable basis" as follows:

> "A court must ensure that an agency has adequately considered all relevant factors, and has demonstrated a rational connection between those factors, the choice made, and the purposes of the enabling statute."

I see that I am out of time. Would you prefer me to continue this after all the other witnesses have testified?

(The Panel conferred.)

HEARING OFFICER SUTHER: Please continue.

MR. LEMMON: Thank you, Mr. Hearing Officer.

The Secretary is, of course, bound to apply the very same standards in adopting or implementing a milk pricing formula if she is to be confident that her decision will avoid being overturned by a reviewing court.

The third point I wish to make is that the record in this proceeding does not contain evidence sufficient to support the current or prospective use of a whey factor to calculate Class 4b milk prices.

The only data regarding the whey factor available in this hearing so far relates to pricing, cost and yield information underpinning the Federal Milk Marketing Orders and related to out-of-state handlers. That data does not pertain to California handlers because information regarding California handlers is, for reasons of confidentiality of handlers, unavailable for introduction into the record.

This evidence therefore falls well short of the call in the Notice of Hearing that seeks data "directly applicable to California plants" and "directly related to the manufacturing and marketing California whey products."

The evidence pertaining to out-of-state handlers subject to the federal orders is unreliable, for all of the reasons identified in Dr. Schiek's testimony and David Ahlem's testimony. Nor are they alone in their skepticism, which is based on the differences between the California milk market and the federal orders. In the Panel's report released after the June 30 and July 1, 2011 Class 4a-4b hearings the Hearing Panel once again reviewed and discussed all of these key differences.

The Department's efforts in the past to use Federal Order Class III prices as a basis from which to extrapolate the whey factor in California and California's Class 4b prices have been woefully inaccurate and unreliable. As Dr. Schiek noted, in 2003 the Department added a whey factor to the Class 4b formula. Since an audited manufacturing cost study for skim whey powder was not then available, the department relied on testimony from the 2003 hearing. Most of that was drawn from federal order hearings or from budgeted financial information. The Department then set the manufacturing cost allowance at $0.02 higher than the manufacturing cost allowance for nonfat dry milk.

In making that decision the Department missed by a mile. In 2004, when the results of the Department's skim whey powder processing cost survey became available, that survey showed that the 2003 manufacturing cost allowance was actually $0.09 below the average costs incurred by

California plants then processing dry skim whey. Since 2003, in other words, California handlers had overpaid for Class 4b milk, as the Secretary recognized implicitly when she increased the manufacturing cost allowance and the resulting Class 4b price in 2005.

The demonstrated unreliability of Federal Milk Marketing Order data as applied to California handlers, coupled with the unavailability of California-specific evidence, compels the conclusion that there is no reasonable basis in this administrative record on which the Secretary may adjust or even continue the whey factor as an element of Class 4b pricing. If "reasonable basis" means anything, it requires that the Secretary inquire whether there is any reliable evidence in the record to support the whey factor as an element of the Class 4b price. In the face of the proven unreliability of Federal Milk Marketing Order data in the application to California and the unavailability of data directly related to California handlers, this question must be answered in the negative.

The last point is, Food and Agricultural Code Section 62062 does not permit the Secretary to use Federal Milk Marketing Class III prices as a substitute for California-specific data.

Section 62062 of the Agricultural Code identifies a number of factors the Secretary must take into consideration in setting minimum prices. Petitioners want us to single out one of those factors for special emphasis in their argument that the whey scale in the Class 4b formula should be modified, resulting in an increase in 4b prices. They focus on the requirement that California prices bear a "reasonable and sound economic relationship with the national value of manufactured milk products." Petitioners argue that Class III prices exceed the California Class 4b prices and that the California Class 4b prices must therefore be increased.

But that argument is misguided.

Section 62062 lists other pricing factors manifesting the legislative intent that the Secretary also take into account, among other things, the "cost of producing and marketing milk for all purposes, including manufacturing purposes." The inclusion or application of a whey factor in Class 4b prices must accordingly be supported in the record by evidence showing, first, why dry skimmed whey is a suitable proxy for all whey end uses; second, why the inclusion of a whey factor boosting the Class 4b price is appropriate as applied to handlers for whom whey is a cost center, not a profit center; and thirdly, if in spite of the foregoing a whey factor is nevertheless to be used, the actual prices charged by California handlers for the finished product, manufacturing costs incurred by California handlers and yield for California handlers.

In the absence of evidence in the record regarding any of these items, the Secretary is obligated under the law to reject any proposal regarding the whey factor. Moreover, using Federal Order prices as a proxy for California pricing, cost and yield data does not satisfy the reasonable basis test that the courts will apply to the Secretary's decision in this case. The requirement that the Secretary's pricing decisions have a reasonable evidentiary basis and have a "ration connection" to the pricing factors listed in the statute is grounded in two considerations: participants in hearings like these must be allowed to comment on and contest evidence introduced by other parties; and the court must have the basis for reviewing the agency's decisions.

Viewed against that backdrop, there is no dissonance between the statutory requirement that California prices bear a "reasonable and sound economic relationship" with national prices and the statutory requirement that the Secretary base her pricing decision on cost, price and yield data specific to California handlers. The Secretary's pricing decisions must be driven by such cost, price and yield data specific to California handlers as is included in the administrative record; national prices, based on other data, provide a reference point but not a target.

In conclusion, considerations of both fairness and the law require a conclusion -- excuse me.

Considerations of both fairness and the law require a conclusion that the Department cannot continue to use the current whey factor in calculating Class 4b prices.

As a matter of fairness, the use of a single end-product, dry skimmed whey, as a proxy for all whey uses is insupportable. Further, most handlers purchasing Class 4b milk have not made, and may not have the ability to make, the capital outlay necessary to convert whey from a cost center to a profit center in their production.

As a matter of law, the use or application of any whey factor without inclusion in the administrative record of evidence showing prices, costs and yields of California handlers would flout the statutory and decisional authority carefully developed by California courts to balance agency discretion with judicial oversight.

I thank the Panel for the opportunity to testify and I echo Dr. Schiek's request that we be permitted to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

MR. EASTMAN: Where to begin. Actually because of the mere volume of things it might take a little bit. I wanted to go to the appendices of your testimony, Dr. Schiek, just to clarify a few things.

So in Appendix A it appears that Figure A-1 sort of mimics, according to what I see, something else presented by the witness -- by Hilmar. I assume that's kind of -- is that the same graph?

DR. SCHIEK: Probably it's pretty close. Did you -- A question to you.

MR. EASTMAN: Okay.

DR. SCHIEK: Did you want to expound on the methodology, because I can --

MR. EASTMAN: Yes. Was his description of how you came up with the effective plant capacity accurate?

DR. SCHIEK: Yes.

MR. EASTMAN: Or would you agree with that?

DR. SCHIEK: I would agree with that. It was based on -- since I came to work in the California dairy industry, plant capacity was always adequate. When I first saw that it wasn't was in the spring of 2006. And the particular month, I believe, was March and that was when we first started getting the reports of milk being distressed and moving out of state. And so basically I benchmarked to that daily average milk production in March of 2006 as a sort of high water mark of what we could handle, it was somewhere around that.

Since then, as Mr. Ahlem testified, we have been tracking, as best we can, plants that are closing, plants that are expanding, new plants, and looking at the sort of announced capacities in the press reports and everything on those facilities and trying to keep track on sort of where that top line might be. It, you know, can't be accurate to the pound but it's in the ballpark.

MR. EASTMAN: Okay. So you would agree there is probably some measure, some margin of error there. Because if a plant is running a certain product that takes longer to, say, manufacture, move through the plant --

DR. SCHIEK: Sure.

MR. EASTMAN: They could switch products then. There could be some -- a margin of gray area.

DR. SCHIEK: Yeah, sure. And I guess you would say we're trying to -- trying to estimate maximum effective capacity. The actual effective capacity may be less if the economic incentives aren't right for plants to take on all the milk that they could possibly process.

MR. EASTMAN: Okay. When I look at Appendix B, it lists a number of what appear to be economic conditions. And one of the themes so far of what we have heard today are economic conditions that would warrant price increases or those that would not warrant them and so in Appendix B you're going to list some of these things. I know you already -- you mentioned milk production plant capacity or the supply of milk in relation to demand as a factor. What other types of economic factors do you believe would be important in determining whether or not minimum price increases would be warranted?

DR. SCHIEK: I think it's important to look at what is happening in terms of -- we talked about milk production, but in terms of what happening in the future direction of our margins and what the trends are. And so we're looking first at what is going on with feed costs, and there is a chart there, Figure B-6, which tries to look at at least three feedstuffs and illustrates, really, that corn is the one that is changing greatly, it's falling. And I tried to make some adjustment here.

I was using the California Grain and Feed Report data, looking at the first week of the month just as a reference point. So the first week of September, the first week of August, so on and so forth. I then projected forward with the CME futures prices with an adjustment for the California basis, in terms of looking at what those prices might be on a tonnage basis. You know. if you went out and bought corn today, what the CME futures price was. You know, what kind of price that would translate to in dollars per ton. So feed cost.

Milk prices was another, another one, what's happening with milk prices and what the futures market suggests. Futures milk prices will be in the commodity prices.

Also looked at the issue of consolidation because we have had some testimony today about consolidation, which is -- which is a painful and just devastating change in the industry. But I think some of the charts show that consolidation has been kind of a constant in our industry. At times it's greater, at times it's not as great, but I had a chart in here that kind of compared consolidation in California with some other major dairy states and the US average. And the issue there is that's kind of a feature of the landscape. It's not unique to California nor is California experiencing it in a greater degree than other, other states. You read reports from places like Dairy Australia, reports out of Europe on milk marketing and you're finding it's happening everywhere. Feed cost is pretty universal in terms of the way it impacts dairy farming.

I also mentioned -- the last chart in there is on the dispersion of the milk production cost estimates.

MR. EASTMAN: I'm sorry, which figure are you referring to?

DR. SCHIEK: That would be Figure B-8. which has taken the cost of production feedback data from the Department for the first quarter of 2013 and just plotted it for every farm that's in the sample and it shows the dispersion of those costs.

And one of the issues that drives consolidation is our current pricing system and the fact that it basically channels all the sort of competitive effort for dairymen into the cost arena. You see you've got some dairymen who were high cost, some were a lower cost. I think the spread here in the sample is something like around $11/cwt difference between the high and low cost farms in the sample. And when you have that kind of spread there is an average that kind of helps determine where the milk supply comes, you know, on average.

But the low cost farms are making more money and so they're -- they have money to expand and take advantage of scale economies and lower their costs even further, which tends to bring prices down. And that, obviously, makes it really tough on the higher cost farms and they eventually exit. So when you have a system where people are competing on cost, that's the only way they really can improve their profitability, it drives consolidation.

MR. EASTMAN: Okay. So moving on to Appendix C. Okay, on Figure C-3, I was -- I understand the Federal Class III price and the current 4b price. What exactly does that third price mean? What is that?

DR. SCHIEK: It represents essentially that federal Class III price less the cost of shipping from

California to that market. I think this is the East Coast, actually it's Boston. So the cost of moving cheese from California to Boston, expressed on a per hundredweight basis. Subtract that from the local Class III price. That's representative of what a California plant, all other things being equal, would have to be paying for milk in order to have a landed cost that is competitive with the local plant.

And the point I was making there is that, you know, where that -- obviously there are some differences in timing of ups and downs, but where that line lies is pretty close to the current 4b.

MR. EASTMAN: So can you repeat again exactly how you're getting the transportation cost exactly?

DR. SCHIEK: That was from surveying. You know, informally surveying members who ship cheese those distances.

MR. EASTMAN: Your California Dairy Institute members?

DR. SCHIEK: Yes, yes.

MR. EASTMAN: Okay. And I think Exhibit C-1 is something that's been -- and this is sort of a cost of doing business, business climate-type index, right?

DR. SCHIEK: Right. Right. That's this year's data.

MR. EASTMAN: Okay. And then in Appendix D, D-1. It looks like you're just taking a per pound protein basis comparison.

DR. SCHIEK: Right.

MR. EASTMAN: And what percentage were you using for dry whey as a protein?

DR. SCHIEK: Well, let's see. We were multiplying -- multiplying the WPC-34 price by .38, which is -- the data in that table actually came from the CDFA analysis from 2008 so whatever assumption was used there. I think it was .38 times the WPC-34 price, to make an equivalent dry whey protein.

MR. EASTMAN: Right. Okay.

DR. SCHIEK: I think that number is 13 --

MR. EASTMAN: Like 13 or 14 percent.

DR. SCHIEK: -- 14, somewhere in there, yeah, protein. And then I just -- in Figure D-2 just extended it with that same methodology with the more recent data. And what it shows is that there's some times WPC-34 is the more valuable product, sometimes dry whey is the more valuable product. There is no consistency there in terms of which one is the lowest value product.

MR. EASTMAN: Okay. And so on D-2, if I -- just refresh my memory. I think Dairy Marketing News, they report a range, don't they?

DR. SCHIEK: Yes, so this is --

MR. EASTMAN: And so you were taking the midpoint?

DR. SCHIEK: The midpoint, yeah.

MR. EASTMAN: Okay. Okay. I'm glad there's only five appendices.

(Laughter.)

MR. EASTMAN: And then in Appendix E it looks like you're highlighting a little bit of commentary regarding the negotiations that happened between the producer and processor sides of the industry as it related to the state legislature and the legislative activities of this year so far. And so from what I see then you just have a few different versions of AB 1031 (sic) language that have, I guess, changed at certain points.

DR. SCHIEK: Yeah, there's two versions of the AB 1038 language. One was what was in print, I think July 10th, and then the final version that was published on August 13th. And that really reflected what could be agreed to in terms of language in the bill. And it has no reference to pricing, it's all task force language.

MR. EASTMAN: So you have two copies. So are you stating that the July 10th is something that was being accepted or considered by the Dairy Institute or the processing community and then it switched? Is that -- and the second copy is something that you didn't support?

DR. SCHIEK: July 10th was the version that was sort of drawn from the letter that folks have referenced from Joe Lang of Lang Hansen to Dr. Pan. And that bill was amended two hours, probably, before it was heard in committee that Ms. Galgiani, Senator Galgiani talked about. So the final version is the August 13 version.

MR. EASTMAN: Okay. All right, so those were some of my questions regarding the appendices I have. I may have a couple other --

MR. MASUHARA: Can I jump in real quick, Hyrum?

MR. EASTMAN: Sure, go ahead.

MR. MASUHARA: My never-ending quest to find out where these numbers came from. Obviously, with numbers, somebody pushed a pencil around somewhere. Can you offer any insight on this, Dr. Schiek, on the $0.46 and raising the cap from $0.75 to $1.00?

DR. SCHIEK: I think it's fair to say that those numbers were more political calculations than economic ones.

MR. MASUHARA: So it was just a, what can you live with?

DR. SCHIEK: Yeah. I think some of the -- some of the driving folks behind the bill had certain numbers in mind, the big, top line numbers as far as total relief. So there were different proposals discussed but there was no economic analysis done.

MR. MASUHARA: So it was pretty much a political calculus that occurred here?

DR. SCHIEK: Yeah.

MR. MASUHARA: Okay, thank you

MS. GATES: You covered everything I had, you did a great job.

MR. EASTMAN: I have one more question, actually.

One thing that you mentioned, Dr. Schiek, in your testimony is that on the producer side there is a consolidation going on in the industry. And it has been happening for awhile where we have fewer dairy farms that, on average, are larger. Do you not see that's going to have to happen on the processing side as well? In California we have, say, cheese plants of different sizes that have different economies of scale based on size. Do you not believe at some point that is going to happen to the cheese plant? To really compete they're going to have to get big enough to develop those efficiencies or find the manner in which to invest in whey processing to be able to balance their product supply and compete in the marketplace, whether it be domestic or global or wherever?

DR. SCHIEK: That's a, that's a good question. You know, from a policy perspective I think you're right, that's certainly a possibility. I think the balancing point, though, is where is the milk supply? If the milk supply is long enough to keep so that we need the -- so the smaller plants, plant capacity in the system to market all the milk, you know, they may hang around for awhile because that's where the milk supply is.

So it's kind of a where is that market clearing price? And, you know, currently and historically the issue has been we have been pushing plant capacity in the state. I don't see any, any evidence yet that that won't be an issue going forward in the next few years.

MR. EASTMAN: Just to make sure I heard that correctly. So you don't think that is not going to be an issue? Did you use a double negative? I'm sorry, it's getting into the afternoon.

DR. SCHIEK: I'm sorry, a double negative.

MR. EASTMAN: Do you think plant capacity is never -- not going to be an issue?

DR. SCHIEK: So the issue of plant capacity I think is going to. Pushing up against plant capacity is going to be an issue in the coming years.

HEARING OFFICER SUTHER: Thank you for your testimony, Dr. Schiek and Mr. Lemmon.

MR. LEMMON: Thank you.

Mr. Garbani. Mr. Garbani, could you please state your full name and spell your last name.

MR. GARBANI: Pete Garbani, spelled G-A-R-B-A-N-I.

Whereupon,

PETE GARBANI

Was duly sworn.

HEARING OFFICER SUTHER: And do you have anything else other than this written testimony that you would like marked as an exhibit?

MR. GARBANI: No.

HEARING OFFICER SUTHER: Your exhibit will be marked number 59.

(Exhibit 59 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. GARBANI: Mr. Hearing Officer and Members of the Panel:

My name is Pete Garbani. I am here to testify on behalf of Land O'Lakes, Incorporated. My business address is 400 South M Street, Tulare, California, 93274. My current title is Vice President of Member Relations. Land O'Lakes thanks the Department for calling this hearing to consider amendments to the Marketing Plans. This hearing will address issues of critical importance to the future of both our California dairy producer members and the entire California dairy industry.

Land O'Lakes is a dairy cooperative with 3,000 dairy farmer member-owners. Land O'Lakes has a national membership base, whose members are pooled on the California

State Program and five 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 210 California member-owners supply us with over 16 million pounds of milk per day that are primarily processed at our Tulare and Orland plants.

Land O'Lakes fully supports the proposal submitted by California Dairies, Inc., California Dairy Campaign, Milk Producers Council and Western United Dairymen.

We agree with the petitioners that the 4b price remains the primary issue. The 4b price has averaged $15.96 in the three month period June through August 2013, representing a decrease of $1.24 from the May 4b price of $17.20. Future prospects for the 4b price presently look bearish in light of the large volume of cheese in storage and projections for another year of strong milk growth in New Zealand. Some market analysts project the 4b price to drop below $14.00 in the first half of 2014.

We remain concerned about the persistent gap between the California 4b and the Federal Order Class III prices. Since May, the difference has averaged $1.69 for the four month period May though August 2013. The 4b discount has averaged $1.60 per hundredweight lower than the Class III price for the seven month period February through August 2013.

It is important to note that the monthly Western dry whey price used by the Department in the whey portion of the Class 4b formula has continued to exhibit significant market strength in 2013. The Dairy Market News dry whey western mostly has averaged slightly over $0.58 for the first eight months of 2013. Recall that when the whey trades at $0.58 the whey factor in the 4b formula contributes $0.6875 to the 4b price; by comparison, at a whey price of $0.58, the whey factor in the Class III Federal Order formula contributes roughly $2.31 to the Class III price - a difference of $1.62 per hundredweight.

Equally important, dairy market analysts project that whey prices will remain at levels exceeding $0.50 for the rest of 2013 and 2014, which will continue to ensure that the large California cheese plants will return significant margins on their processed whey operations. In light of the continued strength forecasted for the whey market and the administrative price constraints under which the 4b price is presently calculated, the gap between the 4b and Class III will very likely persist into the immediate future.

In sum, without the proposed changes to the whey factor in the 4b formula and the temporary increase in the 4b price, California's dairy farmers will feel the full force of a decrease in cheese prices while receiving only a portion of the benefits of a strong whey market.

The petitioners' proposals would have the potential to add much needed revenue to California's dairy farmers' accounts over a 12 month period. This additional revenue would have a significant positive financial impact on California's dairy farmer families and would send an important message to California dairy farmers that the CDFA Secretary understands the seriousness of the financial pressure that California dairy farmers have experienced in recent years.

By contrast, cheese processors have continued to enjoy the benefits of a discounted 4b price even with the four month, $0.30 increase and the current six month $0.15 increase in 4b. Recall that in 2012 the 4b price averaged $1.91 lower than the Federal Order Class III. Even after taking into account both of the recent administrative price increases, the 4b price has still offered a significant discount of $1.60 to cheese processors.

Financial Conditions Continue to Challenge California Dairy Farmers

As we noted in our testimony last December, California's dairy farmers experienced negative margins in the first three quarters of 2012. Recall that when comparing the Department's statewide cost of production estimates, before any allowance for returns on investment or management, with the Department's statewide blend price, we identified how California dairy farmers absorbed a loss of $0.70 per hundredweight in the first quarter of 2012, a loss of $2.22 per hundredweight in the second quarter of 2012 and a loss of $1.97 per hundredweight in the third quarter of 2012.

While the Department's data indicated that California dairy farmers received a blend price above their cost of production during the fourth quarter of 2012, the situation has changed drastically since then. During the first quarter of 2013, the statewide blend price averaged only $0.02 above the cost of production, reducing margins to break-even levels.

Milk prices have continued to steadily decrease since the peak levels of November 2012. For example, the Department has reported that the overbase price decreased by $1.64 per hundredweight to $16.85 in July, down from the November peak of $18.49. The California all-milk price decreased $2.41 over the same eight month period and the statewide blend decreased by $2.35 per hundredweight.

On a quarterly basis, the Department reported that the statewide blend decreased $1.73 from the fourth quarter of 2012 to the first quarter of 2013. During the second quarter of 2013, the statewide blend lagged behind the blend price in the fourth quarter of 2012 by $1.31. Margins on the farm have followed milk price down as the margin over feed decreased by $1.42 in Q1 of 2013 compared to Q4 of 2012. Clearly, California's dairy farm families have been experiencing another period of tightening margins.

Many market analysts have written about the opportunity offered to California dairy farmers from corn futures trading at lower levels due to the projections of an abundant harvest this fall. The fact of the matter is that the fixed whey factor severely hinders a California dairy farmer's ability to make an effective use of dairy futures to hedge their milk and take advantage of the projected corn prices to lock in their margins. The fixed whey factor exposes California dairy farmers, who attempt to lock-in their margins using a Class III futures contract, to a huge amount of basis risk.

For example, the Class III futures contract offered by the Chicago Mercantile Exchange is the most heavily used of the dairy product futures contracts. Price movements in the Class III futures market may not be offset on a one-to-one basis in the cash 4b market. This difference between the cash 4b and the Class III futures price, the basis, drastically increases the risk that a California dairy farmer takes on when entering a Class III futures contract to hedge their milk.

The size of the basis can be quite volatile, even from month to month, due to the stark differences between whey values in each of the formulas. For example, the Class 4b basis, the Class 4b price less the Federal Order Class III, in April 2013 was -$0.67; in May 2013 it rose to -$1.32 and by June 2013 it had risen to -$2.11. This gross mismatch between the Class III futures price and the 4b cash price coupled with the high level of volatility of the Class 4b basis prevents the California dairy farmers from making effective use of Class III futures as a hedging tool.

We fully realize that the proposal does not address this basis problem arising from the fixed whey factor. We offer this information to shed light on the challenges that California dairy farmers face in taking positions on Class III futures to protect margins over feed costs.

We acknowledge that both cash and futures contracts on corn have decreased and that dairy farmers may benefit from more price decreases this fall. Despite these potential benefits on the cost side, California dairy farmers' equity position has eroded so drastically in the last several years that we believe a permanent change in the whey scale as well as a short-term increase in the Class 4b price, as proposed by the petitioners, is essential. Our opinion is that market conditions do warrant the changes proposed.

The financial stress I speak of has impacted our cooperative members. Over the past 20 months, 55 dairy farmer members of Land O'Lakes have discontinued milking, 43 dairy farmers in 2012 and 11 dairy farmers in 2013.

We again want to thank the Secretary of Agriculture and the Department for calling this hearing. Cooperative producer-owners request a response from the Department that benefits all California dairy farmers equally. There is no question that our proposed increase in the 4b price will have a positive, financial impact on all California dairy farmers at a time when they could really use it.

In conclusion, we thank the panel for your considerations and we would like to request the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

MR. EASTMAN: I have two questions. The first question is a similar question that's been asked of other members -- I mean other witnesses today. And that is, we have seen that when different organizations will compare dairy margins they'll use cost of production. And then it appears that they choose different forms of income, whether it be the overbase price, whether it be quota, mailbox prices, in this case you used the statewide blend. Is there any particular reason for that? Do your members tend to -- do you feel your members are paid something closer to that or is there some other reason why you would choose that form of an income measure?

MR. GARBANI: Well we believe that the statewide blend factors in the concepts of having higher fat and solids in the price that is paid as well as a proportionate share of the quota that's paid throughout the state. So it is really the average price across, you know, that factors in both components and quota.

MR. EASTMAN: Okay. And then my second question has to do -- towards the end of your testimony you would request that if a change is made that the benefits would benefit all California dairy farmers equally. And I wonder, we have heard other testimony that might suggest that might not be possible in the sense that we know that processing cooperatives, those producers have invested in processing facilities that any increase in that class price would affect them compared to producers who haven't. We have heard testimony that some producers are paid premiums based on market factors or quality of milk. And that if prices are increased for them their premiums would go down. Is there really a true way to treat all producers equally?

MR. GARBANI: I'm not sure I can completely answer the question, I would offer you this scenario. If the increase is in the class price it is guaranteed to all producers. And it is not up to the whim of the manufacturer on whether they had a good month or a bad month or they feel like their milk might be threatened. It is their right under law to have that price and it is not left up to the discretion of the manufacturer whether they get it or not.

MR. EASTMAN: Okay.

MR. GARBANI: I think it puts a little bit of security in their business as producers.

MR. EASTMAN: Okay.

MS. GATES: I have one question. On page two of your testimony you speak to that when the dry whey levels are exceeding $0.50 that that continues to ensure that the large California cheese plants will return significant margins on their processed whey operations. Do you have any data or information to support that or is that strictly anecdotal?

MR. GARBANI: I would tell you that we have a small cheese plant in Orland. We do not dry our whey, we sell our whey liquid. And that plant, which is relatively small in the size and scheme of things, has a very handsome return in relationship to the other assets that we have in California. So although it's proprietary and I can't share the raw data with you, it does quite well.

MS. GATES: Okay, thank you

MR. MASUHARA: Related to what Candace just asked you. It actually begs the question, if that plant is doing quite well, has there been discussions in your organization about expanding your operations and increasing your assets that can generate income from a whey stream?

MR. GARBANI: You know our company is a butter company, That's where we built our brand recognition. And I will tell you that we continually evaluate all kinds of different alternatives around investment and opportunities within our marketplaces.

MR. MASUHARA: And then similarly to what I asked CDI earlier. You're a butter and a powder manufacturer. Are you guys manufacturing certain powders that are not reflected in the current 4a formula? And this is purely from the standpoint of us evaluating basically the sufficiency of the formulas and making relative comparisons between them.

MR. GARBANI: Yeah. I would also point out, though, that what we pay for the solids that go into that product is a very large percentage of the end-value of that product that we sell. If you were to do the same comparison on cheese and whey products, their discount is significantly larger than what 4a -- how it trends against Class IV as well as Class III.

MR. MASUHARA: But then you would generally agree with the notion, though, that it is very difficult in product pricing to find certain products that serve as very good, suitable indexes for coming up with the prices reflective of everything that potentially comes from these components?

MR. GARBANI: Sure. In fact I would offer that we have heard testimony here today from mozzarella cheese manufacturers who don't make cheddar cheese. We have powder products that are part and part of, you know, the market discovery price and in pricing that product. There are probably butter products as well and fat price -- fat products that don't go into that CME butter price. So it seems to me that there are many products that are made throughout the dairy industry in California that are not specific to the market discovery factor that we use to price milk, CME butter, CME cheese, nonfat dry milk. Correct?

MR. MASUHARA: Yes.

MR. GARBANI: So I would --

MR. MASUHARA: Yes, I am not disagreeing with you there.

MR. GARBANI: Okay.

MR. MASUHARA: Thanks, that's all I have.

MR. EASTMAN: I just have one more follow-up question. I just wanted to make sure I understood your response. And just to clarify Candace's question. You responded that you don't dry your whey but you are selling some sort of wet whey from your Orland plant. So you mentioned that it does turn a profit. So what you're stating is that all those proprietary whatever revenue you get from that, minus whatever the cost of transportation, disposal, whatever, is that greater than the whey factor contribution in the Class 4b formula? Is that what you were implying?

MR. GARBANI: Yes.

I feel prejudiced in that I haven't been asked the question about the deal.

(Laughter.)

MR. MASUHARA: Okay, I'm going to ask you the question about the deal. Did you participate in any negotiations? And if you did, can you shed some light on where these numbers came from?

MR. GARBANI: I did not personally participate in the negotiations; indirectly we were represented by a trade group in the negotiations. And it was our understanding as we came out of the legislative piece of the process that we did have a deal that was going to be supported by the entire industry and were very disappointed to find out that we didn't. So as far as the calculations go and so forth, I wasn't there to see them, Kevin, I can't speak any further to them.

MR. MASUHARA: Okay, thanks.

HEARING OFFICER SUTHER: Thank you for your testimony.

Mr. Vandenheuvel. Mr. Vandenheuvel, could you please state your full name and spell your last name for the record.

MR. VANDENHEUVEL: Absolutely. Vandenheuvel, V-A-N-D-E-N-H-E-U-V-E-L, first name, Robert.

Whereupon,

ROB VANDENHEUVEL

Was duly sworn.

HEARING OFFICER SUTHER: So the exhibit that's here, your written testimony that you're going to provide and the flyers that you provided, is there any other information you would like to have marked as an exhibit?

MR. VANDENHEUVEL: No, that's my exhibit.

HEARING OFFICER SUTHER: Okay, these will be Exhibit 60.

(Exhibit 60 was received into evidence.)

HEARING OFFICER SUTHER: You may proceed.

MR. VANDENHEUVEL: Thank you. Mr. Hearing Officer and Members of the Panel, my name is Rob Vandenheuvel. And while I am the General Manager of Milk Producers Council I am testifying here as an individual; I was not prepared to give my testimony when Milk Producers Council's turn came up earlier this morning.

Before going into the issues of the hearing, it's important to remember one of the reasons why CDFA is involved in the business of establishing minimum milk prices. As stated in California law, one specific purpose is to, quote:

"Enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions, bring about and maintain a reasonable amount of stability and prosperity in the production of market milk, and provide a means for carrying on essential educational activities." Section 61805(d).

Obviously we are here today, because among other things, that particular goal is not being achieved.

As for the details of this particular hearing, I want to express my strong support for the proposal before the panel today. While the proposal certainly represents a significant concession on the part of California's dairy families, when compared to the pricing reform we have been seeking in recent years, it is nonetheless an important modification to the Class 4b formula.

This is certainly not the first hearing on Class 4b prices or on temporary price relief, and since all the testimony from previous hearings is already submitted into the record by reference, and in order to keep today's testimony focused, let me go through the specific items outlined by the Notice of Heating published by CDFA staff.

The Notice of Hearing requests that witnesses address, at a minimum, "economic conditions that have changed that would warrant adjustments to the current temporary price established as a result of the May 20, 2013 hearing."

At the time of the May 20, 2013 hearing, the most recent publicly available data from CDFA on the cost of producing milk in California was from the fourth quarter of 2012. Included in the Panel Report from the hearing was commentary that "by the end of 2012, the estimated average margins were positive, suggesting improved conditions." The report went on to state that improved margins were due to "increased mailbox milk prices at levels sufficient to cover production costs, including allowances for return on investment and return on management." That's from page 10 of the Panel Report.

The Report continued that "Since the hearing record is void of any concrete data indicating the level of estimated margins on dairies for 2013, the most current data available indicates that estimated margins were positive again and that the income received by dairies in relation to the cost of production of market milk appeared adequate."

It is unfortunate that CDFA's data on the first quarter's Cost of Production was unable to be used in the previous hearing. In the case of this current hearing, I have spoken with CDFA staff who have indicated that the second quarter's report will be publicly released on or around September 20th. Since that will likely be after the close of the hearing record, I would officially request that information be shared by CDFA's Cost of Production unit, even in a preliminary format, in order to provide the Panel with the most current data possible on the cost of producing milk in California.

In the meantime, I have no choice but to focus this portion of my testimony on the most recent data that is publicly available. Before addressing the first quarter of 2013, there is actually some question as to whether or not the data for the fourth quarter of 2012 truly indicates what CDFA staff wrote in the Panel Report.

Included in Appendix A of this testimony is the "Statewide Cost Comparison Summary" published by CDFA for the fourth quarter of 2012. The average reported cost of production, including allowances for return on investment and return on management, was $20.08 per hundredweight in that quarter, this is the fourth quarter of 2012. During that same quarter, the announced mailbox milk prices were $19.40 in October, $19.71 in November and $18.48 per hundredweight in December. A simple average of those three months provides an average mailbox price of $19.20, or $0.88 below the reported cost of production. So it is unclear why the Panel Report states that mailbox milk prices were "at levels sufficient to cover production costs, including allowances for return on investment and return on management.

Moving forward, we now have the CDFA-generated data from the first quarter of 2013. The average statewide cost of production for the quarter was announced to be $19.16 per hundredweight. Compare that to the average mailbox milk price of $17.45 per hundredweight, an estimated loss of $1.71 per hundredweight. Clearly, any assumptions that were made in the May 20, 2013 hearing about the California dairy farmers being profitable in the first quarter of 2013 are not supported by this data.

In addition, the continued barrage of dispersal sales being conducted on California dairy farms is evidence that we are far from out of the woods financially. I submit for the record, and I have already handed to you, a stack of fliers for dispersal sales conducted just over the past year. This is not an all-inclusive list but rather just the fliers I was able to find on the Internet or received through email.

And before I move on to the next item. There has been quite a bit of talk about feed costs and projections. And I do find it interesting to hear our friends on the processing side making claims about the future of feed costs on the dairy. I don't think that they would take too kindly to me making projections about their future utility costs, natural gas costs at their plants ahead of CDFA's manufacturing cost surveys that are announced every fall. And so what I am basing my testimony on is the reported information coming from CDFA, the Cost of Production Unit, despite what you may have heard possibly might happen going forward. If that's true we'll see it in the reports in the future.

The Notice of Hearing requests that witnesses address "the sufficiency of the calculation of the whey factor by reference to quantifiable economic data and methodologies; such as but not limited to: manufacturing cost data, marketing and sales data, and whey stream valuation directly applicable to California plants.

The modifying "sliding scale" being proposed for inclusion in the 4b formula is based on a letter sent by Joseph Lang, a representative of the Dairy Institute of California, to Assemblyman Richard Pan during discussions about milk price changes in California. And I would note that that letter is not part of my exhibit as it was already included as part of CDI's exhibit. Dairy farmers have indicates in the past that we see a fundamental weakness in the sliding scale methodology, in that it inherently creates a floor and a ceiling for one particular piece of the formula, resulting in a Class 4b price that is not in a reasonable and sound economic relationship with the Federal Milk Marketing Order Class III price that serves as a benchmark price for milk sold to cheese manufacturers around the country.

However, dairy farmers and their organizations have stepped up to support this modification in the interest of providing much-needed revenue for dairy farmers in a form that our processor representatives can support.

The process of coming to this proposal was an exercise in balance, with political concessions made on both sides of the industry.

And just jumping in right there, I really appreciated that Chairwoman Galgiani came and testified before this group. After hearing several witnesses testify that there was no deal I started thinking maybe I was just dreaming all these things because I in my other role, not as an individual but with Milk Producers council, was directly involved in these negotiations through our lobbyist. And I can tell you that the time line was very simple. A, letter was sent on July 8, you've seen the letter, it's in your record. July 11th there was a hearing held that Chairwoman

Galgiani talked about. Both parties testified in support of the agreement and the agreement was certainly capturing the contents of that July 8 letter.

And on July 22nd this petition was submitted. So through this whole process we have been consistent. There was indication that maybe there was, you know, some backtracking on the part of producers. And certainly there is no evidence of that when you lay out the time line on how we got here today and the content of our proposal.

All right, talking about balance. It is with that same level of balance that we ask CDFA to accept this proposal. The standards outlined in the Notice of Hearing for determining the "sufficiency" of the whey factor calculation are exclusively focused on the manufacturing side of the equation. Those items are part of CDFA's consideration to be sure, Section 62076 specifically references those. However, of equal weight is the consideration CDFA must make with regard to the dairy farmer profitability, Section 62062. It is not an accident that both of those sections of the California Food and Ag Code use identical language, "shall take into consideration."

In addition, part of the challenge that CDFA staff has addressed in the past, and we have heard some of this today, with regard to the dry whey component of the Class 4b price is a lack of available data. That same concern is also beginning to impact the cheddar cheese component of the Class 4b formula. It is worth pointing out that under our formulas, as well as under the formulas used by the Federal Order system, they both use basic commodity dairy products to drive the end-product pricing formulas. Forty pound blocks of cheddar cheese are not the most prominently produced cheese in the state. You heard testimony about that earlier. But yet it is used to establish our regulated milk price. The same goes for dry whey, which is also not the most prominently produced whey product in the state. That is intentionally done, as it provides an incentive for manufacturers to move up the value chain, thereby giving them an opportunity to enhance their margins by selling higher value products, eve though their regulated milk prices are based on lower value dairy products. And that really goes to some of the questions that Mr. Masuhara has asked the 4a witnesses as well. They pay a 4a price based on surveys of nonfat dry milk. There are other powdered products that garner a higher value in the marketplace. By basing it on nonfat dry milk it provides opportunities to enhance your markets by going up the value chain.

There is a fundamental unfairness when you consider the fact that the system incentivizes value-added production. And when that system appears to work, and in this case we're seeing it work because most cheese manufacturers do not make those specific products in the formula but instead make higher value products, producers are then punished with a further limitation on the regulated formula with the expressed reason that there is a lack of data on manufacturing costs and marketing sales data for those lower value products. Dairy farmers seem to lose on both ends.

The Notice of Hearing requests that witnesses "include the factual basis, economic and other evidence and legal authority in support of the whey factor, any temporary adjustment and any proposed amendments to the Plans."

There has already been testimony about the facts that led to the development and submittal of this proposal. The economic evidence that relief is needed is also included in earlier parts of this testimony.

As for the legal authority, the Secretary has been granted broad discretion by California law to implement the proposal before the panel today.

And I would go on that there has been some legal discussion this afternoon about some of the Secretary's requirements. And we have found out -- the industry has found out that the Secretary does have broad discretion. The whey factor is not mentioned in the law. The cheese factor or the end-product pricing structure in general is not mentioned in law. The law gives the Secretary broad discretion to establish prices either by selecting a price or by coming up with some sort of a formula or method. In the case of California, for many, many years, the method of end-product pricing has been used. That doesn't mean that the whey factor has to meet some sort of a legal standard. That was insinuated earlier that there is some legal standard for how to set the whey factor. The Secretary has broad discretion to use the whey factor, to not use the whey factor, to pick a price, to not use a formula, however. So I think there was a little bit of a misunderstanding earlier on exactly what the legal requirements are of the Secretary.

While additional discussions toward long-term reforms will continue to be needed, this proposal does move us in the right direction toward a more reasonable relationship with the national value of manufactured milk products, that's Section 62062. And a more reasonable relationship between the various classes, Section 62062(c). Also, given the documented financial condition of the California dairy producing sector, the proposal also addresses, in an admittedly modest way, the consideration of the cost of producing milk relative to the combined income from all the classes of milk, Section 62062(a).

The Notice of Hearing requests that witnesses "address the extent to which the whey factor can be transparently calculated as a component of the Class 4b price and fairly imposed on processors."

Before getting into the transparency that certainly exists in this proposal, must dispute the contention that somehow we are "imposing" something on processors.

Our dairy farmers work tirelessly every day to produce a product that our manufacturers desperately need. Those dairymen even pay the hauling costs to get the milk to the manufacturer on the plant's schedule and in the quantity and quality they need. And all those dairymen have asked in recent years is to receive a milk price that is in a closer relationship to what our out-of-state colleagues already receive for the same quality of milk. To characterize our request for a fair price as some sort of imposition is an offensive notion and it truly lacks the balance that is often referenced by CDFA in terms of considering the needs of producers, processors and consumers.

As for the specifics of the proposal, the modified sliding scale is certainly just as transparent as the current sliding scale, with a clear and defined relationship between the market value of dry whey and the resulting impact on the Class 4b minimum price.

Other Consideration

In addition to the items listed in the Notice of Hearing I want to bring up one additional item that was mentioned in the May 20, 2013 Panel Report, which struck me as odd. In the conclusion of the report, page 11, a statement about the Panel's concerns for being -- there was a statement about the Panel's concerns for being cautious with temporary relief. Rather than characterize the paragraph I've included it below. I'm going to quote it here.

"As a result of the uncertainty regarding the current condition of the dairy industry because of the lack of concrete data, the Panel is concerned and needs to be cautious in recommending temporary price relief, so that the normal marketing conditions of the state's milk supplies or finished dairy products are not disrupted. If, for example, during a period when temporary price relief was in place, dairy markets were to increase significantly, the competitive balance of marketing dairy products could be disrupted. Because dairy markets are dynamic and volatile, these markets can change significantly in a matter of days or weeks depending on changes in such market factors as domestic and global milk supplies, international demand and production costs such as feed corn. Therefore, the Panel is concerned with the uncertain impact that these

relevant economic factors may exert on dairy
markets when potential temporary relief would be
in effect."

The reason this strikes me as odd is because we operate in an end-product pricing structure that is very similar to the structure used around the country in the Federal Milk Marketing Orders. Under those similar structures it is all about "relative position," whether that's relative position to your fellow in-state manufacturers or relative position to your out-of-state colleagues. In other words, if the dairy product prices escalate or fall during the time when we have temporary relief, a plant's relative position in the marketplace remains the same as the prices paid by all plants are rising and falling as well. So it's unclear how the "competitive balance of marketing dairy products could be disrupted."

Conclusion.

The proposal before the panel today meets the political, economic and legal standards being sought by CDFA. Very rarely have we had the opportunity to present a proposal to CDFA that was drafted in writing by the processors and supported by the producers. Economically, there is ample evidence that California's dairy farmers are in much need of this pricing change. And the Secretary holds all the legal discretion needed to implement this proposal as soon as possible. While it's too late for the dairies that have already sold their herds, the dairy families that remain are desperately counting on it.

And that would be the conclusion of my testimony. I would request the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Questions from the panel?

MR. EASTMAN: I have a question. On the first page of your testimony you mention that -- right up front you talk about stability and prosperity in the production of market milk and you state that that goal is not being achieved. We have heard testimony that -- people have taken the other side of that argument that it is. And so just to make sure I am seeing your, looking at this correctly, you sort of -- you touch on aspects of the hearing notice after. When it comes to the goal of that, the prosperity and stability in milk production not being met, what are the factors, what are the -- what is driving your view that they are not being achieved, so to speak?

MR. VANDENHEUVEL: The facts. The facts that are outlined in the first section there talking about the demonstrated losses being seen by dairy farmers. The facts of the stack of dispersal notices. Diary farmers selling their herds. Not because they have made a business decision that they want to move because while things are good they want to go somewhere else but rather some of those are my members who I know directly they're moving because they cannot afford to stay in California; they cannot afford to continue accruing losses.

So my statement that the stability and prosperity of producing market milk in California is based on those facts as well as testimony from previous hearings, which is submitted by reference about historical. I only talked about two quarters so, you know, I'm going back to previous quarters. This has been a theme over the last several years.

MR. EASTMAN: I think I have another question, I need to look for it here. Do you have a --

MR. MASUHARA: I have a question, Rob.

MR. VANDENHEUVEL: Okay.

MR. MASUHARA: On page three you make the statement when we were talking about sufficiency and you addressed some of those issues that had been brought up earlier in the hearing. And you made the statement that it's intentionally done to use these basic commodities so that it provides that incentive to move up the value chain, yet only have to pay out at those basic levels. Why is that intentionally done? Can you cite a reference to which body states that that's an intention of the formula constructs?

MR. VANDENHEUVEL: Well, one of the things that often gets stated at hearings, which I vehemently disagree with but it is a reality of what's talked about is that these formulas are established at market-clearing levels. That's something that I have often seen in hearing panel reports and other statements. That market-clearing concept could also be applied to the types of products that you're pointing to. Obviously, trying to set a market-clearing price for using a product that is not a basic commodity but a higher-value more niche product, those two ideas would conflict. So that's one I cold think of.

The other is my general observations as to why would we have an end-product pricing structure that in California uses cheddar cheese when Mozzarella is a much larger piece of our market portfolio. And so my own inference is that there is a reason we do that. My history goes back seven years. Maybe if I went back further than that I could find some specific reference. But it's some of my belief and some of the statements.

MR. MASUHARA: So it's just an interpretation based on your observations?

MR. VANDENHEUVEL: An interpretation based on what I've heard in previous testimony, the market-clearing aspects as well as my observations on how the system works, yes.

MR. MASUHARA: How would you react to the statement that -- an opinion that this is where we have ended up, not a place that was set out to be a destination many years ago?. You know, as far as end-product pricings and formula constructs and what goes into them.

MR. VANDENHEUVEL: Well, I would -- there is no doubt that there have been changes since the '30s when these formulas were first established. However, the reason that changes are made through hearing processes, administrative hearing processes, considerations, legal analyses, is because there's got to be some specific focus of where these changes are taking us.

You've heard some testimony today that maybe end-product pricing needs to be relooked at. And you would not expect that decision to be made willy-nilly, just go do it without any thought behind it and strategy. So while you're right, this is where we've ended up, not necessarily where we started, I would still point out that there was some strategy behind it. And I think that what I have laid out here is a reasonable justification for why we structure it the way we do.

MR. MASUHARA: Okay. That's all I have.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Vandenheuvel.

Ms. Taylor. Ms. Taylor, will you please state your full name and spell your last name for the record.

MS. TAYLOR: Certainly. It's Sue Taylor, T-A-Y-L-O-R.

Whereupon,

SUE TAYLOR

Was duly sworn.

HEARING OFFICER SUTHER: And your statement here, would you like this marked as an exhibit?

MS. TAYLOR: Yes, please.

HEARING OFFICER SUTHER: It will be marked as Exhibit 61.

(Exhibit 61 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MS. TAYLOR: I am Sue Taylor, Vice President of Dairy Policy and Procurement for Leprino Foods Company. I'll condense some of my early testimony in the interest of efficiency and time.

In the notice of today's hearing the Secretary asked proponents of change to:

Address the economic conditions that have changed since the May 20th hearing.

Regarding to the whey valuation, address the sufficiency of the calculation of the whey factor by reference to quantifiable economic data and methodologies.

And also include reference to issues and concerns with the serviceability of end-product pricing components.

Relative to these issues, my belief is that:

Economic conditions have improved since the May 20th hearing and lower corn prices related to this year's crop will result in an improved competitive position for California diary producers vis à vis dairy farmers in regions dominated by homegrown feed. Milk prices are rising seasonally and are expected to soften modestly over the next 12 months as the result of greater milk supplies generated by greater farm level profitability nationally. However, strong international dairy demand is expected to keep milk prices from dropping in parallel with the reduction in cost of production, leaving an improvement in dairy farm margins.

With respect to the second factor: The current whey factor cannot be substantiated by California-specific data, given the inability of cheese plants below a certain size to extract full whey value. Given the binding nature of California's minimum regulated milk pricing system on all Grade A milk produced and processed in California, it is difficult to construct a sound whey factor in the minimum milk pricing formula that extracts greater value than that attainable from the sale of liquid whey. Incremental value extracted from the further processing of whey can and is being shared with producers through competitive premiums outside of the regulated milk pricing system.

With respect to the third issue: The broader lack of data that can be published to provide the basis of an informed debate around end-product price formulas begs for a broader discussion and adoption of an alternative approach to milk price regulations in California. We endorse the efforts of the California Dairy Future Task force in that regard.

Although these conclusions may appear to drive toward the elimination of the $0.15 per cwt emergency price relief that is in place through September 2013 and significantly change the structure of the current Class 4b formula, I urge the Department to determine that no change is warranted as a result of this hearing and urge the industry and the Department to move forward with broader reform discussions in earnest and with urgency.

Economic Conditions

Economic Conditions have improved since the May 20 hearing. USDA's AMS estimates of corn prices in the San Joaquin Valley show a decline of 12.7 percent in corn prices relative to the year to date May average and also a 12.3 percent versus the May 18th quote.

Although this year's corn crop is not in the bin it is past the highest risk stages of the growing season. The futures prices on corn reflect the improvement in this year's crop. This improvement is reflected in the settlement prices for the December 2013 corn futures contract. At the time of the May 20th hearing, December corn was trading in the $5.50 per bushel range and it was trading this morning at $4.70.

While this doesn't capture the California basis, the trend is what is relevant. The expectation for new crop corn prices is that they will be $0.80 per bushel lower than the expectations that existed at the time of the 5/20 hearing.

Milk prices are rising seasonally but are expected to soften modestly over the next 12 months as the result of the greater milk supplies generated by greater farm level profitability, nationally. However, strong international dairy demand is expected to keep milk prices from dropping in parallel with the reduction in cost of production, leaving an improvement in dairy farm margins.

This commentary is responsive to the question of the economic conditions trend and is not intended to argue that I believe that dairy farming is overly profitable at this time. We recognize that many dairymen suffered financial losses over the last couple of years and some will continue to struggle under their increased debt burden. The prices derived from the supply and demand balance for dairy commodities nationally will, over time, generate a level of dairy farm profitability sufficient to generate the needed supply to satisfy demand nationally. Some regions may be more challenged than others due to region-specific issues. Those issues can be best addressed outside of the regulated milk pricing system. Leprino has a long history of paying competitive premiums above the regulated minimum prices and substantially increased its milk payments outside of the minimum regulated milk pricing system a year ago out of concern for the health of the dairy farmers supplying us in our California plants.

Whey Factor

The current whey factor cannot be substantiated by California-specific data given the inability of smaller cheese plants to extract full whey value, even under best management practices. We have testified regarding this issues in numerous prior hearings.

Much testimony has been incorporated into prior hearing records regarding the inability to economically process whey in smaller cheese plants. Whey processing is highly capital intensive. The extraordinarily high capital cost creates a barrier to entry for small cheese plants. In its raw form, dilute whey from a cheese vat has limited value in the marketplace. Skim whey, prior to condensing, is typically 6.1 to 6.5 percent solids. At this low level of concentration, transportation costs quickly consume the historic market value above costs of processing. Some intermediate size plants can condense their whey for more economic transport for further processing at larger plants. However, the returns achieved for any products short of the finished whey that is used in the milk price formulas fall short of finished product value.

The diversity of whey products also creates challenges relative to explicit inclusion of a whey factor in the regulated pricing system. Sweet whey was historically viewed as the lowest common denominator amongst all whey products. This was because it is the most generic whey product requiring the least advanced technology and returns were generally lower than those for the more highly refined whey proteins. It was thought that so long as the milk price was based upon sweet whey prices, the whey contribution to the milk price would not be overstated for those who process whey. This long-held assumption was proved to be incorrect in 2007. As more processors invested in whey fractionation technology, the increased production of whey protein concentrates depressed those prices. Simultaneously, as older plants producing sweet whey were motballed, the supply and demand balance pushed sweet whey prices up. Consequently, the portion of the milk price attributable to the sweet whey value outstripped the returns from whey protein concentrate, particularly in operations that did not also produce lactose. It was one contributing factor to replacing the explicit whey factor with the $0.25 fixed factor in 2007. This issue was also a problem for cheesemakers buying milk in Federal Milk Marketing Orders. However, cheesemakers operating in Federal Orders had the opportunity to negotiate a lower milk price in that period and many were rumored to have done so. The same flexibility is not afforded manufacturers operating under the California State Order.

Leprino Foods processes its whey protein stream into WPC-35 and WPC-80 and some specialized whey proteins within the state of California. As part of this production, lactose is produced and delactose permeate is generated. In California, we produced 41 WPC product codes and 25 lactose product codes. Many of these products have been developed by our R&D staff to address specific applications requiring such attributes as high gelling properties or high heat stability applications for retort applications. Our production of "generic" WPC-35 or -80 is only a portion of the volume that CDFA would have categorized as WPC-35 and -80 and will likely diminish over time as we expand into those more specialized markets.

The bottom line is that there is not a common whey product produced within California and the nature of supply and demand in the various whey products, both domestically and abroad, make it nearly impossible to identify a whey product that will accurately reflect market clearing returns generated by the whey complex on an ongoing basis.

Shifting Emergency Price Relief to Class 4b

The proposal to shift the emergency price relief from other classes of milk to 4b should be rejected. This proposal is a back-door way of extracting additional revenue from cheesemakers, premised on the erroneous assumptions that all cheesemakers have the additional revenue stream from whey, which have already discussed as being false.

Alignment with Federal Milk Marketing Orders

Although the proposals being considered at this hearing do not all for a matching of whey value in the 4b formula to that in the Federal Order Class III value, several witnesses have indicated that is their ultimate objective. This one again ignores that manufacturers in California must pay the minimum regulated price for all Grade A milk processed, whereas manufacturers outside of California can choose whether to participate in minimum milk price regulations. The only entities upon which the minimum regulated price is fully binding in the Federal Milk Marketing Order system are bottlers. Manufacturers of all other dairy products make an economic decision regarding participation. Even if they opt to buy milk pooled under the Federal Order System, they can purchase milk at below minimum prices.

We appreciate the Department's interest in evaluating the health of the dairy production sector and the potential need for emergency price relief through the regulated system. However, we believe that the marketplace is the better venue for such price relief and we have acted accordingly.

Need for Regulatory Reform

The structure of the minimum milk pricing system in California needs to be reevaluated for both structural and market reasons. The Department's concerns about the lack of publishable cost data upon which to have an informed discussion related to factors in the milk price formula in the public hearing process are valid and should propel the industry to develop an alternative approach.

Additionally, the evolution of US dairy markets from largely domestic with a governmental support outlet to increasingly international markets warrant another look at the milk pricing system and its implications. in its study commissioned by the Innovation Center for US Dairy of the implications of globalization of the US dairy industry, Bain Consulting ranked "Reform regulated milk pricing systems, both federal and state, and price supports" as the top two priorities to make the US a "consistent supplier" to export markets. The broader conclusion of both the study and the

Innovation Center Board representing dairy farm cooperatives and processors across the country was that the US dairy industry will benefit by the demand created by participation on a consistent basis in the international markets.

It is critical that the industry review and reform the broader milk pricing system to achieve an end-state in which all sectors of the dairy industry thrive.

I appreciate the opportunity to testify today and request the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Questions from the panel?

MR. EASTMAN: I have a few questions. On page two there's a chart and the units of the vertical axis says $/cwt of corn. Is that right? I've never -- I guess I haven't -- I'm not used to seeing that, normally it's expressed in bushels or tons.

MS. TAYLOR: Yes. That chart was pulled from the University of Wisconsin website. It does dairy product risk management. And they're quoting the USDA price quote. But it was directly pulled from their website, the website that is maintained by Brian Gould.

MR. EASTMAN: Is that -- do you know whether or not they are trying to express the price of corn in terms of its value to milk, so to speak? How does that --

MS. TAYLOR: No, I believe that that's per 100 pounds. I think a bushel of corn is what, 52 pounds, so this would be almost double what you're used to seeing.

MR. EASTMAN: Gotcha.

MS. TAYLOR: Fifty-six, okay.

MR. EASTMAN: Okay, that makes sense. I just -- normally --

MS. TAYLOR: I didn't run the conversions myself but I believe it -- my belief is it's still 100 pounds of corn, not a 100 pounds milk equivalent.

MR. EASTMAN: Right, okay. Now based on the number that seems to -- that would seem to make sense based on the number.

On page three you have a chart there that the print is a little too small for me to determine exactly what that is. Can you just give me a title?

MS. TAYLOR: Okay. That is the settlement prices for the December corn futures contract as that contract closed between the 1st of January of this year and as it was trading this morning about ten o'clock.

MR. EASTMAN: Okay. So it's a settlement price for December corn through year-to-date, more or less.

MS. TAYLOR: Yes.

MR. EASTMAN: Okay. And then you mentioned in a couple places that it's expected that strong dairy demand will -- expected to keep milk prices from dropping and parallel to the reduction n the cost of production so it's sort of an estimate that margins should improve. Is that based on some sort of specific calculation or a publication or paper or is that just an anecdotal sort of estimation of what's coming?

MS. TAYLOR: The futures market if you line up the milk prices. And of course, there has been some testimony at this hearing that you can't use futures to estimate California milk prices but in fact you have cheese futures that help you calculate an expected 4b price and then you also have, of course, the butter and nonfat futures. If you line those up against a projection of feed costs, that would imply increased margins.

That also is a pretty widely held belief, I believe, across the industry. I do receive some publications from some of the dairy farm co-ops that highlighted over the last few months that producers can lock in higher margins at this point because of that improved relationship.

MR. EASTMAN: And then the cost of production would just assume a similar type thing using grain future prices?

MS. TAYLOR: Right, since those are the highest volatile factors that contribute to farm level cost of production.

MR. EASTMAN: That's all I have.

MR. MASUHARA: Just a clarification. I think I know the answer to this but the way I'm reading it, I just wanted to make sure. On page four you give a little bit of the history of sweet whey, on its way out basically, and WPC's starting to ramp up. You make the statement that this long held assumption was proved to be incorrect in 2007. As more processors invested in whey fractionation technology, the increased production of whey protein concentrates depressed those prices. "Those" meaning WPC prices started to come down as they moved away from being a novelty item to being more mainstream?

MS. TAYLOR: Yes.

MR. MASUHARA: That's what I thought you meant but I wasn't sure because the paragraph starts off talking about sweet whey and then you just use the word "those."

MS. TAYLOR: Yes. Particularly WPC-35 or -34 prices became more commoditized.

MR. MASUHARA: Okay. That's what I thought you meant but I just wanted to clarify it. Thanks.

MS. TAYLOR: Yes, thank you.

MR. MASUHARA: That's all I have.

HEARING OFFICER SUTHER: Thank you for your testimony, Ms. Taylor.

Is there anybody else in the audience that would like to testify?

(No response.)

HEARING OFFICER SUTHER: Then for those of you who are submitting a post-hearing brief, that post-hearing brief period is -- it must be received to the Department by Tuesday, September 17th, 2013, by 4:00 p.m. The brief may be e-mailed to dairy@cdfa.ca.gov or submitted to the Department's Branch Office located at 2800 Gateway Oaks Drive, Sacramento, California, 95833, or may be faxed to area code 916-900-5341.

And this will conclude our testimony.

(Off the record at 3:59 p.m.)

(On the record at 3:59 p.m.)

HEARING OFFICER SUTHER: This hearing is now closed at 4:00 p.m.

(Thereupon, the public hearing was closed at 4:00 p.m.)

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CERTIFICATE OF REPORTER

I, RAMONA COTA, an Electronic Reporter, do hereby certify that I am a disinterested person herein; that I recorded the foregoing California Department of Food and Agriculture consolidated public hearing and I thereafter transcribed it.

I further certify that I am not of counsel or attorney for any of the parties to said public hearing, or in any way interested in the outcome of said matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 17th day of September, 2013.

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