STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

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

CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE
AUDITORIUM
1220 N STREET
SACRAMENTO, CALIFORNIA

THURSDAY, JUNE 30, 2011
9:00 A.M.

ACCELERATED BUSINESS GROUP
(916) 851-5976

A P P E A R A N C E S

California Department of Food and Agriculture Panel

Robert Maxie, Hearing Officer

Candace Gates, Branch Chief

Hyrum Eastman, Agricultural Economist

Venetta Reed, Supervising Auditor

California Department of Food and Agriculture Staff

Amber Rankin

Karen Dapper

Others Present

Dr. Eric Erba, California Dairies, Inc.

Thomas Wegner, Land O'Lakes, Inc.

Michael Marsh, Western United Dairymen

William Schiek, Dairy Institute of California

Joe E. Paris, Gallo Cattle Company, LP *and* Western Marketing & Sales, LLC

Baird Rumiano, Rumiano Cheese Company

Rob Vandenheuvel, Milk Producers Council

Steve Kluesner, Nestle USA *and* Dreyer's Grand Ice Cream Holdings, Inc.

Scott Hofferber, Farmdale Creamery, Inc.

Michael Shotts, Farmdale Creamery, Inc.

Kevin Abernathy, California Dairy Campaign

Justin Freiberg, Commodity & Ingredient Hedging

Greg Dryer, Saputo Cheese USA Inc.

Ervin Holmes, Challenge Dairy Products)

David Ahlem, Hilmar Cheese Company

Joseph Airoso, Airoso Farms

Barry Murphy, BESTWHEY, LLC

Jonathan Kennedy, Tulare Dairy Center of Farm Credit West

Glenn Wallace, Dairy Farmers of America, Inc.

Rich Lewis, DairyAmerica, Inc.

Xavier Avila, dairy farmer and supplier

Michael McCully, Kraft Foods

I N D E X

E X H I B I T S

P R O C E E D I N G S

9:00 a.m.

HEARING OFFICER MAXIE: Good morning everybody. If I can get your attention, before we get started this morning I would like to mention a few details to make sure this hearing runs smoothly as possible.

First, I would appreciate it if you would silence your phones so they don’t cause a distraction. Also, if you're going to be coming up to testify, as I know a number of you will be, the place you will testify is over on the left side at the end. If you have something that you would like to be considered as an exhibit for the hearing record, please bring it up to me first before you sit down to speak.

Most of you know where the restrooms are. If not, they are outside and to the left, and they’ll be on the right side of the interior hall.

We will probably break for lunch hopefully around 11:30 so we can be ahead of the lunch crowd. The room has to be vacated before five o'clock this afternoon, so depending on testimony we’ll end the day a little before that and the hearing will resume tomorrow morning at nine o'clock again in this room.

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, June 23rd, 2011, (sic) beginning at 9:00 a.m.

My name is Robert Maxie. I've been designated as the hearing officer for today's proceedings and I have no personal interest in the outcome of this hearing. I will not be personally involved in any decision that may result from this hearing.

On May 11th, 2011, the Department received a petition from California Dairies Incorporated requesting a public hearing to consider amendments to the Class 4A pricing formulas for the stabilization and marketing plans for market milk for Northern and Southern marketing areas. On May 24th the Department received a petition from Land O'Lakes requesting a public hearing to consider amendments to the Class 4B pricing formulas of the stabilization and marketing plans for market milk for Northern and Southern California marketing areas. On May 25th the Department announced the call of the hearing to consider the petitioners' proposed changes of components to the current Class 4A and 4B pricing formulas.

Further, this hearing will also consider any other aspects of the Class 4A and 4B pricing formulas that were raised by alternative proposals received by the June 10th, 2011, deadline. 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 Department received two alternative proposals in response to the call of the hearing in addition to the Department proposal. The alternative proposals are from Western United Dairymen and Dairy Institute of California.

The two petitioners will have up to 45 minutes each to submit testimony and relative material to support their proposals, which will then be followed by questions from the panel. The two parties who submitted alternative proposals will each be provided 30 minutes to give testimony and evidence, followed by questions from the panel. Anyone else wishing to testify must sign in on the hearing witness roster located at the back of the room. Each witness will be allowed 20 minutes to present testimony and evidence. Witnesses will be called in the order they signed up on the roster. The time clock to my right has been established to assist you in testifying.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a period of time to file a post-hearing brief to amplify, explain, or withdraw their testimony. Only those individuals who have made such a request may file a post-hearing brief with the Department. I will analyze the situation and let you know later when those will be due.

As a courtesy to the panel, the Department’s staff, and the public please speak directly to the issues presented by the petitions. Please direct your comments to the hearing panel and avoid personalizing disagreements. Such conduct does not assist the panel in any way.

The hearing panel has been selected by the Department to hearing testimony, receive evidence, questions witnesses, and make recommendations to the secretary. Please note that the questioning of witnesses by anyone other than the members of the panel is not permitting.

The panel is composed of the members of the Department’s Marketing Services Division and the marketing -- Dairy Marketing Branch. They include to my left Venetta Reed, to my right Candace Gates and Hyrum Eastman. I am not a member of the panel and will not be taking part in any of the deliberations relative to the hearing.

And I forgot to mention your titles. Venetta is a Supervising Auditor I with the Dairy Marketing Branch, Candace is a Chief of the -- I'm sorry, I'm from the Marketing Branch so I'm forgetting to say Dairy Marketing Branch. And Hyrum Eastman is an Agricultural Economist now with the Division of Marketing Services.

The recording of the hearing will be handled by the firm of Accelerated Business Group located in Sacramento. The transcript of today's hearing will be available for review at the Dairy Marketing Branch headquarters located in California -- located in Sacramento, California, at 560 J Street, Suite 150.

Testimony and evidence pertinent to the call of the hearing will now be received. At this time Amber Rankin, Agricultural Economist with the Dairy Marketing Branch will introduce the Department's exhibits. The audience may ask questions of Ms. Rankin only as it relates to the exhibits.

Ms. Rankin, will you please state your full name and spell your last name for the record.

MS. RANKIN: My name is Amber Rankin, R-A-N-K-I-N.

Whereupon,

AMBER RANKIN

was sworn and duly testified as follows:

MS. RANKIN: Mr. Hearing Officer, my name is Amber Rankin. I'm an Agricultural Economist with the Dairy Marketing Branch of the California Department of Food and Agriculture.

My purpose here this morning is to introduce the Department's hearing Exhibits numbered 1 through 44. Relative to these exhibits, previous issues of Exhibits 9 through 44 are also hereby entered by reference.

The exhibits entered here today have been available for review at the offices of the Dairy Marketing Branch since the close of business on June 23rd, 2011. An abridged copy of the exhibits is available for inspection at the back of the room. A copy of the exhibit list is also available at the back of the room. I ask at this time that the composite exhibits be received.

HEARING OFFICER MAXIE: Thank you Ms. Rankin.

Are there any questions of Ms. Rankin from the audience?

(No audible response.)

HEARING OFFICER MAXIE: Okay. Not hearing any questions, the Department's exhibits are now entered into the record and they will be Exhibits 1 through 44.

(Thereupon, Exhibits 1 through 44 were received and entered into evidence.)

HEARING OFFICER MAXIE: Do you have anything else to present?

MS. RANKIN: I do. Additionally I'm entering a document posted to the Department website on June 28th, 2011, showing pounds of milk processed into Class 4A products and pounds of milk processed into cheese, sorted by plant size. This will be entered into the record as Exhibit 45.

I'm also entering the following letters. This first is a letter from Security Milk Producers Association dated June 27th, 2011, and signed by Ed Haringa, Board President, as Exhibit 46. Next is a letter from California Grain and Feed Association dated June 30th, 2011, and signed by Chris Zanobini, Executive Vice President, as Exhibit 47. Next is a letter from Food and Water Watch dated June 30th, 2011, and signed by Eleanor Starmer, Western Region Director, as Exhibit 48. Copies of these letters are available at the back of the room.

HEARING OFFICER MAXIE: Thank you. These

exhibits will be entered into the hearing record as Exhibits 45 through 48.

(Thereupon, Exhibits 45 through 48 were received and entered into evidence.)

HEARING OFFICER MAXIE: Please proceed.

MS. RANKIN: Mr. Hearing Officer, I also request the opportunity to provide a post-hearing brief.

HEARING OFFICER MAXIE: That request is granted.

MS. RANKIN: At this time I would like to present the Department's proposal, which is included in the Department's hearing exhibits that have been submitted today, specifically number four.

The Department proposes to make administrative changes to the Class 4A and 4B pricing formulas to include language to implement the collection of security charges provided by the Milk Producers Security Trust Funds as found in Section 62561 of the Food and Agricultural Code. Effective January 1, 2007, legislation changed the trust funds to include assessments on all classes of milk including Class 4A and 4B. The Department's proposal will update the language in the stabilization plans to correspond with the language in the Food and Agricultural Code.

Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER MAXIE: Thank you. Are there -- are there any questions of the witness before she escapes us?

(No audible response.)

HEARING OFFICER MAXIE: Hearing none, thank you very much.

MS. RANKIN: Thank you.

HEARING OFFICER MAXIE: At this time I'd like to call the first Petitioner, California Dairies Incorporated. Petitioner will have 45 minutes to submit testimony. You will notice that we have a time clock, again to my right, to help you time your testimony.

Thank you, sir. Thank you. For the record would you state your full name and spell your last name.

DR. ERBA: My name is Eric Matthew Erba. Last name's spelled E-R-B-A.

HEARING OFFICER MAXIE: You distributed a document to us. Is that a copy of your written testimony for this morning?

DR. ERBA: Yes, it is.

HEARING OFFICER MAXIE: Would you like that document entered as a hearing exhibit?

DR. ERBA: Yes, I would. Thank you.

HEARING OFFICER MAXIE: All right. The exhibit will be entered as Exhibit number 49.

(Thereupon, Exhibit 49 was received and entered into evidence.)

Whereupon,

DR. ERIC MATTHEW ERBA

was sworn and duly testified as follows:

DR. ERBA: Good morning Mr. Hearing Officer and members of the panel. My name is Eric Erba. I hold the position of Senior Vice President of Administrative Affairs for California Dairies, Inc., whom I am representing here today.

California Dairies is a full-service milk processing cooperative owned by approximately 450 producer-members located throughout the State of California. They collectively produce almost 17-billion pounds of milk per year, or 42 percent of the milk produced in California. Our producer-members have invested of $500-million in large processing plants at six locations, which are projected to produce about 350-million pounds of butter and 725-million pounds of powdered milk products in 2011.

On June 23rd, 2011, the Board of Directors for California Dairies unanimously approved the position that I will be presenting here today.

We thank the Department for calling this hearing and allowing us the opportunity to explain our proposal and the reasons for submitting the petition for the hearing. The testimony that I will present today will be consistent with the idea of maintaining current plant capacity in California by adjusting the manufacturing cost allowances appropriately.

We recognize that many of the factors that companies consider before investing in new facilities or expanding current facilities will not be influenced by the Department’s decision. However, the results of this hearing do determination whether or not plan margins are adequate to ensure each plant’s continued operation. The California dairy industry is not far removed from a critical tipping point where milk production outpaces processing capacity. While we have not reached the crisis that we experienced in 2008, we do see pockets of imbalance. Since the spring of this year we have verified with processing facilities outside of California that some California milk is, in fact, moving out of California to other states for processing. It seems clear that California cannot afford to lose any more of its processing capacity.

For decades California has established minimum milk prices through the use of end product pricing formulas. End product pricing formulas depend on a variety of factors including established manufacturing cost allowances. The Department has long held that those manufacturing cost allowances need to be representative of verified processing costs incurrent by California processing plans. Fortunately, the Department has conducted cost studies of California manufacturing plans for years, and the published studies allow for regular review and discussion of manufacturing costs by the industry. More recently, the Department has collected and published information on the prices actually received by cheddar cheese manufacturers and butter manufacturers in California so that a comparison to the average prices at the Chicago Mercantile Exchange can be made. The results of these comparisons are manifested in the pricing formulas as f.o.b. price adjusters. We fully support the regular review and updating of cheese and butter f.o.b. price adjusters based on the most current information available.

The latest cost studies conducted by the Department were released in November 2010 and they indicate that adjustments are warranted and justified for the manufacturing cost allowances and f.o.b. price adjusters. That is to say they do not continue to reflect the current marketing conditions in California’s dairy manufacturing sector. As you are aware, the manufacturing cost allowance and f.o.b. price adjusters for Class 4A have not been adjusted since December of 2007 and the amendments to the pricing formulas according to the record that time were based on data from, 2006, and the early part of 2007.

The proposed Class 4A pricing formula: California Dairies proposed that the following formula for Class 4A milk be adopted.

On the Fat price the CME AA butter price, minus 4.85 cents for the f.o.b. price adjuster, minus 11 -- or it should be 18.11 cents for the manufacturing cost allowance, multiplied by a yield factor of 1.2. On the Solids-Not-Fats side a California weighted average nonfat dried milk price less the manufacturing cost allowance of 19.84 cents multiplied by a yield factor of one.

The proposal simply amends the Class 4A pricing formula to increase -- by increasing the butter and nonfat dry milk manufacturing cost allowance to the weighted average cost for both commodities, as published in the November 2010 Manufacturing Cost

Exhibit. The Department's data verified that the cost of manufacture butter is 18.11 cents per pound, and increase of 2.51 cents per pound over the current manufacturing cost allowance for butter. Similarly, the cost exhibit verifies that the cost to produce nonfat dry milk is 19.84 cents per pound, an increase of 2.86 per pound over the current manufacturing cost allowance for nonfat dry milk.

California Dairies' plants handle large volumes of milk and are well managed and operate efficiently. More importantly, all of our plants operate every day because of our commitment and responsibility to balance most of the state's milk supply We make our proposal with full understanding that our proposed manufacturing cost allowances will leave some of our manufacturing plants uncovered. However, we think it is appropriate that the manufacturing cost allowance be set so that our largest and most efficient plants are covered. It is axiomatic that establishing manufacturing cost allowance that do not cover the costs incurred by the largest and most efficient plants has grave ramifications for processing capacity in the state.

To be consistent with past practices, the Department should also consider adjustments to the f.o.b. price adjuster for butter at the same time that it is considering changes to the manufacturing cost allowances contained in the Class 4A pricing formula. The Department's data shows that the difference is 4.85 cents per pound for the 24-month period ended June 2010, an increase of 1.76 per pound over the current f.o.b. price adjuster. The Department has a long history of using the results of a 24-month of pricing data collected, published every year, and the Department itself has stated that the method for a recent 24-month period provides the most objective information available on California cheddar cheese and Grade AA butter sales.

Changes in the Class 4A manufacturing cost allowances that do not allow the results of the Department's -- do not follow the results of the Department's cost studies, that is to say increasing them by less than what is justified, reduces the value of the investment in milk processing facilities made by our member-owners. It would also differentially benefit those producers in California who do not have investments in butter and nonfat dry milk processing facilities and, therefore, carry no responsibility of costs in balancing and stabilizing the state's enormous milk supply.

On the percent of volume covered, prior panel reports have typically references the volume of product in the cost studies that would have been covered at a given level of manufacturing cost allowance. The Department has repeatedly stated in its panel reports that the level of volume covered is not predetermined and has attempted to choose manufacturing cost allowances such that 50 to 80 percent of cost study product volume is covered. Reporting the percentage of volume covered is not at issue here today. However, selecting manufacturing cost allowances using a percentage of volume covered as a guiding principle is at issue because the process is problematic, in part because of small number of plants involved in the cost studies.

Using the percent of volume covered as a guideline, even one as loose the Department has used in the past, has a built-in circularity to it. Let me provide you with an example. Say initially that the manufacturing cost allowance is set to cover 70 percent of the volume of product produced. In subsequent cost studies the plants that were less efficient and had higher costs may have exited the business, leaving only those plants that were considered to be the most efficient plants in the study. If the percent of volume covered guideline is applied to this group in subsequent cost studies, a plant -- a plant once considered to be efficient will then be deemed to be a higher cost plant or cost inefficient. This result is simply because the percent of volume covered guideline, by construct, draws a line under which some of the plants will necessarily have to fall.

The obvious question is, what then should the Department consider as an alternative to the volume covered rule of thumb. Eliminating the percent of volume covered guideline will shift a great deal of responsibility to the Department's staff for knowing intimately the plants in the cost study. If the higher cost plans in the cost study do, in fact, drop out and there are only efficient plants left, which can be verified by Department staff, then setting the manufacturing cost allowance to cover all of the volume, or most of it, would be an acceptable and correct decision, and far preferred to blindly striking a line at 60 percent, or 70 percent, or 80 percent of the volume covered. Consequently, the panel should give serious consideration to eliminating the percent of volume covered guideline as a criteria to be used in the decision-making process.

Other proposals that are under consideration:

administrative amendments by CDFA. The Department submitted an alternative proposal for administrative changes to the Class 4A and Class 4B pricing formulas. The intent is to include language to implement the collection of securing charges provided by the Milk Products Security Trust Fund and to eliminate the conflicting language contained in the Stabilization and Marketing Plans relative to the Food and Agricultural Code. We recognize the need to keep regulations aligned with state laws and support those changes needed to maintain that consistency.

On the Class 4B proposals, manufacturing cost allowance and f.o.b. price adjuster, Land O'Lakes submitted a proposal to adjust the manufacturing cost allowance for cheese and the f.o.b. price adjuster for cheese in accord with the Department's cost studies that were released in November of 2010. We note that the approach used by Land O'Lakes in their proposal mirrors what California Dairies has proposed for the Class A formula. The method of relying on the Department's cost studies to update the pricing formulas is understandable, reasonable, and justifiable, and we support those changes to the Class 4B pricing formula.

Class 4B proposals, whey factor: It should be clear that the fixed factor of 25 cents per hundredweight to represent the value of whey in the Class 4B pricing formula was never intended to be permanent. The fixed factor was not a proposal from the dairy industry; it was a placeholder set in place by the Department to give the industry the time and opportunity to work out a mutually agreeable solution. A solution was not arrived at by the industry despite the considerable time and effort put forth by the Department and many key representatives of the dairy industry. Consequently, as the market price for dry whey has increased, California producers have seen the spread between the prices generated by the Class 4B and federal Class III pricing formulas grow over the past two years, largely the result of the difference in the manner in which whey is valued. I personally participated in several discussions that began months that favored a sliding scale for the whey contribution to the Class 4B formula. The mechanism is easily understood. When the market price for whey increases, the contribution to the Class 4B formula increases as well. I point out that there are proposals from both producer representatives and processor representatives under consideration that follow this exact same sliding scale concept.

We recognize that cheese processors of all sizes would be impacted by all the proposals that have been submitted to the Department. The Alliance of Western Milk Products, of whom California Dairies is a member, attempted to introduce a concept of dry whey credit for smaller cheese plans in 2007, but the Department steadfastly refused to accept the concept, citing lack of authorities in the Food and Agriculture Code. We remain convinced that no specific authorization is required to implement and administer a dry whey credit for smaller cheese plants. Both the Stabilization and Marketing Act and the Milk Pooling Act give the Secretary broad discretion regarding pricing and related matters. The Acts are intended as broad policy guidelines and not every detail as to how to administer the dairy programs must be spelled out in the Food and Agricultural Code.

It is unfortunate that no resolution to this general disagreement on Departmental authority has surfaced. However, the issue of the whey contribution to the Class 4B pricing formula and the subsequent value to produce as a whole cannot be ignored any longer.

Therefore, we support the Land O'Lakes proposal on the sliding scale for the whey factor in the Class 4B formula.

Concluding remarks: As the largest supplier of milk to California dairy processing plants, California Dairies balances milk on a daily basis. Any change in our producer-owners’ milk production or in our customers’ orders must be accommodated by using the capacity in our plants 24 hours a day, seven days a week, and 365 days a year. We also help to balance milk supplies for other cooperatives and other processing plants on nearly a daily basis.

It is critical that the Department’s decision maintain standby balancing capacity in California, particularly when we, as an industry, are looking at relatively stagnant plant processing capacities in the near future. To do so, the Department must follow its own cost studies and make the adjustment to the manufacturing cost allowances and f.o.b. prices adjusters whenever the data are available. California Dairies’ proposal does just that for the Class 4A formula, and we support the same method being applied to the Class 4B formula as proposed by Land O’Lakes. We also support the Land O’Lakes proposal of using a sliding scale to value whey in the Class 4B pricing formula as a replacement for the fixed factor that exists currently.

Thank you for your attention. I’m happy to answer any questions that you may have. I request the opportunity to file a post-hearing brief.

HEARING OFFICER MAXIE: Thank you, Dr. Erba. Your request for a post-hearing brief is granted.

Are there any questions from the panel?

MS. GATES: Dr. Erba, on page one of your testimony you speak to the California dairy industry is not far removed from a critical tipping point where milk production is outpacing the processing capacity. And you speak to -- that you verified that with processing facilities outside California. Do you know what volume of milk we’re moving at this point out?

DR. ERBA: Well, it’s variable. I think you can understand that and it’s going to probably go down as the future months come. I can get the actual numbers for you in a post-hearing brief if you wish, but it’s probably on the order of a million pounds a day at its peak.

MS. GATES: Okay. Yeah, I’d appreciate that, thank you.

Kind of speaking to that issue, compared to 2007, you know, at that time when we had the hearing there were certain landscapes that the dairy industry looked at at that time with regards to production, plant capacity, milk movement. You know, at that point in time we had -- we were short on plant capacity, production was high. What do we see different today or is everything the same? It's kind of speaking to that same issue.

DR. ERBA: Well, I don't think that much has changed, Ms. Gates. We took a little bit of a downturn in production over the last couple of years but, if you look at milk production in the last 12 months in California, especially the last few months, it's been a very strong increase. Cow numbers are up. We really didn't go down that far in milk production in the last couple of years compared with what the capacity is. We're continuing in danger of losing processing capacity in the state and part of that is going to be supported by the manufacturing cost allowance and where that -- where that level is set. So even though we're maybe not at the danger zone where we were a couple years ago, we're really not that far removed.

And I think the example that I provided of milk moving out-of-state verifies that we are, we're already close. And spring has already passed, we're into hot weather now, we should be in okay shape through the rest of the year. The hard fact that we had milk in California moving out-of-state to get processed this year indicates that we are close to that tipping point again.

MS. GATES: What percentage of capacity is CDI at at this point? Are you guys at capacity, processing at capacity?

DR. ERBA: Capacity's kind of a funny question. We've discussed this quite a bit internally. It's you don't receive milk continually on the same uniform volume every day, day end and day out. You have peaks and valleys. You may be under capacity during the week and over capacity on the weekends. So, I mean, overall we probably have a little bit of room right now but again it's peaks and valleys. We're one breakdown away from a plant on our customer, our own plants, affecting a fairly major crisis. We're that tight.

MS. GATES: Okay. CDI has significant year-end payouts -- was retained to the end of 2010. How did that affect the Board's decision to call for an adjustment to the pricing formulas?

DR. ERBA: I don't think it was related at all. We looked at the historical information provided by the Department of the cost studies. It is a pretty well held belief that we should have these kinds of hearings on a regular basis. As soon as the cost studies come out, a hearing ought to be called to discuss it. And it could be an adjustment up, it could be an adjustment down. The fact that we haven't had a hearing to address this for several years, to me personally, is a little bit alarming because the numbers have gotten quite a ways away from the cost of where they are today, quite a ways away from what the manufacturing -- our cost allowances are in the formula.

So I don’t think they're related at all. I think it’s always been in my mind that we should have had this hearing, despite how well or how poorly we did as a company.

MS. GATES: Thank you.

MS. REED: Okay, I have a couple of questions for you and this is going to be more related to the -- your costs, manufacturing costs, since you talk about that quite a bit.

How do you feel that your startup expenses and lower production have impacted the cost for your plants?

DR. ERBA: Well, there’s going to be some of that, to be sure. Startup costs, we had some of that with our first plant in Visalia. Had less of it in the second plant because we had some experience of how that equipment was going to run. But those costs are going to be there, the volumes are going to be lower, and eventually those are going to wash out over time.

Those plants started up in -- one started in 2008 and one started in 2009. So at some point those will wash out of the costs as we perfect how those plants are running.

MS. REED: Okay. So basically -- I was going to ask you another question, but I guess that sort of answers this. Basically when you feel that those plants have reached full production, full capacity or whatever, that will then wash out and basically lower your costs is what you're saying. They will become more even.

DR. ERBA: Right, right. But I do point out that both those plants were very expensive to build, much higher costs than any of our other plants by a huge margin. And, no matter what, the depreciation costs, the interest cost, because of the higher cost of building it, that’s going to be in there no matter what. You're not going to be able to wash those out.

MS. REED: Exactly. And that -- yeah, it’s because those would affect a couple of areas within the cost study --

DR. ERBA: Right.

MS. REED: -- but not all of the areas that are being affected at this point.

DR. ERBA: Right. I would expect that some of those costs would come down over time, but I would not expect those to be huge numbers. Those costs were expensive, those plants were expensive to build and those costs are embedded in there.

MS. REED: Right, and I agree with that. I think that, you know, you're right that the costs will be there but I think as the production increases then that’s what will sort of wash those out and make it more, you know, more uniform.

DR. ERBA: Sure. And we’ve already seen that in the first of the two Visalia plants.

MS. REED: Exactly, yes. Okay. Also just one final question. How do you feel that the costs in the Department’s 2009 exhibit represent the costs for your plants?

DR. ERBA: Well, seeing as we make up most of the plants in the study anyway, I would say they're very representative.

MS. REED: Okay, yeah. They’re representative but you have to take into consideration there are others also, so it’s not going to be an exact number but --

DR. ERBA: That’s true.

MS. REED: -- you think it’s falling in the ballpark for where -- the weight of that, which is falling in the ballpark, you're thinking.

DR. ERBA: Right. And the plants that we have in the cost of these, we've got plants that are above the weighted average and below the weighted average.

MS. REED: Okay, thank you.

HEARING OFFICER MAXIE: Mr. Eastman?

MR. EASTMAN: Yes, I have a couple of questions for you, Dr. Erba.

DR. ERBA: Sure.

MR. EASTMAN: You mentioned that in 2011 milk production has been increasing, especially over the last couple of months. There’s obviously more cows that are coming on, milk prices over the last number of months have been increasing, and so prices paid to dairy producers have gone up. How would you expect, say, your membership to react to this? Do you think they're going to be adding more cows to increase production as we go throughout the summer and the rest of the year? What would you estimate or guess that to be knowing that, obviously, we don’t have a crystal ball and we can’t predict the future, but what would you anticipate?

DR. ERBA: That’s a good question and a fair question. (Indiscernible) brought 450 members and I expect that that decision will range A to Z. We’ll have some members that are going to have a tough time making it even with these kind of milk prices because their costs are higher. Our costs, as you well know, are extraordinary at this point. And we’ve got some members who are probably a little bit better off in the way they planned ahead, contracted for feed. And those contracts are going to expire at some point, but at this point, for this year, they're situated pretty well. And we’ve got folks all the way in between.

So I don’t know that I can give you a great answer there because of the size of the co-op, the diversity, kind of members we’ve got are, I think, you'll see all kinds. You'll see some that are trending toward the expansion mode and some that are just trying to hold on.

MR. EASTMAN: Okay. So let’s suppose that over the next foreseeable few months or the rest of the year, on average CDI’s milk production of all of your members in aggregate tend to start increasing now. Do you think that’s going to (indiscernible) issues of handling milk? You mentioned before that you felt these were times or were just demand going down, being in crisis mode. Do you feel like even at milk plants where they go down, do you think we could reach that tipping point again?

DR. ERBA: Well, we have -- we have our own supply management program at CDI. It's still in place. It was put in back in 2008. And so we do have some mechanism for monitoring and adjusting our milk supply within our own co-op. I don't think we're in any danger of getting past our theoretical handling capacity, but that remains to be seen. As I told Ms. Gates, we're one breakdown at a plant away from having a fairly large disaster on our hands.

But back to your question, I don't think we're going to have any real issues with that because we do have a supply management program that's already in place at CDI.

MR. EASTMAN: If maybe you could refresh my memory. So with your supply management, your production-based program, if you get too much production and have problems placing that milk and, say, you have to ship it out of state at discounts or -- except, if I remember correctly, you charge them. There's some sort of surcharge, a (indiscernible), or something that's placed on those producers who have grown.

DR. ERBA: That’s right.

MR. EASTMAN: And so have you been, over the last few months or lately at all, have you had to implement any of those surcharges on your members?

DR. ERBA: We haven't had to do that since 2009.

MR. EASTMAN: Okay. So it’s been a couple of years. But from what you're stating now, if you were to start creeping to that tipping point, so to speak, you would implement those surcharges and try and have your production base then function the way it’s supposed to with regards to limiting production then.

DR. ERBA: That’s correct. The same mechanism that we had available to us as a co-op in 2009 we still have available to us.

MR. EASTMAN: I think that’s all the questions I had.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you, Dr. Erba.

DR. ERBA: Thank you.

HEARING OFFICER MAXIE: I’d like now to call the second Petitioner, Land O’Lakes. Land O’Lakes will also have a period of 45 minutes to present testimony.

Could you state your name and spell your last name for the hearing record.

MR. WEGNER: Thomas Wegner, W-E-G-N-E-R.

HEARING OFFICER MAXIE: Thank you. And you handed a document just now. Is that a written copy of your testimony?

MR. WEGNER: It is.

HEARING OFFICER MAXIE: Would you like that testimony entered into the hearing record as an exhibit?

MR. WEGNER: I would.

HEARING OFFICER MAXIE: Very good. It will be entered in as Exhibit number 50.

(Thereupon, Exhibit 50 was received and entered into evidence.)

Whereupon,

THOMAS WEGNER

was sworn and duly testified as follows:

MR. WEGNER: Mr. Hearing Officer and members of the panel, my name is Tom Wegner. I am here to testify on behalf of Land O'Lakes, Inc. My business address is 4001 Lexington Avenue North, Arden Hills, Minnesota 55164. My current title is Director of Economics and Dairy Policy.

We thank the Department for promptly calling this hearing to address issues of critical importance to the future of all of our California dairy producer members.

Land O'Lakes is a dairy cooperation with three thousand 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 275 California member owners supply us with over 16-million pounds of milk per day that are primarily processed at our Tulare and Orland plants.

Updating the whey portion of the Class 4B formula: The current Class 4B formula contains a factor that values whey at a fixed level of 25 cents per hundredweight regardless of the price whey is trading at in the Western whey markets. This fixed 25 cent value stands in stark contrast to the Federal Order Class III formula, directly comparable to the California Class 4B formula, containing a variable, market-based whey factor that has effectively returned values in excess of $1.40 per hundredweight in recent months. In fact, from January 2011 through April 2011 the federal whey formula added an average of $1.46 per hundredweight to the Class III prices in federal order markets. The total difference between the Class 4B and Class III prices was actually $1.56 per hundredweight due to the use of different cheese price series and the f.o.b. adjuster in the Class 4B formula.

Land O'Lakes proposed changes would result in a more equitable sharing of whey's market value. Land O'Lakes proposes that the 25 cent fixed factor remain in place when dry whey's market value, as measured by the USDA's Dairy Market News Dry Whey Mostly Price, averages 24.49 cents or lower. And when the average market value of dry whey exceeds 24.5 cents per pound, the whey portion of Class 4B will increase in accordance with the following table.

I'm not going to read the following table. It's right in the testimony.

Since fewer than three plants manufacture dry whey in California, the Department no longer publishes whey manufacturing costs to utilize in an end-product pricing formula. In the absence of manufacturing cost data for whey, the industry has proposed other methodologies to share the market value of whey between producers and processors. The Department has rejected these methodologies in favor of the 25 cent fixed factor

With the goal of a more equitable sharing of whey’s market value in mind, while considering the constraints of incomplete whey manufacturing cost data, Land O’Lakes believes the best approach is one that will roughly approximate the value of whey in the Class 4B formula, based on the market value of dry whey. The approach strikes a reasonable, logical, and equitable sharing of whey values between producers and processors. At the same them, the proposal limits the financial exposure to cheese plants when whey market prices exceed 38.5 cents per pound.

Our proposal approximates the value of why be retaining the 25 cent fixed factor and modestly increasing the whey value in Class 4B by five cent increments based on the Western Dry Whey Mostly. The increase, in five cent increments, begins when why prices rise to 24.5 cents per pound. The value of why in the Class 4B formula increases to a maximum value of one dollar when the Western Dry Whey Mostly averages 38.5 cents per pound.

Our proposal returns an increasing whey value to milk producers when the whey market trades in the range of 24.5 cents to 38.5 cents per pound. During the 60 months, May 2006 through April 2011, prices of the Western Dry Whey Mostly ranged from 24.50 to 38.50

38 percent of the time. By contrast, during the same 60 month period, dry whey prices ranged from 38.50 to 83 cents per pound roughly 47 percent of the time. The other nine months Western Whey traded at less than 24.49 cents per pound. Our proposal strives to equitably share the value of whey processes and acknowledges the challenges in finding whey processing options by limiting the financial exposure to cheese plants at one dollar per hundredweight.

The maximum value of one dollar in the Class 4B formula would still fall 13 cents below the value whey in the Federal Order Class III formula when the whey market is trading at 38.5 cents per pound. As whey market prices rise about 38.5 cents per pound, the value of whey in the Class 4B formula remains at a dollar per hundredweight, effectively capping the exposure to California’s cheese processors. By contrast, the Federal Order Class III formula puts no limit on the exposure to cheese plants from whey prices exceeding 38.5 cents per pound.

This one dollar maximum, an effective ceiling, will likely become more important in the immediate future if dry whey prices continue to trade in the 50 cents per pound range. At the close of the Chicago Mercantile Exchange on June 27, 2011, futures for dry whey averaged 48 cents per pound during the next nine months, July 2011 through March 2012. Assuming a dry whey price of 50 cents per pound, the value of whey in the Class III federal order formula would be an estimated $1.83 per hundredweight. By contrast, and again assuming a dry whey price of 50 cents per pound, the value of whey in the Class 4B formula would still be one dollar. Thus, under the Land O'Lakes proposal the whey contribution for the Class 4B price would be 83 cents per hundredweight lower than the whey contribution to the Federal Order Class III when whey prices average 50 cents a pound.

Why update the whey factor? In short, the Class 4B price is out of alignment with the Federal Order Class III price. As a result, California producers are not being treated fairly compared to producers shipping to processors regulated under federal milk marketing orders. Adopting the Land O'Lakes proposal help to bring the Class 4B price into better alignment with the Federal Order Class III price and reduce this price inequity.

As you know, the California Food and Agricultural Code, Section 62062, states with respect to classified prices, including Class 4B, that "The methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products."

Currently whey markets have been trading at nearly 50 cents per pound, adding over -- and here I have a change -- $1.80 per hundredweight to the Federal Order Class III price -- instead of $1.50. By stark contrast, even though whey markets have been trading at nearly 50 cents per pound, the contribution of whey's value to the California Class 4B price remains fixed at 25 cents per hundredweight. Clearly, the relationship between the Federal Order Class III price and the California Class 4B has not, is not, and will not meet this requirement of the Food and Agricultural Code if the 25 cent fixed factor remains in place. Thus, California producers are not being treated equitably when compared to producers shipping to processors regulated under federal milk marketing orders or when compared to cheese processors who buy milk from handlers who typically pool this milk on federal orders.

Milk sold to unregulated cheese plants in federal order marketing areas: Testimony by participants in previous Department hearings asserted that cheese plants outside of California are able to buy milk below the Federal Order Class III price. This testimony -- the testimony may have been referring to milk purchased by cheese plants in unregulated areas like Idaho, but I’d like to focus my comments on sales of regulated producer milk to unregulated cheese plants in federal order markets.

As previously noted, Land O’Lakes pools producers’ milk in several federal milk marketing orders each month. In fact, Land O’Lakes pools producer milk on the upper Midwest, Central, Northeast, Appalachian, and Southeast federal milk orders. Combined, these five orders accounted for over 70 percent of the 57.3-billion pounds of Class III milk pooled in the entire federal order system during 2010. In the upper Midwest federal order alone, the Class III utilization averaged 83.7 percent in 2010.

Land O’Lakes sells Class III -- I think I've got IV there; that should be III -- milk to cheese plants not regulated under federal orders and also buys milk from cooperatives and nonmember producers for use in our own cheese plants located in the upper Midwest. Typically, in almost every case, the price charged for milk sold to unregulated cheese plants exceeds the Federal Order Class III minimum price.

It only makes economic sense that the milk sold to unregulated cheese plants by cooperatives that pool this milk on a federal order is not priced at levels below the Class III minimum price, since the cooperative must account to the federal order pool for Class III sales at the Federal Order Class III price. The price charged for milk sold to unregulated cheese plants has direct consequences on the handler’s ability to pay a competitive price to successfully retain existing and attract new producers. It makes absolutely no sense to charge below the Federal Order Class III prices when the cooperative handler must account to the federal order at Class III minimum prices.

Previous hearings have also included statements about the advantages of depooling or the voluntary choosing by handlers to remove a portion of their milk from a federal milk order. Let me offer another perspective on how depooling impacts prices paid to producers.

Firstly, there has been an assertion that processors who depool milk have an advantage over California processors. Land O’Lakes and other handlers who depool milk must continue to compete for milk supplies. They must remain competitive in their markets to retain their milk supply. Plants buying milk depooled by a federal order handler must still pay the going market value, which is at least the Federal Order Class III price. By depooling, handling forego receipt of the producer price differential, the PPD, but must still typically pay the Class III minimum price for milk sold to and processed at cheese plants.

Secondly, the volume of depooled milk has dropped considerably in recent year, in part resulting from amendments proposed by processors and cooperatives and adopted by producers in the upper Midwest, Central, and Mideast federal orders. These are the three federal orders -- federal order markets where the vast majority of depooling has occurred. The amendments limit the volume of milk a handler may pool during most months to 125 percent of the volume of milk pooled in the immediately preceding month. Handlers can still depool milk, but the volume a handler chooses to depool will directly limit the volume that the handler can pool in the following month.

Evidence of this decreasing volume of depooled milk can be found by comparing volumes depooled in 2009 under the federal orders to volumes depooled in 2010. For example, in 2009 USDA estimated that handlers chose to depool 4.4-billion pounds of milk, representing just over 3.3 percent of the total volume of milk pooled and priced under federal orders. In calendar year 2010, the USDA estimated that handlers chose to depool 2.8-billion pounds of milk, representing just over two percent of the total volume of milk pooled and priced under federal orders.

Updating the manufacturing cost allowance for cheese: Land O'Lakes proposes that the Class 4B formula be updated to reflect the most currently available manufacturing cost data for cheese. Land O'Lakes proposes that the Class 4B formula be amended to the most current weighted average cost for cheese published in the November 2010 Manufacturing Cost Exhibit for the period January through December 2009. The Department reported that the weighted average cheese manufacturing cost in 2009 was 19.6 cents per pound, a decrease -- excuse me -- a decrease of .22 cents per pound compared to the current manufacturing cost for cheese in the Class 4B formula. Thus, Land O'Lakes proposes that the Department consider reducing the cheese manufacturing costs to 19.66 cents in the Class 4B formula.

Updating the f.o.b. adjuster for cheese: Land O'Lakes proposes that the Department consider adjusting the f.o.b. price adjuster for cheese to be consistent with the most current data reported by the Department in November 2010. The Department reported that the difference between cheddar cheese prices from the Chicago Mercantile Exchange and prices from audited sales of California cheddar cheese for the 24 month period from July 2008 through June 2010 to be negative .18 cents per pound. Land O'Lakes proposes that the Department consider reducing the f.o.b. cheese adjuster from 2.52 cents per pound to .18 cents per pound in the Class 4B formula.

Market conditions have changed on California dairy farmers since 2007. California dairy farms have gone through very trying financial times over the past four years. In 2008 income over feed dropped 32 percent from 2007 levels, and in 2009 margins over feed dropped to a catastrophically low level of $2.74 per hundredweight, representing a decrease of 73 percent from 2007 levels.

The financial train wreck of 2009 left many California dairy farmers with severely reduced equity, mounting debt, and tightening credit lines. Margins in 2010 rose back to profitable levels for most, but didn't come close to repairing the financial damage inflicted in 2009. We understand that cow and facility values on some California dairies have been improving, but we suspect that overall the equity position of California's dairy farmers has still not even come close to a full recovery from 2009. This weakened equity position makes them much more financially vulnerable in the event that we go through another period of catastrophically low margins like 2009.

Land O'Lakes has concerns about feed costs, which have risen dramatically in 2011. Current corn prices are about 83 percent higher than a year earlier, rising by nearly $3.00 per bushel from $3.49 per bushel in 2010 to $6.40 in 2011, according to the USDA Agricultural Prices Report for May 2011. This is even before taking into account the California local basis for corn that can add as much as $2.00 more per bushel. Hay prices have also risen to dramatically high levels. USDA reported a price of $305.89 per ton for the week ending June 17 for premium alfalfa in the Tulare-Visalia-Hanford-Bakersfield region.

The data collected by the Department for the first quarter of 2011 reveal that feed costs increased by 17.9 cents -- 17.9 percent from Q1 2010 to Q1 2011, to represent slightly more than 61 percent of total costs on California dairy farms. More specifically, and still comparing Quarter 1 2011 to Quarter 1 2010, dry roughage costs rose 10.7 percent, wet feed and wet roughage increased 24.7 percent, and concentrates rose 26.9 percent. The Q1 2011 feed costs of 903 per hundredweight -- $9.03 per hundredweight represented an increase of $1.34 per hundredweight over Q1 2010, and has already surpassed the 2009 average feed cost of $8.77 per hundredweight.

Up to this point in 2011, milk prices have kept margins over feed above levels experienced in 2009. Even if margins over feed remain at current levels, it will take more time for California dairy farmers to recoup the equity lost in 2009. We have concerns that feed costs have risen in Q2 2011 and will continue to rise through 2011, especially in the corn market as U.S. corn stocks have fallen to 35 year lows and in light of the challenging weather conditions prevailing in the Corn Belt.

Feed cost projections for 2011-12 offer little relief. USDA projects corn prices remaining in the $6.50 range, corn futures continue to trade in the $7.00 range for 2012, putting more pressure on California dairies that purchase the bulk of their feeds.

Adding to the financial stress at the farm level is the fact that California dairy farmers have limited opportunities to protect themselves from the negative impacts of volatile milk prices and rising feed costs. The fixed whey factor severely hinders a

California dairy farmer's ability to make effective use of dairy futures to hedge their milk.

For example, the Class III futures contract offered by the Chicago Mercantile Exchange is the most heavily used of the dairy product futures contracts. As noted earlier, the Class 4B price and the Federal Order Class III price differed by an average of $1.56 per hundredweight from January through April 2011. This difference, the basis, drastically increases the risk that a California dairy farmer takes on when entering a Class III futures contract to hedge their milk. Price movements in the Class III futures market may not be offset on a one-to-one basis in the cash 4B market.

Accordingly, 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 minus the Federal Order Class III price -- in February 2011 was negative eight cents. In March 2011 the Class 4B basis ballooned to negative $2.64 per hundredweight. This gross mismatch between the Class III futures prices and the 4B cash price, coupled with the high level of volatility of the Class 4B basis, prevents California dairy farmers from making effective use of Class III futures as a hedging tool.

On the feed side, cotton and corn has been outbidding hay acreage in California. An export demand for hay has pressured prices up, as well. This additional acreage in cotton and corn has reduced the hay supply and has led to higher hay prices. There are no established futures markets for hay, and the cool, wet spring in the Corn Belt has limited opportunities to lock in feed at price levels that ensure an adequate income over feed margin.

Additionally, dairy farmers need a hedge line of credit to make effective use of futures markets as a tool to ensure their future margins. Since many California dairies lost significant equity in 2009 that has not been recovered, the availability of hedge lines to these farms has been severely limited.

Market conditions have changed in the whey market since 2007. As you know, the federal orders use the National Agriculture Statistic Service's, or NASS', monthly whey prices and NASS cheese prices to calculate the Federal Order Class III price. From June 2009 through May 2011 the NASS whey price averaged 37 cents per pound and the Western whey market averaged 39 cents per pound. From June 2009 through May 2011 the whey contribution in the federal order formula exceeded the fixed whey factor of 25 cents in each and every month. From December 2007 through May 2011 the NASS whey market averaged 31.6 cents per pound and the Western whey market averaged 32.8 cents per pound. Even though the Western whey market price was slightly higher than the NASS whey market price, California’s dairy farmers received far less value from the whey market in the Class 4B price than dairy farmers delivering milk in federal order markets.

During the period June 2009 through May 2011 the whey contribution to Class III averaged $1.07, or 82 cents more per hundredweight, than the fixed whey factor of 25 cents per hundredweight. For the entire period since the last hearing results were effective, the whey contribution to Class III averaged 75 cents per hundredweight, or 50 cents more than the fixed factor of 25 cents per hundredweight.

But the real advantage, or disadvantage, for cheese makers would be reflected in the price paid for cheese milk. For the period June 2009 through May 2011, the Federal Order Class III price averaged $14.22 per hundredweight compared to the current Class 4B price of $13.18 per hundredweight, or $1.04 per hundredweight less. For the period December 2007 through May 2011, the Federal Order Class III price averaged $14.82 per hundredweight compared to the current 4B formula at $13.97 per hundredweight. The Class 4B price has averaged 85 cents per hundredweight less than the Federal Order Class III price since the 25 cent fixed whey factor was implemented by the Department in December 2007.

Small cheese plants have had the opportunity to develop their whey business since 2007. All cheese plants, large and small, have benefitted from the fixed whey factor since 2007. From December 2007 through April 2011 the 25 cent fixed factor has benefitted cheese plants over 80 percent of the time. By limiting the financial exposure to a maximum value of 25 cents for a product with the potential for capturing far more than that value in the market, the 25 cent fixed whey factor has provided a huge incentive and a golden opportunity for small cheese makers to develop a whey business.

We encourage, respectfully encourage, the Department to ask small cheese processors how they handle their whey and if they have pursued new ways to take advantage of the rising values in the whey market. We would also be curious to know how small cheese processors manage to compete for milk supplies if they have no outlet for their whey.

Since 2007 Land O'Lakes has had first-hand experience with the issue of a small cheese plant finding an outlet for whey processing. Our Orland cheese plant had been condensing and trucking the whey to our Tulare plant for further processing. This ended in 2010 when we chose to idle our cheese and whey processing facility in Tulare. We continue to condense Orland's whey into whey protein concentrate and have established a new relationship with a cheese manufacturer in California for further processing. We don't capture the full value of the lactose in the permeate, which is sold to area dairy farmers, but we have found an outlet for our condensed whey.

We also respectfully encourage the Department to ask large California cheese makers how their whey enterprises have performed since December 2007 and to compare and contrast their California plants to cheese plants operating in federal order markets. On the surface, it appears that the California cheese plants have had a significant advantage over cheese plants operating in federal order markets because of the fixed whey factor.

Processing capacity has changed since 2007 and 2008. In 2007 we raised concerns about the lack of processing capacity in California. This developed because new plants were not coming on line fast enough to accommodate the growth in milk production. We testified that through August 2007 milk production had increased year-to-date by 4.7 percent, and we stated that if milk production increases continued at that pace there would be five million pounds of additional milk per day in 2007 compared to the previous year. As a result, the state’s processing capacity was being pressured and, in fact, milk had to be shipped out-of-state and, in some cases, less attractive alternatives were instituted. The situation in 2007 through 2008 was precarious. Certainly one could argue that California’s milk processing capacity was in deficit.

Things have changed since 2007 and 2008. Currently there is adequate capacity to handle and process California’s milk supply. This does not mean that there could be short-term problems on certain weekends and/or holidays when milk backs up or when one of the large manufacturing plants goes down for maintenance. But even in those cases, while some out-of-state shipments may be necessary, we are not aware of milk finding its way to less attractive alternatives nor being shipped out-of-state on a regular basis. The current market conditions differ significantly from market conditions of 2007 and 2008.

What has changed?

Number one, during the peak of the crises, a large proportion of the cooperatives and some proprietary firms with direct shippers adopted a base plan and, in some cases, producers were assessed for the cost of disposing of milk in excess of their base production.

Number two, milk production has declined in California since 2008. In fact, average milk output per day was 4.3-million pounds less in 2009 than it was in 2008. This occurred for at least two reasons: One was the base plans that were put in place; secondly, the milk prices declined sharply from their peak in 2007 and 2008. In fact, the average over base price in 2007 was $17.27 and by July 2009 the over base price dropped to $9.60 per hundredweight, and the average for 2009 was only $10.81 per hundredweight. From August 2007 to July 2009, the over base price dropped by 52 percent.

Number three, milk processing capacity on a net basis is significantly larger today than it was in 2007 and 2008. There was an expansion in cheese processing capacity on the part of two firms for a total of 67 loads of milk per day, and a combination of new powder plants, expansion of current capacity for

Land O'Lakes, and a reopening of an old plant that processes powder, condensed, and cream cheese, which added a total of 287 loads a days.

There were also some losses in processing capacity. Land O'Lakes idling a cheddar plant, and another large cheese plant was closed, for a total loss in processing of 145 loads of milk per day.

In sum, this means that California has experienced a net increase in processing capacity of about 209 loads of milk per day than at the time of the fall 2007 hearing. It's true that in 2007 and 2008 the California milk supply exceeded processing capacity so we had deficit processing capacity. Because the processing capacity was deficit in 2007 and 2008, it would be inaccurate to say that we have excess processing capacity of 209 loads per day. Taking into account the deficit processing capacity and the growth in processing capacity on a net basis, and based upon industry sources, we believe California has excess processing capacity of an estimated 80 to 90 loads of milk per day as of April 2011. We believe this to be a conservative estimate. At this point in time the manufacturing capacity in California can adequately handle and process California's milk output.

Position on CDI's 4A petition: Regarding the petition by CDI to update the make allowances for butter and nonfat dry milk, Land O'Lakes respectfully requests that the Department conduct a thorough review of the reported manufacturing costs for 2009. Specifically we encourage the Department to consider the level of plant capacity utilized. Land O'Lakes would like to remind the Department that the manufacturing cost data upon which the make allowances are based need to represent costs in plants operating at full utilization of the plant's capacity.

We know that from our own butter and nonfat dry milk plant operations in Tulare that our 2009 costs were impacted by startup costs, reduced milk volumes through the plant, and underutilization of plant capacities. Additionally, Land O'Lakes would like to note that the 2010 survey of manufacturing costs will come out within the next few months, providing the Department and the industry with the most current data available on such costs.

We support the CDI petition to update the f.o.b. adjuster on butter. We have no concerns about how the f.o.b. adjuster for butter was compiled. The reported f.o.b. adjuster is based upon audited numbers from butter plants and represents the cost of moving butter east. We need to stay competitive with butter processors located outside of California.

Position on alternative proposals: Land O'Lakes supports the Department's alternative proposal to make administrative changes to the Class 4A and 4B pricing formulas to include language to implement the collection of security charges provided by the Milk Producers Security Trust Fund.

We support the Western United Dairymen proposal, but prefer our proposal.

We oppose the Dairy Institute's alternative proposal. We are pleased to see the Dairy Institute recognizes the inadequacy of and inequity resulting from the current 25 cent fixed whey factor; however, the proposal would not do enough to bring the Class 4B price into better alignment with the Federal Order Class III price.

Conclusion: We thank the Secretary for calling this hearing. We thank you for your consideration and Land O'Lakes would like to request the opportunity to file a post-hearing brief.

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

Are there any questions from the panel?

MS. GATES: Mr. Wegner, I have a couple of questions for you.

Going back to your position on the 4A petition that’s out there, did I understand correctly that you didn’t take a position on the f.o.b. adjuster for 4A, it was just 4B?

MR. WEGNER: We did take a position on the f.o.b. adjuster for 4A. We support that.

MS. GATES: You support that. So it’s just the cost, net efficient costs that you're --

MR. WEGNER: Raising.

MS. GATES: -- raising.

MR. WEGNER: Raising questions about, yes.

MS. GATES: Raising concerns with. Okay.

MR. WEGNER: Yes.

MS. GATES: Okay, all right. Does Land O’Lakes still have a base plan in effect?

MR. WEGNER: Yes, we do.

MS. GATES: Okay. Could you speak a little bit to why Land O’Lakes chose the Dairy Market News Price series versus NASS series?

MR. WEGNER: Well, we thought that from a Department perspective in terms of what you’ve used, you'd prefer to have a California market price. That’s why we chose that one.

MS. GATES: And you feel that that more accurately reflects the California price versus the

NASS.

MR. WEGNER: Yes.

MS. GATES: I understand it correctly. Okay. One more.

How did Land O'Lakes come to the floor and the ceiling on this scale, the graduated scale that you guys have proposed?

MR. WEGNER: We looked at what we thought was fair. We felt that the -- since there had been no stated opposition to the 25 cent fixed floor that it would be best to retain that in the event that whey would drop out again. We felt that the dollar ceiling was a fair number and it was important to max -- to minimize or -- excuse me -- to limit the exposure to a dollar. We felt that that was a fair number, especially at it relates to the two factors, especially as it relates to the federal order whey formula and the other being that we've got, is it, 40-41 months with a 25 cent fixed factor had been in place. We thought it was time for cheese prices to recognize that value and share it a bit more.

MS. GATES: Okay, thank you.

MS. REED: Mr. Wegner, I have a couple questions to ask you.

You're talking then, on page 10, about how you feel that your costs have been impacted by startup, you know, fees, and reduced milk and all. And I will ask the same question that I asked of CDI. So how do you feel those things that happened that year as far as fluctuation in volumes and expansions affected your plant, in what way?

MR. WEGNER: I think our costs were higher due to the startup costs, the lower (indiscernible), we were getting used to the efficiency of moving product through in a new system.

MS. REED: Okay. Also, do you feel that the costs and the Department’s -- you're going to, I already know what your answer’s going to be -- the Department’s 2009 exhibit reflect your costs, how do you feel it reflects your costs in all areas, because you do butter, powder, and cheese? And if you could, speak to each one of those.

MR. WEGNER: Well, I think the point we’re raising is that they may, in fact, represent the costs at the plant. Do they represent plant costs when a plant is running at full capacity is our point. We would definitely raise those concerns about the butter and powder operations specifically.

MS. REED: Okay. And then one final question. Knowing that you guys do still process cheese in California, but you're asking for a reduction in the make allowance and also the f.o.b. adjuster. Could you explain why you're going in that route?

MR. WEGNER: Well, we felt that the survey numbers weren’t affected by startups, weren’t affected by through put, and they did represent where the costs are for the industry.

MS. REED: Okay, thank you.

HEARING OFFICER MAXIE: Mr. Eastman?

MR. EASTMAN: Thanks. I have just a couple questions.

So piggybacking on what Venetta just asked, you mentioned you still make cheese. And how will your (indiscernible) proposal affect you as a processor of cheese? Obviously Land O’Lakes is a processing cooperative, so you kind of wear dual hats where you have interests on dairy farmers but then also you are a processor of butter, powder, and cheese. How does your forby (phonetic) formula affect you as a processor in marketing, a marketer of cheese?

MR. WEGNER: Well, it will certainly impact our Orland facility. We’re well aware of the impact there, it would be. But again from a cooperative member-owner perspective the inequity between the Class III and the 4B is a very important point for our member-owners. We understand the impact, the negative impact on our plant but a very positive impact to our producers, our producer-owners. So we're well aware of that.

MR. EASTMAN: All right. And as a national organization you do mention that you make cheese in California but you also make cheese in the upper Midwest, other areas of the country. When you look at the price alignment issue that you've raised in your testimony, and you've mentioned that possibly California cheese processors, due to that price alignment issue, had some sort of maybe advantage. Do you feel that you've been able to take advantage of that in the sense that you've mentioned in your testimony you pay the Class III or above Class III price in -- outside of California, but you've had a lower price in California. Have you been able to leverage that?

MR. WEGNER: Well, no secret, we have a much smaller footprint in cheese at this point and a lot of the cheese that we use out of Orland is within an internal process within our own plants. It certainly has helped. I won't deny that fact. Whether it's been a big advantage with the small stake we have in cheese, I wouldn't say it has been.

MR. EASTMAN: Okay. In your testimony you raise an issue of price alignment between the cheese price in California and federal orders, and you focus a lot on the whey values. Did you look at or consider the other aspects of the (indiscernible) and formulas? For example, the cheese price series, butter price series. Did you look at the formula constructs, things of that nature when you were looking at pricing line (indiscernible) or did you just focus on the whey?

MR. WEGNER: Well, certainly we looked at the other components within the formula, but the bulk of the difference, the majority of the lion's share is certainly in the whey factor. So that's why we focused on that whey factor. And in light of all the discussions we've had here, and as Mr. Erba pointed out, the temporary sort of option that was put in place, the 25 cent fixed factor, clearly needed some updating with the strength that we'd seen since December of 2007. So we -- it's pretty glaring when you look at the amount of the difference between Class III and 4B, that the whey factor is a pretty obvious one to address.

MR. EASTMAN: I apologize. I'm going to start writing really quickly, but apparently you can speak faster than I can write.

You mentioned in your testimony that in the past there’s been statements at hearings, at federal orders there’s the depooling option and (indiscernible) and provides an advantage in federal orders. You also mentioned a statement that cooperatives in federal orders are responsible for the Class III (indiscernible) with regards -- probably the pooling. Do you feel there’s ever any circumstances where maybe milk is long or there’s some sort of distressed milk and the cooperative could, say, offer milk to cheese plants at a price below the Class III price and eat the difference and blend it to the members maybe?

MR. WEGNER: It’s very possible. The spot market is very different from the -- having established full supply contracts that are in place. But yes, that is a possibility. How often? I can’t give you a number on how often that happens. A distress time, like a holiday period, like a plant breakdown, then that might be the case where you would move it. And you're exactly right, though, it would come back in the cooperative and their membership would, as you said, eat the difference. Because you still have to account to the pool at the Class III price.

MR. EASTMAN: Sure. Do you have any anecdotal evidence, have you ever heard stories of things like that happening?

MR. WEGNER: I know it happens on, like I said, long times when you have holidays. We didn't have much of a flux in the upper Midwest and East this spring, but certainly other springs we'd had points where you had to sell -- in order to find a place for the milk you would offer it a bit lower.

MR. EASTMAN: Okay. Another question. And I have another question. You mentioned that you much favor a sliding scale with regards to whey values rather than the fixed factor. And the question I have is let's suppose there were a price alignment issue and the Department were to seek to correct that issue. And part of that, let's suppose, were to change the whey value that's incorporated in the 4B formula in California. Would it be your position that in your mind a sliding scale would be better than, say, a fixed factor even if on average over time the fixed factor were to correct whatever price alignment there would be? Or would it be the same for you?

MR. WEGNER: I'd need to see what you meant by a fixed factor. And you probably are talking of over a period of time that it would perform as well as a sliding scale. From my vantage point I think the sliding scale offers a clear indication of where they're going, tied into that market a little more. Maybe predictability isn't quite the right word, but a little more fairness in terms of approximating. I think we’re in a tough spot here in approximating value without the costs. We need -- from our vantage point we need to have something that approximates value. I would think that as value goes up in the marketplace you'd like to see something connected to the producer value as opposed to -- I won’t argue, sure, you're going to set it at a dollar, a fixed floor? I mean, that’s -- I don’t think that’s as good as moving it up and down from a quarter to a dollar.

MR. EASTMAN: So in essence you'd rather see those whey values rise and fall with the market then.

MR. WEGNER: Yes, that’s what I’d prefer.

MR. EASTMAN: Even if -- I’m just going to throw a number out, these are just hypothetical numbers I’m pulling out of the air. Let’s just suppose they rose over a certain period of time, your sliding scale were to provide, say, 50 cents a hundredweight, your weight value. Let’s suppose there was a fixed factor that over the same period of time was set at 50 cents. So on average both of those would perform over the long haul the same, but obviously with regards to ups and downs in the market they wouldn’t. Would it still be your position that you would prefer the sliding scale just because it would follow the market even though the end result could be the same? And hopefully that's not (indiscernible), it's your hypothetical.

MR. WEGNER: Are we taking a bid here? In all seriousness, from my vantage point as representing Land O'Lakes, we try to strike something that had some fairness to it and I think, from our vantage point, the sliding scale is a bit more fair in being connected to the whey market. Certainly at the end of the day we're interested in seeing what the return would be as compared to another alternative. But clearly the 25 cent fixed factor is not returning an equitable, fair, logical, reasonable value to dairy farmers right now in California.

MR. EASTMAN: Okay, I appreciate that answer. I realize that question was a little wordy, but I appreciate that. Let me just check one more thing.

MR. WEGNER: I guess I should ask if I answered the question, right?

MR. EASTMAN: No, I thought that was a fair answer.

MR. WEGNER: Okay.

MR. EASTMAN: I think that's all my questions.

MS. GATES: I just have a couple more follow-up.

On the last page of your testimony when you were speaking to plant capacity and where the state was at this point in time, and you felt that at this point the capacity was find to handle what was going on. What do you see moving forward? Do your, you know, members want to grow? I mean, has that allowed for that or what do you see, like in the next year or so?

MR. WEGNER: If you tell me the milk price, I'll give you my response.

MS. GATES: Okay.

MR. WEGNER: But no, seriously, I think we're cautiously optimistic, I think, but very cognizant of the impact of rising feed costs. I'm hoping we can hear a little bit more about equity on dairy farms, because that's probably my biggest concerns is that we're really in a very serious position regarding equity, so that a dairy farmer can't withstand another period of very low, much less catastrophically low, margins.

So where are we going in the future really depends. I'm very concerned about New Zealand milk coming back onto the market this fall quarter. I'm concerned about China deciding not to buy as much whole milk powder and skim milk powder. That all impacts on that butter/powder side. Will New Zealand go back to cheese?

Lots of variables in places is what I'm saying. Our dairy farmers continue to want to produce milk, but I'm not sitting here thinking that there's going to be expansion at this point. But a little bit like Mr. Erba suggested, 275 dairy members, it's hard to generalize what they're going to do. But right now the prices are staying ahead of feed costs. I'm not sure we're going to continue to see that as we go on to the remainder of 2011, much less into 2012.

MS. GATES: Okay, thank you.

Back to the Dairy Market News versus the NASS price. Was there any concern with the Dairy Market News being a phone survey versus an audited type data series that the NASS series is?

MR. WEGNER: We didn't raise that point specifically. I know that's been talked about in previous hearings. At this point, again, we're trying to reflect the Western whey markets and --

MS. GATES: California price.

MR. WEGNER: -- that's the best number we can find.

MS. GATES: Okay.

MR. WEGNER: It’s in the California dairy markets and that’s the best market we can find for it.

MS. GATES: Okay, thank you.

MR. EASTMAN: I’m sorry, I have one more question.

With regards to your testimony on the manufacturing costs surveys and how that should be implemented when studying make allowances, you mentioned that you -- in your testimony you draw concerns to the level of, say, butter and powder costs, the manufacturing costs. Are you in favor, then, do you support the idea of updating manufacturing cost allowances in butter, powder in general --

MR. WEGNER: In general --

MR. EASTMAN: -- knowing that there are some worries in your mind about the levels maybe?

MR. WEGNER: In general we support the idea, specifically regarding 2009 when we had the concerns we’ve raised earlier about capacity, startup costs, through put.

MR. EASTMAN: Okay. So just like on (indiscernible) you're supportive of changes to the make allowances on both.

MR. WEGNER: On cheese we are specifically supportive to the changes and have no concerns. On butter and powder we have the concerns as I've stated before.

MR. EASTMAN: Okay, thank you.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you, Mr. Wegner.

We’ll now call on the first alternative proposal, and that came from Western United Dairymen.

We have some complaints on the panel of the air conditioning being too cold up here.

UNIDENTIFIED SPEAKER: I agree with that.

MS. GATES: Would you? Okay.

HEARING OFFICER MAXIE: If there’s anybody back there that can adjust that.

MR. EASTMAN: That’s not (indiscernible).

HEARING OFFICER MAXIE: All right. It’s now about two to two.

MS. REED: I’ll take five votes for myself. I don’t have anybody over here to block the air.

HEARING OFFICER MAXIE: Mr. Marsh, would you state your name and spell your last name for the record.

MR. MARSH: Yes. Michael Marsh, M-A-R-S-H.

HEARING OFFICER MAXIE: Thank you for the written copy of the testimony. Would you like that entered into the record as an exhibit?

MR. MARSH: Yes, I would.

HEARING OFFICER MAXIE: Very good. We'll enter it as Exhibit number 51.

(Thereupon, Exhibit 51 was received and entered into evidence.)

Whereupon,

MICHAEL MARSH

was sworn and duly testified as follows:

MR. MARSH: Mr. Hearing Officer and members of the hearing panel, my name is Michael Marsh. I am the Chief Executive Officer of Western United Dairymen. Our association is the largest dairy producer and trade association in California, representing approximately one thousand of the state's dairy families. We are a grass-roots organization headquartered in Modesto, California. An elected board of directors governs our policy. The board of directors met by teleconference June 9th to approve the position I will present here today.

We would like to point out that usually Western United Dairymen uses an extensive and inclusive process to arrive at a position for a hearing. A Dairy Programs Committee composed of 30 producers from around the state is in place to discuss dairy pricing policy issue when they arise. The committee's position also reflects the voice of an extended number of dairy producers, as committee members discuss the issue at hand with their neighbors. Dr. Dan Sumner of the University of California is also a member of the committee. Following analysis and debate, committee recommendations are then typically presented to the board of directors for review, modification, and approval. In this instance, with a very limited amount of time between the day the Land O'Lakes petition was received and today -- 37 days to be more specific -- we were not able to proceed as usual. Nevertheless, California dairy families are still greatly concerned about this pricing issue. We still would like to thank the Department for the call of this hearing and for allowing us the opportunity to shed light on the challenges being faced by the California dairy families and why we believe changes to the class price formulas are necessary.

Our alternative proposal calls for adjustments to the Class 4B price formula. More specifically, we seek adjustments to the whey factor, cheese manufacturing cost allowance, and cheese f.o.b. adjuster. Our testimony will focus on the why value in the Class 4B formula. Other proposed changes will be discussed at the end of our testimony.

Whey factor and its relationship to the federal order: The California Food and Agricultural Code states that “the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk product,” and that comes from Section 62062. According to CDFA analysis, with the current formula the Class 4B price would have averaged 97 cents per hundredweight less than the federal order Class III price for the period May 2006 to April 2011. That difference is even more striking when looking at the last 12 months of data, where federal Class III was an average $1.31 per hundredweight higher than 4B.

The deviation between Class III and 4B prices was caused by several factors. Notably, formulas differences such as different prices series -- that being the CME versus the NASS -- make allowances, yield, and formula construct all contribute to the divergence. But they whey value is what creates the most variance between the two class prices and this is a big concern to the members of Western United Dairymen. According to our analysis in 2007, 77 percent of the difference been Class 4B and Class III was attributable to the whey value. More specifically, assuming current formulas had been in place since January 2007, the average difference between Class III and Class 4B would have been $1.02 per hundredweight. Of that amount, 23 cents per hundredweight would be due to formula differences other than the whey factor. The remaining 79 cents per hundredweight is due to the difference in the whey value. With whey values that follow market movements in Class III and a stagnate value in Class 4B, such a discrepancy was not unlikely. As the price of whey fluctuates, so will the variance between the two classes if California retains a fixed factor. Clearly the current 25 cent fixed factor violates the mandates outlined in Section 62062 of the Code.

Our proposal would achieve a much closer relationship between Class 4B and Class III by removing the potential for unbearable discrepancies in the whey portion of Class 4B that can occur if we do not directly tie our whey value to the end product pricing formula used in federal orders. As outlined in our alternative proposal, we propose the following whey value in Class 4B: Whey would equal 80 percent times the dry whey less the make allowance factor, times the yield factor of 5.9318.

The footnote below also extends the discussion on that.

While we recognize the Department has been leery of federal order data before, we believe tying our whey value to that of Class III is a very good way to solve this significant discrepancy. Although the formula above looks slightly different than the corresponding portion of Class III, it was adjusted to result in the same whey value per hundredweight as Class III when included into the California 4B formula. And again I refer to the footnote at the bottom of the page. The only differences when comparing the whey value generated by the Class III formula and the whey value generated by our proposal in the Class 4B formula should come from the different price series -- Class III uses NASS and our proposal uses Dairy Market News -- and our proposed 80 percent. Figure one illustrates the impact of our proposal on the whey value.

We propose using Dairy Market News, the Dry Whey West Mostly series average data, as the source of dry whey prices instead of NASS to avoid lag issues. NASS dry whey prices are typically released a week later. When comparing NASS and Dairy Market News dry whey data sets on a weekly basis from January 2007 to prices for the week ending June 11th, 2011, the difference amounts to less than a penny or .0094 cents per pound. Dairy Market News is timelier than NASS, the difference between NASS and Dairy Market News is very small, and the Department has favored using Dairy Market News in the past. Therefore, we believe that Dairy Market News Dry Whey West Mostly series is the appropriate one to use.

State if the industry: 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 added costs, something farmers in no other states have to deal with. Aside from this regulatory burden, costs of production on the diary have increased significantly.

As everyone well remembers, producer milk prices fell significantly through most of 2009, posting an over base price of only $9.60 per hundredweight in July 2009 compared to $17.35 per hundredweight in the prior year. For the second half of 2009, prices slowly increased to $14.47 per hundredweight by the end of the year. However, prices dropped again to the $12.00 to

$13.00 per hundredweight range for the first part of 2010. With a statewide average cost of production of $15.02 per hundredweight for the first quarter of 2010, the financial situation for dairy producers was unbearable. After prices softened through the first half of the year, they showed signs of improvement by the end of the summer when the August 2010 over base price reached $14.84 per hundredweight. The over base price made it all the way to $15.95 per hundredweight in October. With statewide average cost of production $15.13 per hundredweight for the third quarter of 2010, some producers were likely experiencing positive margins again. While prices were overall improving, the cost of production was also increasing. Improving dairy prices is good news, but it will take a prolonged period of improved margins for dairy producers to recover the immense losses and eroded equity that arose from the economic disaster of 2009. Data from the accounting firm Frazer and Torbet illustrates this fact as 2010 revenues per cow do not come close to the losses per cow incurred in 2008 to 2009. And that is included in Attachment A.

A comparison of California over base price to the average cost of production in California since 2001 reveals the challenge faced by producers. Production costs were on a steady upward trend until the beginning of 2009. At the same time, prices were not only volatile but far below costs in many months. The difference between the costs of production and over base price in 2009 is striking evidence of the catastrophe that occurred for California dairy families. And please see Table 1 below.

To understand the impact of the losses, one can look back at the milk production trends that occurred from the end of 2008 until mid-2010. California dairymen could not afford to milk cows anymore and it clearly showed in milk production numbers. From an average year-over-year four percent growth in 2006 and 2007, growth slowed to one percent in 2008 before falling to an average negative four percent in 2009. And you can see that in the chart in Attachment B. Most likely this also had an impact on manufacturing plants that were forced to operate at less than optimal levels, thus unusually increasing their cost per hundredweight of milk produced.

A minimal softening in feed costs had been a notable mover in the reduction in cost of production observed from the first quarter of 2009 to early 2010. According to CDFA data, feed costs rose from just over 51 percent of the total cost of production in 2003 to

60 percent of total costs 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; lower, but still historically high. The slow decline in feed costs was short lived. Since fall 2010, feed prices have skyrocketed. Recent estimates from USDA reported the corn ending stocks-to-use ratio at its lowest level since 1995-96. Higher than expected usage, notably corn diversion to ethanol production -- and please see the attached chart -- was cited as one of the causes for lower stocks. This outlook has led to dramatic increases in feed prices. It makes a big difference if you're using 40 percent of your corn crop going into ethanol production. This has also stimulated significant concern in the dairy industry that the cost of production will climb to new highs due to rising feed costs, further eroding already tight margins. CDFA data indicates that feed costs reached an all-time high of 61 percent of total cost of production for the first quarter of 2011. The tight margin issue is not likely going away anytime soon.

Due to all those increased costs, California dairymen have lost much of their competitive position relative to the rest of the nation. Failing to capture the value of whey, which has turned out to be a very marketable product, is hurting their competitiveness further.

We review the state of the industry for two main reasons. One, the Department must take into account the cost of production. “In establishing the prices, 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 market 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.” And that comes from Section 60262 of the Food and Ag Code.

Two, the California dairy landscape has changed. Current dairy prices have significantly improved in the last few months, but feed prices are showing no reprieve and margins are still very fragile. The memory of the 2009 dairy crisis is still fresh in producers’ minds. Waiting for good times does not suffice. Volatility has been a buzzword in the last few years for a reason. It’s here to stay. As you know, dairymen have no way of passing along added costs. To avoid a repeat of that economic catastrophe, many producers have turned to risk management tools to attempt to protect their operations. More specifically, hedging has become an increasing part of dairy operations 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 futures prices and cash prices.

The futures contract most commonly used by California dairymen is tied to Class III, federal Class III. The difference between futures and cash prices is called basis. A hedge will never be perfect due to changes in the basis, which can be negative or positive. But, over time with similar formulas, dairymen can assess their basis risk much more effectively. As illustrated earlier, the spread between federal Class III and our milk price has gotten much larger due to higher whey values being reflected in federal Class III 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 that dairymen attempt to buy to insure some operating margin does not perform as they expected nor intended.

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. For example, let’s look at the month of May. Two years ago the whey value in federal orders general six cents less than in California. Last year it generated 72 cents more. And this year it generates $1.48 more than the fixed 25 cent factor. Looking back at the historical relationships between prices received at the dairy and federal 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 dairymen’s minds, it is not very far from lenders’ minds either. During a bankers’ panel at the latest Western United Dairymen Risk Management Seminar in December 2010, lenders emphasized the importance of risk management and reliable business strategies. Lending standards have tightened and banks like to know where their borrowers’ bottom line will be. At a dairy financing conference cosponsored by Land O'Lakes and Western United Dairymen in Visalia on February 22, 2011, speakers stressed that "borrowers will need to have a prudent business strategy and a very clear objective." Again, this has encouraged many dairymen to turn to risk management tools and, unfortunately, it is becoming less and less of an option.

Additionally, processors have always been supportive of the use of risk management tools by dairy producers. As an example, the very first point mentioned in the dairy policy reforms proposed by the International Dairy Foods Association, IDFA, is to "provide risk management tools for dairy." They recognize the importance of those tools and want producers to be able to use them effectively. Adjusting the whey factor to allow fluctuation with markets prices will better enable California dairymen to utilize these risk management tools.

Whey markets: Whether whey has a value or not is not the main question any more. It is widely recognized that they whey stream has generated considerable revenues for the cheese processing industry. Since the last hearing various sources point to the increasing use of high value whey products, domestically and abroad. According to the U.S. Dairy

Export Council, USDEC, data, in 2010 shipments of whey protein concentrate and whey protein isolates were a record high 439 million pounds. That is nearly triple the volume sent offshore just five years ago. USDEC also reports 23 percent -- excuse me -- “The U.S. exported 55 percent of the whey proteins it produced in 2010, sweet whey exports increased 23 percent to 557-million pounds, and China and Southeast Asia continue to drive whey volume, accounting for more than half of 2010 exports.” While specific California trade data is not available, with its proximity to Asia and its major shipping ports, California is well positioned to participate in these markets.

The number of whey applications that have emerged in recent years is amazing. America’s dairy farmers understand the importance of developing higher valued products and have contributed to the process over the years. The DMI website says, “Research can play a critical role in turning product concepts into product successes. Whey protein research at Dairy Management, Inc. has led to an entire new industry developed around whey protein-enhanced foods and beverages because of their many benefits.” DMI is funded through -- that’s end quote, I’m sorry. DMI is funded through dairy check-off dollars. We realize a wide range of whey products are produced from the whey stream, and California producers need a fair share of the basic raw commodity, just like with cheddar cheese and nonfat dry milk. Producers and processors should both be able to benefit from higher prices in whey product markets.

We would like to commend the Dairy Institute for proposing a minimum value of 25 cents for whey in the Class 4B formula and recognizing that whey does indeed has a value. But as the value of whey fluctuates, it is only equitable that producers share in a portion of the revenues generated from by-products of their raw milk, and we believe that that value should fluctuate with the market. Whey futures, as of June 22, 2011, forecast prices to average 48 cents per pound in the next year. Based on the Dairy Institute proposed scale, this would yield a whey value of 55 cents per hundredweight. While better than the current 25 cent factor, it still falls significantly short of the value generated by the Class III formula at that price, which would be $1.71. The shortcomings of the Dairy Institute’s proposal are illustrated in Figure 2.

Furthermore, this was a concern of the panel at the December 2006 hearing. While the report focused on Class 1, the potential issue remains the same. “The panel concurs with the concern that an increase in the Class 1 pricing formula may address the ‘reasonable relationship’ that existed in the prior year, but it does little to address potential reasonable relationship issues that may happen in the future. The panel believes it is more important to incorporate changes in the Class 1 pricing formula that will be more reflective of the market factors driving prices in contiguous states now and in the near future. It is a far more proactive approach to ensure that California Class 1 prices maintain a reasonable relationship with contiguous states than the approach of simply correcting prices after the fact.”

One difference between California and federal orders that we cannot fail to discuss is the fact that processors in federal orders have the ability to depool much more easily, giving federal order cheese makers the ability to escape the minimum regulated price when it is advantageous for them to do so. We are cognizant of this situation. As described in a FAPRI/University of Wisconsin Policy Briefing Paper on Federal Milk Market Order, Pooling -- and footnote two identifies that, where you can locate that -- “For manufacturing plants, called pool supply plants, pooling is optional. But there is usually an economic incentive for doing so because they receive producer settlement fund payments to pay producers.” The paper presents depooling as an issue and adds, “Some orders have been and are going --“ excuse me, “Some orders have been are being amended to make it more difficult for plants to depool.”

Recognizing whey has a value that California producers are not capturing currently, putting them at a disadvantage, we also recognize that California processors need to stay competitive with cheese makers in the rest of the nation. With the importance of tracking Class III more closely in mind, the Western United Dairymen board of directors carefully considered what portion of the Class III whey value would be crucial. We understand that plants need to have adequate incentives to invest and operate in California, and the Western United Dairymen board believe that 80 percent would be an appropriate value. It’s always better to have more competition for your milk than less.

Other proposals: For reasons mentioned above, we oppose the Dairy Institute proposal. While we appreciate their effort to provide more value for whey than the current fixed factor does, we believe it is plainly insufficient. Not only does it provide very little more than the current formula, it also fails to bring the whey value in the Class 4B formulas in line with the whey values in federal Class III. This leaves California dairymen at a continuing disadvantage, which we understandably oppose.

We support Land O'Lakes' petition to reduce the cheese manufacturing cost allowance and cheese f.o.b. adjuster and increase the whey value.

At this time, due to the continued economic peril experienced by California dairy families, we cannot support any increase in manufacturing cost allowances.

Understanding that California processors depend on the f.o.b. adjuster to allow their products to compete in markets east of California, we have historically supported adjustments to the f.o.b. adjuster based on the verified CDFA butter and cheese sales data. The latest data, released November 2010, showed that for the period July 2008 through June 2010 butter in California sold for an average -- excuse me -- 4.85 cents less per pound than butter at the CME. For the same 24 month period, cheese sold for an average .0018 per pound less in California than at the CME. We support adjusting the f.o.b. adjusters to reflect these values.

This concludes our testimony. We would like to reserve the rest of our allowed time for later to further clarify our position if we deem it necessary. The members of Western United Dairymen thank CDFA staff for their effort in preparing for this hearing. I would be pleased to answer any questions you may have, and request the option to file a post-hearing brief.

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

MR. MARSH: Thank you.

HEARING OFFICER MAXIE: Are there questions from the panel?

MS. GATES: Mr. Marsh, you spoke a little bit today, 80 percent on the whey formula. That's just you felt it was a fair, if I understood what you've written in your testimony, that was just a fair number you came up with.

MR. MARSH: Yes. We looked at different values, 80 percent, 90 percent, 100 percent, and I think -- well, our board of directors was clear that they understand that we need to have competition for dairy producers' milk and it's always better to have more plants competing for your milk than fewer. So providing some incentive on that side in order to maintain plant capacity and, at the same time, perhaps provide incentive for additional plant capacity in the state, that was the reason that we arrived at 80 percent.

MS. GATES: Okay, thank you. Western United took the federal order whey formula and kind of just -- that was their proposal -- but changed it a little bit when it came to the Dairy Market News versus the NASS. Could you speak to that a little bit about why you chose that?

MR. MARSH: Yes. Since the Department has previously looked at Dairy Market News more favorably, and probably with good reason, in looking at just the Western whey part in particular. And also the fact, as I noted in my testimony, that it's more timely and NASS, of course, is delayed. So we felt that that would be a better price series to use, I mean in that sense.

MS. GATES: And you didn't have concerns because it weighed out over time --

MR. MARSH: No.

MS. GATES: -- the price difference, that you didn't have a concern with it not being audited or --

MR. MARSH: Yeah, it was very, very minimal.

MS. GATES: Okay.

MR. MARSH: Yeah.

MS. GATES: Thank you.

MR. MARSH: You're welcome.

MR. EASTMAN: I have a couple of questions. Let’s see here.

With regards to your Attachment A --

MR. MARSH: Yes.

MR. EASTMAN: -- which was data for -- sorry, I forget the name of the organization.

MR. MARSH: Frazer and Torbet is a CPA firm.

MR. EASTMAN: Exactly, thank you. Did they -- I assume that’s some proprietary data based on the producers that contract with them.

MR. MARSH: Okay, well, they use them, yes.

MR. EASTMAN: Right, do you have a -- sorry.

MR. MARSH: So they compile data. I’m sorry?

MR. EASTMAN: Do you have a sense of how many California dairy producers follow them or study, or how many are Western United members, or have any sense of what they're going to -- able -- what they cover in the data that you’ve provided?

MR. MARSH: No, I do not. Actually, it would be inclusive of all the costs and revenues associated with the folks in their study.

MR. EASTMAN: Do you think it would be possible, maybe, to go to them and ask that and, if possible, get that answer in the post-hearing brief?

MR. MARSH: Certainly.

MR. EASTMAN: If they're willing to provide that.

And then in reviewing your proposal for changes in the whey (indiscernible) factor and it’s -- it mimics to a certain extent, it has some similarities with the federal order whey value factor, so to speak. And so it appears, then, that based on your proposal and that factor that value is going to go up and down with the market. But it does have the chance to go negative by way of values going really low or can go really high. Do you have any concerns with their not being limits on that? I noticed that some of the other proposals and some of the other testimony, they’ve spoken to having limits on both ends of the spectrum, that there’d be a floor and a ceiling. In your mind do you feel those are unnecessary or did you have other reasons for not capping them, not wanting them --

MR. MARSH: Well, again, our board supports the Land O’Lakes proposal as well because, of course, the goal of both the Land O’Lakes proposal and Western United’s is identical. How can we capture some additional value from the whey stream and make that value discrete to producers in the State of California and keep us competitive with the balance of the country? We did look at that and we have had some -- did have some discussion of that as well. It appeared to us in our alternative that we needed to have it work with market, at the same time kind of keeping in mind the same thought that we need to have California producers competitive but we also can't put our processors at a competitive disadvantage by allowing that, when that factor falls below or could fall below -- I believe our chart indicates that at one point it fell below our 25 cent fixed factor here in the State of California -- that it needs to adjust with the market so we don't discourage plant capacity and plant investment in the State of California.

Again, getting back to the same point, it's always better to have more competition for your milk than less.

MR. EASTMAN: So in that sense rather than having a ceiling, you're saying that 80 percent is a way to, I guess, limit the upward value on the whey value.

MR. MARSH: Yes, that's correct.

MR. EASTMAN: And then the other question I have is you mentioned, just like Land O'Lakes mentioned, that it seems both of the organizations tend to support your concept, even though technically they're constructed differently and they look differently. Do you prefer having a variable factor over a sliding scale of a table if push came to shove, so to speak, or hypothetically speaking would you be indifferent if the whey values -- let’s suppose you had your variable factor over a certain period of time and that returned a certain value. Let’s suppose the sliding scale, over the same period of time, reflected the exact same value. In your mind would both of those then be equal or do you prefer the variable factor over the sliding scale for other reasons besides just the value?

MR. MARSH: We oppose the Dairy Institute’s sliding scale. But with regard to Land O’Lakes and Western United’s alternative proposals, we support them both. Either one would secure additional value from the whey stream for California dairy producers and that clearly is our goal.

MR. EASTMAN: Okay. So it sounds like the value is more important than rather the (indiscernible).

MR. MARSH: Absolutely.

MR. EASTMAN: But knowing that you’ve -- you say that you support either one, a table or the variable factor, do you prefer both of those over the current fixed factor?

MR. MARSH: Absolutely.

MR. EASTMAN: Even if hypothetically, if you looked at the same time period of all three and they provided the exact same value, would you still prefer those others over the fixed value?

MR. MARSH: Our board took that position.

MR. EASTMAN: Okay. Okay, one more question, not to hog them all, but --

MR. MARSH: Well, you try to pass it off to -- in a dream.

MR. EASTMAN: Yeah, I guess not. With regards to your factor, obviously you have the Dairy Marketing as a price series and then you have a make allowance, which that make allowance corresponds to the dry whey make allowance in the federal order formula. And then you have a yield that equates value so it ties the yield here to what you would experience in federal orders, and I understand that. How would you view over time if the Department were to hypothetically implement your proposal (indiscernible) variable factor? How do you think the Department would maintain that over time, knowing that there’s a dry whey make allowance and then a yield factor there, how would the Department handle that going in the future pass yields or if things were to fluctuate?

MR. MARSH: The 19.91 cents dry whey make allowance in the federal orders was established across a very broad spectrum of different dry whey processing facilities outside the State of California, and it may have included some California plants, too. I'm trying to remember the survey exactly. But those costs seem to be far more indicative of what actual costs were.

You might recall from the California price series that when we were accumulating dry whey values, there were -- there appeared to be some outliers that actually influence the relative value of manufacturing costs, manufacturing dry whey in the State of California. Of course, today we only have two plants that are still manufacturing dry whey but practically everyone else is manufacturing much higher value products, whey protein concentrates, whey protein isolates, different types of products from the whey stream versus dry whey. Dry whey, as you might recall from previous hearings, was used as a surrogate for all whey products and it should retain that same -- that same level.

At some point in the future, if the federal Class III would look to adjust their federal -- their make allowance with regard to dry whey, I would guess very quickly you would also have -- if we were to adopt that here in California, I believe that the institute would very quickly move to make some adjustment, provided it went up.

MR. EASTMAN: And would you do the same thing if that make allowance were to change in your benefit? I think you'd be calling a hearing right quickly to --

MR. MARSH: I think we’d refer that to our board of directors and if they gave us that direction we certainly would.

MR. EASTMAN: So, in essence, it sounds like in order to maintain that value in California, the Department would have to look to federal orders and how they would maintain their value (indiscernible) us maintaining that more than the hypothetical one.

MR. MARSH: Not without hearing, of course.

MR. EASTMAN: Obviously.

MR. MARSH: Right.

MR. EASTMAN: And then -- so the last question I had was typically the formulas that we have are (indiscernible) pricing formulas, as we know, and for the most part we try and capture California-specific type factors, whether it be a (indiscernible) series or a make allowance or a yield, et cetera.

We’re trying to equate those factors in the formula to California conditions. Do you consider there would be any concerns with the factor based on federal order conditions and aspects other than California-specific ones?

MR. MARSH: Not with regard to this product because, again, we are looking at dry sweet whey versus the products that are actually manufactured here, the higher protein, whey proteins and concentrates and isolates, et cetera. So the answer to that would be no.

MR. EASTMAN: So you feel, then, the dry whey would be a lesser value commodity so --

MR. MARSH: Yes.

MR. EASTMAN: -- the fact that California then appears to be making more and more of the other types of whey products, that would sort of neutralize or make up for any inadequacies in that factor then.

MR. MARSH: Correct.

MR. EASTMAN: Great. That’s all the questions I have.

HEARING OFFICER MAXIE: Thank you, Mr. Marsh.

MR. MARSH: Thank you.

HEARING OFFICER MAXIE: We have a request from the panel for a short break so we’ll take ten minutes and then get back to more testimony. We'll be off the record until then.

(Off the record at 11:02 a.m.)

(On the record at 11:16 a.m.)

HEARING OFFICER MAXIE: And we've heard from several people that the microphones aren't working as well as they would like, so if everybody can try and talk directly into the microphones it would be appreciated.

Mr. Schiek, would you state your name and spell your last name for the record.

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

HEARING OFFICER MAXIE: And you handed us a couple of documents. One appears to be a copy of your written testimony and appendage to the testimony. Would you like those entered into the record?

MR. SCHIEK: Yes, I would.

HEARING OFFICER MAXIE: Very good. We'll enter them in as Exhibits 51 and 52 (sic).

(Thereupon, Exhibits 52 and 53
were received and entered into evidence.)

Whereupon,

WILLIAM SCHIEK

was sworn and duly testified as follows:

MR. SCHIEK: Mr. Hearing Officer and members of the hearing panel, my name is William Schiek and I am the Economist for the Dairy Institute of California and I am testifying on the institute’s behalf. Dairy Institute is a trade association representing 30 dairy companies which process approximately 75 percent of the state’s fluid milk and manufacture about 80 percent of the state’s cheese and 75 percent of its cultured dairy products and ice cream. Member companies also represent a small percentage of the butter manufactured in the state. Dairy Institute’s members operate in both marketing areas in the state, and the position presented at this hearing was adopted by our board of directors.

Dairy Institute is grateful for the opportunity to testify at this hearing, where proposals to change the Class 4A and 4B pricing formulas are being considered. In authorizing the state’s dairy regulatory programs, the legislature has declared that “It is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of commodities necessary to its citizen, including market milk, and to eliminate economic waste, destructive trade practices, and improper accounting for market milk.” Orderly marketing is the stated purpose for most dairy regulation and the level of regulated price plays a key role in maintaining an orderly market.

In establishing a regulated price so that milk production and marketing are orderly, it is important that the Department balance the needs of producers, dairy product processors and manufacturers, and consumers, not favoring one group’s needs over the others. Producers are not ultimately helped when the Department sets prices so high that consumer demand is negatively impacted and investment in new plant capacity, technology, and market development is stifled. The role of regulated prices should be to undergird the market, providing some stability yet leaving room for market forces to work. In particular, there should be room under the state’s pricing regulations for market-based premiums to allocate milk according to the market’s needs. If most market transactions are occurring at or very near the regulated price, then resources are probably being misallocated and milk is not moving to its highest use.

In marked difference to the federal order system, California regulated prices for manufactured products must clear the market. Milk in federal orders moves frequently at under-order prices when milk is long and needs to be cleared. In contrast, California limitations on depooling and handler-to-handler transactions make it nearly impossible to step out of the regulated pricing system in order to make sure that all the state's milk gets marketed.

In 2007 and 2008, milk moved outside the state to find a home at below minimum prices, when some plants inside California would have been willing to take milk at similar prices but were prevented from doing so by the state's pricing regulations. The result was that milk trucking companies and out-of-state competitors benefitted to the detriment of California producers and in-state processors. The importance of the state's regulated prices being market-clearing prices cannot be overstated.

Stability in the regulated pricing system is also of paramount importance. Providing stability for producers is often one of the goals of a regulated pricing system. However, to processors and manufacturers that operate under government regulation, stability in pricing is essential as well. To processors, stability means that the pricing rules do not keep changing so that existing investments are put at risk and new investments are discouraged. Regulatory uncertainty discourages investment because it creates too much risk for those who are paying millions of dollars to create or maintain a business in California.

With regard to the whey factor, our recent history is instructive. Prior to 2003 there was no whey factor in the 4B formula. From 2003 to 2007 we had a whey end-product pricing component in the regulated price. Since 2007 we have had a fixed 25 cent whey factor in the formula. Now, producers have proposed the reestablishment of aggressive whey contribution to the 4B price. This type of regulatory uncertainty will likely scare aware any potential new investment in cheese manufacturing. There is tremendous investment potential for cheese manufacturing in California due to growing foreign demand. Our regulated pricing system should encourage, rather than discourage, investment that will increase the demand for California milk.

Regulated prices in California should reflect a California value for milk as opposed to values for milk in other states or regions. The true economic value for milk in California is determined by California costs, yields, and prices, as well as the balance of milk supply and demand in the state. Regulated prices should be determined by these same factors and not factors that are attributable to other market. The statutory requirement that California milk prices be in sound economic relationship with the national value of manufactured product prices will be met if the formula adequately reflects California-specific technical and market-related factors.

Regulated prices must send appropriate signals to producers and processors. Prices are the means by which producers and processors get economic signals from the marketplace. Higher prices tell producers to produce more, lower prices tell them to produce less. Regulated pricing formulas that shrink plant margins tell dairy product manufacturers to produce fewer dairy products in California.

The current conditions in the marketplace are reflective of a regulated pricing structure that is about right. Milk production is increasing modestly, there seems to be adequate capacity to process milk at present. Additional plant investment are being considered and that capacity will be needed as milk production grows.

The greatest risk in any minimum milk price regulation decision is setting prices too high, which might lead to enhanced producer income in the short run but will lead to loss of product sales and manufacturing capacity in the longer run.

Conversely, if regulated prices are set too low relative to the prices of finished dairy products, market-based premiums will develop to ensure that milk supplies are adequate to meet the market’s needs. However, when regulated prices are set too high, or more specifically when there is not enough of a wedge between the manufactured product prices and the milk price, manufacturing plants have no ability to create the margin they need to operate successfully. If they increase finished product prices to customers, these in turn are reflected in higher commodity prices that are then translated through the markets and the product price formula into even higher raw milk prices.

The circuitousness of the milk pricing -- of the milk pricing formula means that there is no escape for plants from these regulatory pricing mistakes. Regulated prices that are too high also artificially stimulate milk production, at least initially, while at the same time the formula’s inadequate plant margins reduce the incentive for plants to procure milk. The result is more milk looking for a home in plants that have reduced incentive to buy it. The milk then becomes distressed and must seek a home in venues outside the state, often at a severe discount to prevailing regulated price level. This was the state of California's dairy industry in 2007 and 2008, and it could happen again if regulated pricing formulas do not result in adequate margins for California plants.

Milk output fell in 2009 as high contracted feed costs and low milk prices created negative margins for most producers. As prices began rebounding in 2010 and have continued to much higher levels in 2011, milk production has recovered. California milk output is up 2.5 percent over 2010 for the year to date, and milk production reached an all-time high on a daily basis during the month of May. Expanding global demand for dairy products has led to higher dairy commodity prices and higher milk prices. Were it not for higher feed costs, California's milk output growth would have been even stronger. Total available plant capacity has grown as well. My estimate of available daily milk processing capacity and milk production from 2006 through May 2011 is illustrated in Figure 1 on the appendix attachment. According to this analysis, if milk production continues to grow at a two percent rate year-over-year, the state's production will exceed available capacity next spring.

The changes that have occurred in plant capacity are instructive. The state's producer cooperatives have been divesting of their large cheese plants. DFA closed its Corona facility in 2007 after selling its Petaluma facility a few years earlier. Land O'Lakes sold its large mozzarella plant in early 2007 and in 2010 ceased production of cheddar cheese at its Tulare facility. Also, during the past years -- few years, DFA, Land O'Lakes, and CDI have expanded their capacity to make dry milk powders. This pattern of behavior would seem to suggest that co-ops have found the profitability of butter powder operations to be greater than cheese making, and suggests that regulated prices for butter powder plants could be increased and those for cheese plants should be decreased. Yet collectively these same organizations are arguing for exactly the opposite at today's hearing.

Though it might be tempting, with current Class 4A prices being higher than Class 4B prices, for producers to believe it is worth the risk of losing a few small cheese plants in order to get more money out of the pool, we state again that the plant capacity these smaller cheese plants represent will likely be needed in the future, and to adopt a pricing structure that discourages cheese plant investment would ultimately reduce producer revenues. If the current formulas had been in place since 2000, the Class 4B price would have averaged higher than the Class 4A price. Class 4A prices may be higher now, but over the long run Class 4B, even under the current formulas, has returned more to producers.

Calendar year 2009 was unusual due to an unprecedented financial collapse that had negative impacts on many industries. The combination of high forward-priced feed costs and low spot milk prices created devastating margins for producers. Producers began seeing prices and margins recover in 2010, and now in 2011 both milk production and milk cow numbers in the state are increasing again, a sign of a return to profitability for a significant portion of the industry.

The best regulated price policy to help dairy farmers continue to recover is one that expands the demand for California milk by encouraging investment in new products, new plants, and new technology that will help us grow our markets both domestically and internationally. High market-based milk prices that are realized through growing demand for dairy products are a far more effective and sustainable path than raising the regulated price by squeezing margins for plants. Today’s high commodity and milk prices are the direct result of a growing -- of growing the market for California dairy products in the global marketplace. That is where our focus should be. The proposals to increase the regulated price will hinder us in that effort.

Make allowances and f.o.b. adjusters are tools to translate commodity prices to milk prices that represent the value of milk in California for the different types of dairy product manufacturers. The role of the f.o.b. adjuster is to accurately translate the CME price so that it represents the value, or price, of butter or cheese in California. As a policy tool the f.o.b. adjuster should accurately depict or estimate the difference between the California and the CME prices during the period when the adjuster will be employed, rather than during a previous time period. Using past observations of the difference between California and CME prices is only valid if that data can be expected to accurately depict the same price differences in the future.

With respect to cheese, the 24 month average cheese price series difference -- that is, the California monthly price minus the CME monthly price -- diverges considerably from the corresponding average that was presented at the last hearing. There does not seem to be a fundamental economic reason for this shift. Rather, the narrowing of the average difference in prices seems due to the peculiarities of the time period under study, one with lots of volatility and with a large, rapid drop in prices at the end of 2008. Also, the fact that California weighted average prices lag those at the CME, much in the way NASS data lags the CME, seems to be a big part of the explanation as well. In fact, there are two months in the time period, December ’08 and January ’09, where California monthly prices are much higher than CME monthly prices due to this lag. And that’s illustrated in Figure 2.

The lag between CME and the California weighted average cheese prices suggests that the methods CDFA has used in the past to establish the f.o.b. adjuster do not get at the true underlying price basis. Also, the use of monthly data for cheese is really a form of aggregation bias that obscures the underlying relationship between the prices. The recorded prices are monthly, while price changes to customers in the marketplace are more often based on weekly or even daily CME price changes. The aging requirements for cheese also enhance the lag between California and CME prices, as product is priced before delivery takes place but the sale is only recorded upon delivery. These facts alone make the use of monthly data inappropriate for the purpose for which it is being used. When combined with the price volatility that we have seen, the asymmetric nature of price increases compared to declines, and the lag in the data, the average of the 24 monthly price differences is a highly unreliable indicator of the underlying relationship between the two cheese price series and is a poor predictor of future prices. And that in Figure 3 just shows how that monthly difference varies. It is incredibly -- become incredibly volatile in recent years.

Let’s see -- in addition, the new 24 month mean of the price difference is different from the current formula factor by a value of $.0234 cents per pound (sic), but the standard deviation of the 24 month sample of the differences is 6.49 cents per pound. With such a large standard deviation of the price differences, the Department cannot say with reasonable statistical confidence that the underlying price relationship is any different from the adjuster used in the current formula. Also, it is difficult to come up with any fundamental economic or market-based reason why the CME-California cheese price difference should have changed. If anything, higher transportation costs should result in a California price being at a greater discount to the CME than in the past.

Because of the volatility in the California-CME price differences, the lack of statistical confidence in the new average as an estimator of the true underlying difference between the prices, and the lack of a fundamental economic reason why the price wedge should have narrowed, Dairy Institute believes there is no sound reason for changing the f.o.b. adjuster from its current value.

The butter price comparison does not show the same level of volatility as the cheese price comparison, so the use of the 24 month average difference is probably more defensible in setting the f.o.b. adjuster for butter. And Figure 4 shows the monthly differences for butter and you'll note that it’s -- except for a few outliers it’s much more consistent month to month than the cheese one is.

The 2009 weighted average manufacturing cost for cheddar cheese was lower than the current manufacturing allowance by a mere .22 cents per pound. Looking over the past few years, cheese manufacturing costs were actually higher than the make allowance during each year from 2004 to 2008, and that’s shown in Figure 5. That was by an average of 1.59 cents per pound and 1.29 cents per pound over the entire 2004 to 2009 period. Therefore, the argument that the cheese make allowance should be reduced is a weak one when the make allowance and manufacturing cost history is examined, especially given that the current difference between the two is so small.

When coupled with the nature of the latest cost study, where some cost factors are unique to the unusual circumstances in 2009, there is even less reason to adjust the make allowance downward. We expect costs to begin rising again in 2010 and new cost data will be available probably around October of this year. Also, we note that costs did not move in the same direction for the two cheese plant cost groupings, according to CDFA’s costs exhibit, indicating that the numbers might be due to unique factors at one or two plants and not representative of the experience of the broader industry.

Based on all the foregoing, the manufacturing allowance for cheese should not be reduced at this time.

At previous hearings we have testified at length about the problems associated with incorporating an end-product whey factor into the regulated pricing formula. Some of those arguments are repeated here.

The proposed formulas from Western United and Land O'Lakes assume that cheese plants recover revenue from the whey side of their operations equal to the midpoint of the Western Dry Whey Mostly spot price range as reported in USDA's Dairy Market News with a cost structure and yield equivalent to the federal order Class III, other solids, formula. While they make modifications, the direct tie to federal order pricing is plain to see. Adopting either of these formulas would put whey into an entirely different pricing structure than the rest of the products used in California's milk pricing formulas, which have always been based on California manufacturing costs, prices, and yields. Such changes would be inconsistent with the other formulas the state uses to price milk.

The majority of cheese plants in the state do not earn revenues from their whey operations that are equal, or even directly proportional, to the reported prices for various whey products. Those products that do -- those plants that do make marketable products from their whey stream produce a variety of products. Some California plants produce whey protein concentrates and isolates from the whey stream of their cheese operations. While these products often sell for more than dry whey, their yields are lower and their costs are higher. Other plants make lower-valued whey products that do not fetch the prices in the market that even dry whey commands.

Still other cheese plants, 46 out of 58 in the state, do not recover any revenue from whey in their operations. These are typically smaller plants, some of which make specialty cheeses. The added milk costs these plants would have to absorb due to either the Land O'Lakes or Western United proposal would threaten their continued viability. Given recent -- the recent level of dry whey prices, the cost of milk to cheese makers would increase by more than many cheese makers could recoup from the market, putting plant capacity at risk that will be needed in the future.

Whey is unlike any other dairy product -- any other dairy products that are manufactured in the state in that there is no single product, or combination of products, that can reasonably approximate the revenue stream that each individual cheese maker receives from its operations. The scale of investment needed to achieve the economies necessary to market whey products competitively is enormous and well beyond the financial means of most of the state's cheese makers.

Because of these complex factors, CDFA

implemented the 25 cent whey contribution after the 2007 hearing. That formula change represented a compromise that in hindsight has served the industry pretty well, providing more money than the old formula when whey prices were low, while being less of a burden to cheese plants when prices were high. We believe that it is essential that the state's regulated pricing formulas be constructed to allow for the differences in cheese maker operations. The whey prices assumed in the pricing formula's construction must be realistically achievable by the diverse cheese plants operating in the state.

California is not Wisconsin. Many of the cheese plants in the upper Midwest that comprise the bulk of the dry whey manufacturing cost survey that was used in establishing the federal order make allowances have a larger scale of whey operations than is achievable by the smaller plants in California. The density of cheese manufacturing plants in the Midwest makes it possible to aggregate whey from smaller plants to achieve a more efficient scale of operation. The distances between plants in California make such aggregation financially infeasible. The dry whey manufacturing cost employed in the federal order Class III price is simply not relevant in California. Also, federal order plants can depool to avoid paying the minimum price if it becomes untenable. Supplying cooperatives can engage in handler-to-handler transactions to clear milk supplies at below-order prices when markets are oversupplied. As a practical matter, such opportunities do not exist in California.

Okay. Our proposal -- basically the only thing we've changed is the -- changing the fix factor to a schedule that's listed in the -- in the document here. We start with a floor of 35, we have a ceiling of 75 cents -- floor of 25 cents per hundredweight and a ceiling of 75 cents per hundredweight with steps up to that for different levels of whey prices.

The whey price series used in the proposed formula would be the weighted average of the weekly United States dry whey prices first published between the 26th of the prior month and the 25th of the current month as revised and reported as of the 25th of the current month in the USDA's Dairy Product Prices report. While we would normally want to use a California-based price series to determine the whey contribution schedule, one does not exist.

Dairy Institute believes that using the Dairy Market News Western Dry Whey prices series is inappropriate because it is unaudited and not weighted.

Other Western cheese makers that produce dry whey would have a financial incentive to misreport prices. By inflating the prices they report to Dairy Market News, they could increase the milk cost of competitors in California while leaving their own milk costs unaffected. I am not suggesting that other Western cheese plants have done this or would do this, only that they would have an economic incentive to do so. Such moral hazards should be avoided. The NASS survey price is audited and is a broader representation of dry whey prices in the industry and is, therefore, more appropriate for use in this case.

The changes are proposed to make the Class 4B pricing formula better reflect the current market situation and to balance the needs of producers and the diverse types of cheese plants that operation in the State of California. By including a cap at 75 cents, we allow for additional revenue to pass through to producers through the regulated price when whey prices rise, while attempting to limit the damage that changes would do to cheese plants without whey processing capability. With a 75 cent cap, our policy committee felt it was important to retain the current 25 cent contribution as a floor. The scheduled contributions between the floor and the cap were derived using the pre-December 2007 whey factor formula multiplied by .5. The schedule is admittedly ad hoc, as is the current 25 cent fixed factor, but as we do not believe in one end-product formula that would adequately meet the needs of the industry for all of the reasons we've stated previously, an ad hoc solution is probably appropriate. Any whey formula or schedule more aggressive than the one we have proposed would put cheese plants and their associated plant capacity at risk.

As we have already noted, cheese capacity will continue to be needed in this state, as milk production growth strains existing available plant capacity. Preserving cheese plants is also important for producers because cheese has historically returned more to the pool than butter and powder.

Land O'Lakes' proposal puts too high a burden on small cheese plants and discourages investments, despite the fact that its schedule cap would limit the impact to a dollar per hundredweight. We appreciate the notion of a cap, but as proposed it is too high and reached too quickly as dry whey prices rise. It is essentially the federal order formula with respect to whey and is, therefore, based on federal order costs, yields, and market realities, and is not representative of California. Land O'Lakes' proposal should be rejected.

Western United’s proposal, like that of Land O’Lakes, is based on federal order assumptions. Its lack of a cap would be devastating to smaller cheese makers that do not have whey processing capabilities. Basically, the Western United proposal has all the same problems that led to the removal of the explicit end-product whey formula in 2007. Nothing has changed since then that would make the old formula or this proposal more workable for the cheese manufacturing side of the industry. Western United Dairymen’s proposal should be rejected.

As we’ve already stated, California Dairies’ proposal for the f.o.b. adjuster we deem to be appropriate. With regard to the make allowances, we have some concerns that maybe some of the startup costs and problems associated in 2008-2009 might have impacted those costs. And we are not questioning the cost survey, just questioning whether when setting make allowances those costs should be considered, and I cite a legal case, Golden Cheese versus CDFA where the court basically determined that the state was not being arbitrary or capricious when they decided to exclude certain plants’ costs from a group of reasonably efficient plants.

So basically we're encouraging the Department to take a careful look at 2008-2009 butter and nonfat milk powder numbers to determine if any unreasonable expenses or extraordinary circumstances led to some of the increased manufacturing costs.

We're going to support the Department's proposed amendments that conform to the legislation on a producer's security trust fund. That's also there.

The current trends for supply and demand of milk in the state and cheese pricing and manufacturing costs suggest that major deviations from the current 4B formula are not warranted. Our proposal represents a modest attempt to balance the needs of producers and various cheese makers in the state. No changes to the make allowance for cheese or the f.o.b. adjuster are warranted. And we caution the Department that a shift in policy that results in substantially higher 4B prices would devastate future plant investments.

Finally, we feel compelled to note that the continued viability of our end-product pricing based regulatory system is in jeopardy due to changes in the market and industry consolidation. It is time for us to begin the discussion about transitioning to a different pricing model that allows the market to determine the price for milk. Such changes are being considered at the federal level for making the U.S. industry better able to compete in the global marketplace. The proposals by Land O'Lakes and Western United take us in the opposite direction.

Thank you for the opportunity to testify and I am willing to answer any questions you have at this time. And I also request a period for filing a post-hearing brief.

HEARING OFFICER MAXIE: Thank you. Your request to file a post-hearing brief is granted. Also, just to clarify the record, your documents will be entered at Exhibits 52 and 53.

Are there any questions from the panel?

MS. GATES: Yes, there are. Doctor, could you explain a little bit more, if you could, about the addition fact --

REPORTER: Could you put your mic a little closer? You're still not coming in very well.

MS. GATES: Really? Is that better?

Additional plant investments are being considered and that capacity we'll need -- will be needed as production grows. Could you explain a little bit more?

MR. SCHIEK: Yeah. Basically I was trying to say there we've got a growing milk supply and I think in Figure 1 in my appendix was showing if plant capacity is not -- if we don’t have any additions to plant capacity we’re going to run out with even what we would call a modest growth by historic standards.

But the good news is that under the current formulas there are people hearing in the industry, talk in the industry, there are people who are actually looking at doing some things in California to increase cheese processing capacity, making expansions to existing operations or building new ones. And my concern is that if we change the regulated pricing picture that those options will go away.

MS. GATES: Okay. Did I interpret correctly from your testimony that we have, like, about a two to three percent leeway on plant capacity, that we’re getting there, that there’s just a little bit of a cushion there?

MR. SCHIEK: Yeah. Basically, and I could in a post-hearing brief if you want, I could detail how I came up with this estimate.

MS. GATES: That would be great.

MR. SCHIEK: Okay. But basically what I did was I took us back to the 2006 hearing, and that was when we first started hearing reports in Dairy Market News of milk moving out-of-state, not having enough home in California. I was kind of looking at that time, where was milk production and when was it Dairy Market News was reporting we were having problems. It seemed to be in March and April when that showed up in 2006. And about that time, you know, we crossed over 110-million pounds a day. So I basically started -- that was my starting point. Okay?

In 2006, 110 million pounds a day was our effective available capacity. Then I just sort of tried to trace through as plants have closed and others have opened how those changes have affected daily capacity, and going forward, looking at things like the closure of Corona plant, the increase in the -- addition of the two cheese plant or the two butter powder plants in Visalia, and others of a smaller scale, Reno's expansion and some other things. That's how I arrived at that red line that shows the available plant capacity. But I can detail exactly what those are.

MS. GATES: That would be great if you could.

The other question I had was you spoke to preferring the NASS survey over Dairy Market News --

MR. SCHIEK: Yeah.

MS. GATES: -- basically because of the audit purposes and you felt that moving forward there could be the opportunity was there for manipulation even though it tracked well in the past.

MR. SCHIEK: Yeah. No, there’s no doubt --

MS. GATES: I mean, trying to get to a California price --

MR. SCHIEK: Yeah, there’s no doubt that, you know, Western prices would -- you would think be more reflective of California. But given that we only have two dry whey plants now in California, I’m assuming that that Western survey is heavily influenced by other plants that produce dry whey outside of California in the Western region. And my concern is, you know, plants operating in the federal areas operate off of NASS, so the opportunity exists, you know, the survey that’s not audited, it’s a phone conversation, to, you know, report on the high side or whatever, influence the cost of milk in California but not influence the cost of milk for the reporting plants would have. And I just think it’s not a good idea, from a public policy perspective, to put something like that in your regulated pricing system. I just think there’s a risk in it.

MS. GATES: And that outweighed the lag.

MR. SCHIEK: I think that outweighs the lag, especially since, you know, what we’re having is a sliding scale schedule anyway, not a direct end-product formula.

MS. GATES: All right, thank you.

MS. REED: Mr. Schiek, I just have one question for you. Just based on your proposal, the fact that you're now putting in a sliding scale for whey factors. In the past -- and you're putting in a floor of 25 cents a hundredweight, but in prior years you’ve given no value to whey. Could you just explain to us what you feel has happened since 2007 to now warrant there to be some value priced on whey?

MR. SCHIEK: Yeah. Well, I should say that the position we arrived at, Dairy Institute, was a difficult position to come to. And you’ll probably hear from some of our members today who will testify to something different, you know, not necessarily supporting our proposal. We felt that basically the industry has evolved (indiscernible), I would say the majority of the people in our policy committee and our board felt that the industry has evolved to a point where maybe some sort of recalibration of how the whey was necessary, particularly as the markets have developed the way they have. But there’s no doubt that for a lot of cheese plants in California even what we’ve proposed is -- would be a tough pill to swallow.

But, again, we’re looking at trying to balance the needs of producers, processors on this issue and we’re recognizing, I think, that producers are facing a challenging time even with high milk costs, you know, feed costs are challenging. So it’s an attempt, basically, to find a middle ground.

MS. REED: Thank you.

MR. EASTMAN: So on the flip side of Venetta’s question, then on the maximum you have a ceiling like Land O’Lakes had proposed in their proposal. Was there any particular analysis or data, thought process, that got you to that value?

MR. SCHIEK: It was a -- it was a discussion in our policy committee and we looked at -- we looked at a dollar, I would say, we looked at 75 cents, we looked at 50 cents as well. And there were a lot of members, particularly those that have either recently laid out a lot of money to invest in processing capacity or those that didn’t have it that wanted to go for 50 cents. But there are others who, you know, felt that 75 percent (sic) would be more in keeping with our goal of balancing some of the needs of the industry.

MR. EASTMAN: Okay. And then you mentioned in your testimony that federal orders are some -- there’s the option to depool and there’s some handler-to-handler transactions that can help with, I guess --

MR. SCHIEK: Clearly.

MR. EASTMAN: -- for the lack of a better word, a safety valve, a (indiscernible) milk. Previous testimony in the morning had discounted that idea that depooling or the fact that a cooperative or handlers obligated to the pool that might limit that actually from happening. Could you explain a little bit (indiscernible) how that safety valve or -- your testimony, your assertion is how that works in federal orders?

MR. SCHIEK: Yeah. I mean, I guess the best way to say it is I heard it differently. My understanding of the situation in the Midwest is different than, you know, a previous witness indicated. I’m obviously not in the Midwest, I’m out here, so I go by what I read in Dairy Market News, for example. Every week there’s a fluid milk and cream report and there’s a section for the Midwest or central part of the country. And frequently in there you'll see reports of milk -- for whatever reason, holidays, just a period when milk is long because of the season of the year, seasonality -- where they’ll report milk moving under class, discounted to find a processing home. And that’s kind of what I've observed.

Now, some of my members who will be testifying here later today have experience in the Midwest and I would encourage you to ask them that question because they probably are more familiar.

MR. EASTMAN: All right, thank you. In your testimony you talk about a current fixed whey factor and the use of a sliding scale. And obviously neither one of those is based on what we call true end-product pricing formula construct with a price series of make allowance and yield, so to speak. Do you feel that one of those methods is better than the other? Somewhat the questions I've asked of other witnesses --

MR. SCHIEK: Yeah.

MR. EASTMAN: -- but do you feel that the fixed or sliding scale is better for any reason, even if they were to yield the same value over time?

MR. SCHIEK: If they yielded the same value over time, you know, you can make money in the long run but go broke in the short run, so I suppose that’s one issue. But, you know, you could set a level that’s pretty high then if whey prices were to collapse and people had nothing but costs of disposing of whey, which is the constant state for some plants, you know, that could be -- that could be a tough position.

So, for example, 25 cents, you know, that’s roughly two and a half cents a pound cost on cheese. If it were 50 cents, that would be five cents. So that’s a lot of money on the street in terms of competitiveness in the marketplace.

But I think probably my bigger concern is actually a policy and kind of the logistics of policy. A sliding scale probably has a little more flexibility if market dynamics change. For example, now I think everybody seems to be of the opinion that whey prices are going to be high for, you know, maybe forever. I don’t know. But that seems to be, you know, some people’s opinion based on testimony I've heard already today. But, you know, in 2007 I remember some of the same witnesses from the same organizations being up there saying, you know, it seems like the whey price is going to be at 40 cents, settle in to a 40 cent per pound whey after being 80 in early 2007. And in fairly short order we were down below 20.

So the reality is we don’t really know where prices are going to go. And a fixed factor would be somewhat less flexible in dealing with those situations. Now, on the other hand if the situation’s changed and I would petition for a hearing and it got called as timely as this one was, maybe I wouldn’t have as much a good (indiscernible). But, you know, I've also experienced having to petition three times to get a hearing and, you know, so I’m not sure that I’m as confident that we could get a situation like that addressed that quickly. So that’s why a sliding scale maybe has more flexibility.

MR. EASTMAN: And you think the flexibility’s on behalf of processors, I presume.

MR. SCHIEK: Well, that’s --

MR. EASTMAN: Just because they’ll be able to compete in the marketplace at similar values, things like that.

MR. SCHIEK: Absolutely right. That’s what I’m representing.

MR. EASTMAN: And then my last question is you mentioned in your testimony about the f.o.b. adjuster. You’ve highlight how -- with regards to volatility and the Chicago Mercantile Exchange that the f.o.b. adjuster seem to maybe work better over the last few years in predicting the future, say, compared to the cheese f.o.b. adjuster where CME cheese prices tend -- appear to be more volatile according to your testimony. Have you, by chance, approached anybody else in the industry regarding this issue or how it will be adjusted or calculated, or how they could be calculated in the view from the sense of reaching out where industry stakeholders talk about this issue?

MR. SCHIEK: Primarily within the membership we've had discussions. I have to say, I mean, it was really a surprise when the data came out. Again I was not expecting that the 24 month average to show what it did. I mean, that defied my economic intuition about how the California price should relate to the CME price based on transportation costs and various market factors. And California, anywhere we are, is typically at a discount to the CME.

And so, you know, we began asking questions and I think one of the things we identified was just that there's this inherent lag. Now, how you deal with that I don't know that I have a solution for you, but that's something that probably will be worth some study.

MR. EASTMAN: Thank you. That's all my questions.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you, Dr. Schiek.

I believe we have about 17 witnesses signed up for this afternoon, so what we'd like to do, given it's just about noon time right now, is to go ahead and hear from one or two of the witnesses and target a lunch break at 12:30. That way we avoid the lunch hour rush.

And so with that we go ahead and call Joe Paris as the first witness. And state your name and spell your last name for the record.

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

HEARING OFFICER MAXIE: Thank you. And you handed us a document just now, which is your written testimony. Would you like that document entered into the hearing record?

MR. PARIS: Yes, sir.

HEARING OFFICER MAXIE: Very good. And if I count right this time it will be Exhibit number 54.

(Thereupon, Exhibit 54 was received and entered into evidence.)

Whereupon,

JOE E. PARIS

was sworn and duly testified as follows:

MR. PARIS: Mr. Hearing Officer and panel, my name is Joe E. Paris and I am a consultant for Gallo Cattle Company, LOP, which currently operates four dairies in Merced County, and Western Marketing and Sales, LLC, which operates a cheese plant located at

10561 West Highway 140 in Atwater, California. I am here to testify in support of the Dairy Institute of California's alternative proposal submitted to CDFA on June 10, 2011. This testimony has been developed with Michael D. Gallo, CEO of Gallo Cattle Company, and Peter Gallo, Managing Member of Western Marketing and Sales.

We believe that dairy farmers should receive income from the whey stream as plants increase their ability to further process whey. Even though whey processing has increased from where it was in 2007, October 2007, when we last addressed this whey issue, there are still many cheese plants in the State of California that do not have whey processing capabilities. Dramatically increasing the cost of 4B milk, which would be the result in both the Land O'Lakes proposal and the Western United Dairymen's proposal, would not only make many of these plants uncompetitive with cheese plants that currently process whey, but would also eliminate any investment capital that would enable them to develop whey processing facilities in the future.

We support the Dairy Institute of California's proposal because it does share more of the whey stream revenue with dairy producers than the current formula. It also continues to provide for some needed investment capital for further whey processing facilities and expansion of existing processing. As new technology is developed in the processing of whey, more cheese plants can take advantage of those developments but they need the capital to improve. Producers benefit from the additional plant capacity and the increase in the ability to manufacture whey products by processors.

Milk price regulations should be based on minimums, including minimum prices for the whey stream. Various plants have various types of whey products. It should be incumbent on dairy producers and/or their cooperatives to negotiate prices from the processors based on the type of income they individually have from their processed whey. The 25 cent whey factor that has been for several -- used for several years in the 4B pricing formula has worked well for both producers and processors. Producers not involved in plants producing 4B products should only have a minimal share in the whey income through the pool.

There are still several cheese plants in California that have no ability to further process whey and must pay to get rid of it. I know of at least two plants that are currently attempting to add whey processing equipment in their plants. Extraordinary increases in the 4B price will cause them financial harm and could impair their ability to continue. It is interesting to note that one of the proponents of large increases for the 4B price through the whey stream income has divested themselves of a large amount of cheese making capacity over the last few years.

We oppose the proposals submitted by both Land O'Lakes and Western United. We are taking no position on the proposal from California Dairies, Inc. We do support the administrative changes proposed by the Department of Food and Agriculture in order to align the stabilization plans with the California Food and Agricultural Code in regards to the producer security fund.

This concludes my statement and I would like the opportunity to file a post-hearing brief if necessary.

HEARING OFFICER MAXIE: Your request is granted.

Are there questions from the panel?

MS. GATES: Mr. Paris, could you explain any changes, if any, in whey processing actions that are going on at Gallo, whether it's processing, the value received from the whey, you know? Have there been any changes since 2007 or is everything still the same?

MR. PARIS: We have increased the amount of whey processing we do there and have actually bought whey from -- or concentrated whey from people that do not have further ability. We do make 90 percent whey protein isolate there.

And as far as Gallo’s operation is concerned, we’ve been able to invest because -- probably that 25 cent factor has probably been beneficial to us over the years. WPI has been up and down. There have been years where we’ve lost money on that process (indiscernible).

MS. GATES: I’m a little bit unclear in your testimony. Did you prefer a fixed factor over a sliding scale, or did you have a preference?

MR. PARIS: We support the -- we support the sliding scale that’s in the Dairy Institute --

MS. GATES: Okay, thank you.

MR. EASTMAN: You mentioned that you support the sliding scale so that it will -- for reasons I think we’ve already heard. Do you feel that as a cheese processor as you're marketing your cheese that the sliding scale benefits you more than fixed factor, or you just like the scale for other inherent reasons?

MR. PARIS: You know, in all honesty we

looked at the different proposals, we decided not to come up a proposed alternative proposal of our own. When we looked at that, we felt that Dairy Institute's proposal was reasonable and so we just opted to support that. We didn't look at any other way of looking at the factors or anything.

MR. EASTMAN: So it's mostly based just on the value then of the proposal, the value in the way it was (indiscernible).

MR. PARIS: It's just based on what they had put in, and comparison to the other proposals.

MR. EASTMAN: Okay.

MR. PARIS: We didn't do a big analysis, though, as to how it would affect us.

MR. EASTMAN: Understandable. I have another question. You mentioned that you've expanded your whey processing over the last, I guess I assume since 2007.

MR. PARIS: Yeah, since 2007. It's kind of been a work in progress.

MR. EASTMAN: Okay, so --

MR. PARIS: Still is.

MR. EASTMAN: Over years, we'll say. You mentioned that you're obtaining concentrated whey from all the other cheese plants, various cheese plants.

MR. PARIS: That is correct.

MR. EASTMAN: When you were negotiating that was -- did you go out looking for concentrated whey so that you could have more or did they approach you to try and find a -- well, like to get rid of it?

MR. PARIS: Both.

MR. EASTMAN: Okay. About how many distances do you -- does that concentrated whey have to travel to get to your plant as it goes from theirs to yours? And if you can’t -- if you can’t cite that off the top of your head --

MR. PARIS: I’m thinking basically from 30-40 miles at most. There have been some other instances when we bought some spots that came actually from out-of-state.

MR. EASTMAN: Oh, really? And were you buying that spot concentrated whey just to fulfill your operations at the (indiscernible)?

MR. PARIS: It was available.

MR. EASTMAN: Okay. Do you -- could you envision you expanding that operation, taking even more and more volumes of, say, concentrated whey and processing it further?

MR. PARIS: My answer would be yes, but that probably would be limited. We’re in the process right now of expanding our cheese operation, which will increase our ability to manufacture cheese there by somewhere between 20 and 25 percent. That will also entail needing more capacity in the protein plant. But I would think there would be some -- we’ll continue to keep our current customers and could expand us on others as well.

MR. EASTMAN: Has your plans for plant expansion, are those -- are you actually implementing that or are those just in the development or the --

MR. PARIS: They’re in the process. We hope to have the expansion finished by no later than September 1, hopefully August 1.

MR. EASTMAN: So that’s this year?

MR. PARIS: Yes.

MR. EASTMAN: That’s all the questions I have.

MS. REED: I do have one, Mr. Paris. You spoke a little earlier about the fact that the 25 cents has helped you guys quite a bit in, you know, your whey processing and everything. Well, and I’m hoping that this hasn’t been hit before, but I just want to, for clarification for myself, can you tell me over the past four years how do you feel that the values that you're getting from the whey plus -- and the costs for producing the whey have changed?

MR. PARIS: I would say our cost of producing, because of the extra volume that we’ve had going through that has certainly come down somewhat, producing that protein (indiscernible). And that’s probably been more volume driven than it has been to anything else. And that was one of the reasons we went out to find other sources and have other sources come to us and they readily took it.

Does that answer your question?

MS. REED: Yes, that does. And what about the value that you're getting from the whey also? Your costs, you say, have gone down but the values that you're getting from --

MR. PARIS: You mean the overall --

MS. REED: Right. How has it changed over the last four years?

MR. PARIS: Well, the overall market to some extent follows what dry whey prices do, not completely and there are those additional costs in there. But the market has come up on the whey protein isolate from where it was in 2006. It has increased, too.

MS. REED: Thank you.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: All right, thank you, Mr. Paris.

I'm going to try and squeeze one more witness in before we break for lunch, and that will be Baird Rumiano. Welcome. If you would state your name and spell your last name for the record.

MR. RUMIANO: Blair Rumiano, R-U-M-I-A-N-O. I have no prepared text today. I would just like to say that recently we --

HEARING OFFICER MAXIE: I think we need to swear you in for the record.

MR. RUMIANO: I'm sorry.

Whereupon,

BLAIR RUMIANO

was sworn and duly testified as follows:

MR. RUMIANO: Okay, thank you. Recently Rumiano Cheese Company of Crescent City put in a WPC-80 drying facility at a cost of $6-million. We make approximately 10-million pounds of cheese a year so you can see the expenditure was very, very high compared to what we -- actually what we're going to get, because you only get eight hundredth of one percent on the yield on WPC-80. Even though it's very highly priced, you get very, very, very little product when you're done at the end of the day.

So without this 25 cents that we did back in

2007, it would probably have not been feasible for Rumiano Cheese to actually endeavor and go into this very expensive whey processing that we do now today.

Now, you have to remember we still have 98.9 percent liquid left, which feed back to cows and also spread on the ground at a cost of probably $250- to $300-thousand a year. So the cost is not all gone. There’s still costs in, you know, taking the permeate, as they call it, and sending it to the dairies. And since all my dairies are very small, I have maybe a hundred to two hundred cow dairies, I have about 40 of them. We run about 300-thousand pounds of milk a day.

We do have some organic producers, which really pushed us into the WPC-80 because there was a market for organic WPC-80. And that has helped offset the cost of the manufacturing but it still costs you a dollar a pound to make it.

Our fuel costs in Crescent City are atrocious. We’re on propane, we have no natural gas or diesel. Electricity is very expensive, as you all know. So it’s not inexpensive to manufacture in any way.

But, of course, you know the rigmaroles of banking today. It took us a year to get the money, you know. It took 10 months to have the equipment manufactured. So it’s not a -- you just don’t the switch and have a whey protein plant tomorrow. You have 10 months of construction and you have all the hassles of going to the bank and borrowing money. Since I am not a co-op, I can’t spread the wealth or spread the debt, if you know what I mean.

I mean, I pay my producers on end-product pricing. Most of my producers are Grade B producers making more money than the Grade A producers in California just because they're all Jersey and I pay them for what I get out of their milk. If I get 12 pounds of cheese out of a hundred pounds of milk, that’s what they get paid for. I also pay premium bonuses for manufacturing of clean milk and low somatic cell counts.

So I’m in kind of a different world than most of you. I do buy Grade A milk, though. I do buy it from a co-op. So if that milk were to increase by a dollar, it would be pretty devastating on, you know -- I can’t make cheese for nine cents a pound. That’s essentially what it’s going to do on the cheese side.

So, and I’m so rurally located. I’m 400 miles north of San Francisco, I’m 400 miles south of Portland, Oregon, on the coast. I don’t know even if you know where Crescent City is. But anyway, it’s a small little community, 80 percent of the property there is owned by the stated, federal, or local governments so we have a very low tax base there. So it’s very important to the people of Crescent City and the people of Del Norte County that Rumiano Cheese is there. I have 50 employees. I’m the second largest employer next to the prison.

So anyway, it would be very devastating to the people of Crescent City. The dairymen, I believe, the way I pay are being fairly paid for their product.

And thank you very much for letting me speak today.

HEARING OFFICER MAXIE: Thank you. Do we have any questions from the panel?

MR. EASTMAN: I have a few questions for you. You were talking too quickly. Can you tell me what your yield was on your WPC-80? You mentioned the yield.

MR. RUMIANO: The yield, .008. So a thousand pounds of whey, you get eight pounds of WPC. And that’s optimum; usually it’s around seven.

MR. EASTMAN: And then do you support one of the proposals for today?

MR. RUMIANO: No, I do not.

MR. EASTMAN: So you're not supporting. Do you oppose them all or are you just --

MR. RUMIANO: Pretty much, yes.

MR. EASTMAN: Okay. And so at this point, though, we do have a fixed 25 cent whey factor in the formula, which you mentioned has helped you to make the investment that you did for whey processing. Do you still support that? Well, I don’t know if you supported it. Do you support it or oppose it right now?

MR. RUMIANO: No, I support the 25 cents. And I understand that there is money in the whey right now, but for the last 40 years that I've been in the cheese business there hasn’t been any. So all of a sudden there’s money there so everybody comes and wants part of the pie. So I think that the cheese processor should be allowed a little bit of leeway. Maybe not -- maybe for a couple of years so that maybe they can develop a whey protein or a whey product like I did. But, you know, to slap a dollar a hundredweight on a small cheese maker, you know, somebody like me, like the 10-million pounds guy, I mean, some of these cheese plants make 10-million pounds in two days, I mean. So, I mean, I can’t compete with that. I don’t have the technology or the people to do that.

MR. EASTMAN: You're making about 10-million pounds a year?

MR. RUMIANO: Correct.

MR. EASTMAN: And then, if necessary, did you want the chance to file a post-hearing brief?

MR. RUMIANO: I don't, thank you.

MR. EASTMAN: All right, thank you very much, Mr. Rumiano.

MR. RUMIANO: Thank you very much for letting me speak. Thank you.

HEARING OFFICER MAXIE: Okay, why don't we go ahead and take a lunch break at this time. By my watch it's 20 after 12, and we'll reconvene at 20 after one. And we'll go off the record at this point.

(Off the record at 12:20 p.m.)

(On the record at 1:24 p.m.)

HEARING OFFICER MAXIE: We'll go back on the record at this time. We've now reconvened for the afternoon session here on June 30th.

Before proceeding with testimony, the opportunity to submit a brief amplifying, explaining, or withdrawing testimony is granted for all witnesses who request a post-hearing brief period. In order to be considered by the Department they must be received by Monday, July 11th, 2011, by 4:00 p.m. The brief may be e-mailed to dairy@cdfa.ca.gov. Let me repeat that:

dairy@cdfa.ca.gov, or submitted to the Department's Dairy Marketing Branch office located at 560 J Street, Suite 150, Sacramento, California 95814. Also, the brief may be faxed to area code (916) 341-6697. And if you need any of that, just contact us at a break and we can give it to you.

We'll call the next -- the next witness who is Rob Vandenheuvel representing Milk Producers Council. If you'll state your name and spell your last name for the hearing record.

MR. VANDENHEUVEL: All right, get your pen out. Rob Vandenheuvel, V-A-N-D-E-N-H-E-U-V-E-L.

HEARING OFFICER MAXIE: All right. And, Mr. Vandenheuvel, you've handed us a document here. It appears to be your -- a written copy of your testimony. Would you like that entered into the hearing record as an exhibit?

MR. VANDENHEUVEL: Yes, please.

HEARING OFFICER MAXIE: Very good. We'll enter it as Exhibit number 55.

(Thereupon, Exhibit 55 was received and entered into evidence.)

Whereupon,

ROB VANDENHEUVEL

was sworn and duly testified as follows:

MR. VANDENHEUVEL: Thank you, Mr. Hearing Officer and members of the panel. Like I said, my name is Rob Vandenheuvel. I’m the General Manager of Milk Producers Council. We’re a nonprofit trade association with office locations in Ontario and Bakersfield, California. We represent approximately 75 dairies in Southern and Central California. My testimony today is based on positions adopted by the MPC Board of Directors at a meeting on June 14, 2011.

For the hearing panel I’m submitting the whole testimony for the record and the report for my written. I’m going to not necessarily read it all for the board, so I’ll try to make it clear I’m going to skip certain sections, so --

I think we all know the background of the industry so I’m cut down to: Today's hearing brings to light the issue of how our minimum milk prices for milk sold to Class 4A and 4B minimum -- Class 4B manufacturing plants ought to be determined. The first issue I will be discussion is how to properly value the whey solids that are being generated and marketed by our state’s cheese manufacturers. Later on in our testimony I will be getting into the issue of make allowances and f.o.b. adjusters.

I think we all, based on previous testimony, have a clear understanding of how the federal orders generate their value. Let’s skip to page 2 and the fact that there’s clearly been a difference.

At this point, if I can refer you to page -- Exhibit A of the testimony, which is page 10, just to illustrate the differences. This is an issue that’s come up earlier in the testimony today, as to which amount of the difference between Class 4B and a Class III is attributable to the whey and how much is attributable to other things. I've (indiscernible) down there, starting in the second half of 2003 moving all the way to current, including the six month periods. Oftentimes you're looking at risk management, you're looking at six months out. And so you can see there that a good chunk of the difference between the two series is attributable to whey and that difference in whey has gotten significantly higher in the last couple of years.

Moving back to page 2 in the testimony. The growing difference between the California Class 4B and federal order Class III minimum price is extremely troublesome to California dairy families for two main reasons. One, the difference demonstrates that our current California Class 4B minimum price formula is inconsistent with Food and Ag Code Section 62062, leaving the prices received by our California dairy farmers increasingly behind the minimum prices paid in the rest of the country. Secondly, the difference -- more significantly the broad range of differences -- has made it difficult for California’s dairy families to participate in the risk management strategies that are available to dairies throughout the country. This is an issue that has certainly been discussed earlier.

Section 62062 -- I’m not going to go ahead and read it but I would note that the language I've underlined and bolded there, “shall be,” is significant. The Food and Ag Code includes items that the Secretary must “consider,” and I’ll be talking about those -- some of those later. But Section 62062 is not a matter of considering data. This provision includes the words “shall be,” a dictate to the Secretary. In light of this dictate as well as the data provided in Exhibit A of this testimony that we just -- I just did a point or two, it’s clear that there’s a very weak economic relationship, if any, between the value of milk sold to California’s cheese plants and the same quality of milk sold to cheese plants in federal order areas, to the growing detriment of California’s dairy farmers.

Let me just go on a little bit on this difficulty of participating in risk management. Given the extreme volatility in both the value of milk and the prices of feed commodities, many California dairies have explored the option of participating in risk management tools. The tools most often used by dairy families throughout the U.S. are the CME dairy futures market. The futures markets that settle on the FMMO Class III and, to a lesser extent, Class IV minimum prices are the most utilized risk management tools that are out there.

In order to effectively utilize these tools, a dairy needs to establish a between the Class 4A and 4B prices that drive their ultimate milk price and the Class III and IV prices in the federal orders that determine the value of those contracts. And I refer to Exhibit B of the appendix for a closer look. And if you look on page 11, part of the testimony that's Exhibit B, and you can see the same timeline I used earlier using six month periods. There is the difference in the 4B and the Class III, and the 4A and the Class IV. I just note that there is an outlier there in the 4A, minus the Class 4, in the first half of 2007. There was a growing disparity between the Class 4 and the 4A price. This Department held a hearing on the issue and made some changes to our formula in response to that issue. But I just wanted to note that other than that you can see that the 4A is much more regular difference in basis from the Class 4.

Going back to the written testimony. As clearly indicated in Exhibit B, an adjustment to our Class 4B minimum price is greatly needed in order to give our state's dairy farmers a more reasonable, reliable basis between the Class 4B and Class III minimum prices. Until that happens, participation by California producers in the Class III -- in the Class III risk management tools is really a speculative strategy, not a hedging strategy.

There are three alternative proposals for addressing this problem. You've heard details on each of those proposals. Exhibit C of my testimony is on page 12. I have charted the impact that those different proposals would have, looking at the last several years. This gives a good picture image of how they would act. And you can see the solid dark line is the federal marketing order Class III price, the dotted line there that runs close to the federal order price for the majority of the time is the Land O'Lakes, the Western United is the lighter colored dash line that runs very similar to federal order over time, and the

Dairy Institute is the line there on the bottom with arrows so you can see how the different programs respond.

Going back to the written testimony. The alternative outlined by Western United would directly tie to the dry whey factor in our California Class 4B formula to the calculation used in federal milk marketing orders. And as noted in their testimony, they would use an 80 percent adjuster.

This proposal achieves a result that addresses both the concerns outlined above. One, it would result in a California dry whey factor that is a reasonable and sound economic relationship with the comparable used in the federal milk marketing order Class III formula. Two, it would provide California dairy families with a more predictable basis between the California Class 4B and federal milk marketing order Class III minimum prices, which makes the Class III future market a much more usable risk management tool for our state’s dairies.

Therefore, MPC strongly endorses the Western United proposal and urges the Secretary to adjust our California 4B formula accordingly.

LOL’s proposal, which we heard this morning on as a more of a sliding scale as you guys talked about, Exhibit C which I just pointed out shows that LOL’s alternative proposal represents a dramatic improvement over the current fixed 25 cent hundredweight factor and provides a reliable economic relationship between the California and federal milk market order dry whey factors for a majority of the months. Obviously when the dry whey factor goes below 25 cents or above a dollar in the federal orders, we see differences between the LOL proposal and the federal orders. But otherwise it tracks quite well.

Therefore, MPC urges the Secretary to consider the Land O’Lakes alternative proposal as a secondary option if she is unwilling to grant the preferred option of the Western United alternative proposal.

Dairy Institute also submitted an alternative proposal with a cap of 75 cents and a floor of 25 cents. MPC is very encouraged to see the state’s cheese manufacturers are recognizing that dairy farmers should be sharing in the value of the whey solids being processed and sold in California. This is in stark contrast to the prior two hearings where the Dairy Institute proposed the elimination of a dry whey factor in the Class 4B formula. However, as I pointed out in Exhibit C, it falls woefully short of accomplishing the two objectives mentioned before. It does not bring us into a reasonable and sound economic relationship with the dry whey factor in the federal order formula, and it does not -- or does little to enhance the usefulness of the Class III future markets which is used by dairy families throughout the country. Therefore, MPC opposed the Dairy Institute proposal.

One other issue I would like to bring to the Secretary and this hearing panel's attention is a response to some of the claims that were made at the last CDFA hearing on this issue in October 2007. These claims may very well be made at today's hearing as well. The October 2007 hearing was requested by eight cheese manufacturers who claimed that they were cheese manufacturers -- claimed that cheese manufacturers do not realize the full value that is attributed to them by the current Class 4B formula. They went on to say in order for the class -- California cheese manufacturers to continue production, the whey factor should be removed from the Class 4B formula. The lead Petitioner on the hearing request was F&A Dairy of California Incorporated.

While I won't attempt to refute the claims made in F&A Dairy of California's petition about their ability or inability to capture the maximum value for the whey stream, I would ask the Secretary and this hearing panel to keep the general structure of the Class 4B formula in mind when considering the claims. Our Class 4B formula, in its structure as an end-product pricing formula, purposely utilizes a lower value commodity grade cheese, 40 pound blocks of cheddar, to establish the end-product value for the formula. The value of that commodity grade of cheddar is what dictates the minimum prices all these plants must pay for their milk supply. That means that if you're producing a product that carries a premium to the basic 40 pound blocks of cheddar cheese, the formula does not require you to pass those additional dollars as part of the minimum price.

A majority of the cheese manufacturers that requested the October 2007 hearing are, in fact, manufacturing products that receive higher value than the standard 40 pound blocks of cheddar cheese from the market. As an example, the following information was gathered about F&A Dairy, a former cheese manufacturer in Newman, California, and the lead petitioner in that 2007 hearing request.

And here is an excerpt from the July 20, 2009, press release published by Saputo Incorporated.

According to the press release F&A Dairy was acquired in 2009 by Saputo. The press release reported that for the year ending December 31, 2008, F&A Dairy of California produced 60-million pounds of cheese and sales of about $140-million. Saputo’s website noted that the Dairy Institute -- F&A Dairy of California produced mozzarella and provolone, both of which have a higher moisture content than cheddar cheese, as well as whey product. And Exhibit E, which I will point you to right now, is where that evidence comes from.

It’s not clear from the information given how much of F&A’s income was derived from the whey products, but based on the data we have, we can make some estimates.

The two styles of cheese manufactured by F&A were mozzarella and provolone. Combined, these two styles of cheese are comprised of an average moisture content is 20-30 percent higher than cheddar cheese.

Given this increased moisture content, I will conservatively estimate that a yield of 12 pounds of mozzarella/provolone for every hundred pounds of raw milk.

In order to make 60-million pounds, as noted in the press release, at a yield of 12 pounds per hundredweight, it can be estimated that F&A had to purchase approximately 5-million hundredweight of milk, or 500-million pounds.

Conservatively estimating a yield of five pounds of dry whey per hundred pounds of raw milk, 5-milling hundredweight of raw milk could yield 25-million pounds of dry whey.

Average price for dry when in 2008 on the west coast was 25-1/2 cents per pound. Therefore, 25-million pounds of dry whey could yield more than $6-million of revenue.

If you remove that $6-million from the $140-million in sales that F&A reportedly had, that would have left about $134-million in revenue from their cheese sales. $134-million divided by 60-million pounds of cheese comes out to an average price of $2.23 per pound of cheese. Now, obviously, if they were not able to capture as much as the full value of dry whey, then that $134-million estimate would go up. Obviously these aren’t exact numbers, but kind of a hypothetical example.

By comparison, the daily average price at the CME for 40 pound blocks of cheddar, which is what we use for our price discovery in our 4B formula, was $1.86 per pound in 2008. So you can see there’s about 47 cents, in this hypothetical example, increase or premium that that cheese is carrying.

Looking at these numbers it certainly becomes clear why Saputo Incorporated was interested in purchasing F&A’s operation.

MPC is not opposing the use of 40 pound blocks of cheddar cheese as a price driver for our Class 4B formula. But when evaluating the claims of these smaller specialty cheese manufacturers, the Department must remember that these operations are generating additional value for their cheese they are selling. If given the opportunity, a good question for these individuals would be how similar specialty cheese manufacturers that may or may not process their whey stream are able to profitably operation federal order areas subject to a higher Class III minimum price that includes a variable dry whey factor.

Second, proposed changes to the make allowances for butter, nonfat dry milk, and cheese: There’s been two proposals before us to take a look at changing the make allowances, one by CDI, one by Land O’Lakes. Before going into the details of those proposals, I would like to point out the Section 62062 and Section 62076. And I mentioned earlier in this testimony there’s a difference between the words “consider,” “Secretary shall consider,” and the “Secretary shall,” do something else.

So this is Section 62062 says -- talks about the director “shall take into consideration” a number of things -- factors including the cost of producing milk by the dairy farmer, including costs of management and a reasonable return on investment.

And Section 62076 uses that identical language, “shall take into consideration” the manufacturing costs of Class 4A and 4B.

So you can see it’s clear that the Secretary has been given broad latitude. However, it’s also clear that the legislature requires the Secretary to consider key economic facts when making these decisions.

CDI is asking the Department to increase the make allowances for both butter and nonfat dry milk in the 4A formula. The practical effect of this change would be a 35 cent per hundredweight reduction in the 4A and well as II and III minimum prices.

In their hearing petition CDI utilizes a manufacturing cost exhibit that was published by CDFA in November 2010. And the study period for those manufacturing cost exhibits is January through December of 2009. In the CDFA exhibit it’s estimated that the cost of producing nonfat dry milk and bulk butter rose from 2008 to 2009. In their hearing petition, CDI based their entire request on these reported figures alone.

While dairy farmers can certainly sympathize our state’s butter/powder manufacturers dealing with creased costs, we must respectfully remind our friends and colleagues at CDI that the Secretary is required by law to consider much more than simply the manufacturing cost exhibit when establishing these prices.

In fact, when reading the two sections above, the Secretary is required to consider both the costs of producing and marketing the milk, and the manufacturing costs. That’s why in addition to the manufacturing costs exhibit the CDFA -- that CDI is referencing, CDFA publishes a cost of production survey each quarter, estimating the costs of producing raw milk.

In order to provide a balanced look at how dairy farmers and our state’s butter/powder manufacturers have fared, it’s helpful to compare the financial performance of the two sectors of our industry in an apples-to-apples comparison. And I refer you to page 15 of the testimony, the last page, and that is Exhibit F. And that shows -- the following table shows how dairy producers and butter/powder manufacturers performed financially in the January through December 2009 period. On the left side you can see the dairy producers, the costs taken from the CDFA cost of production survey. The average cost for 2009 is $16.86 per hundredweight statewide. The average price for feed taken from CDFA's numbers is $11.48 per hundredweight. The percentage of the costs covered by dairy farmers by their milk check in 2009 was about 68 percent. Dairy farmers in the state were only able to cover 68 percent of their costs with the revenue they were receiving for their milk.

On the flip side, the right side of that chart there, butter and powder manufacturers, their cost plus return -- and I've taken the cost data from the manufacturing cost exhibit and turned it into a per hundredweight basis -- was $2.49 per hundredweight. Their make allowance, which they claim is aimed at covering that cost, is $2.13 per hundredweight. So the percentage that the manufacturers were able to cost was 85.7 percent of their cost.

There's a stark difference between the producers who could cover a 68 percent of their cost and the manufacturers who cover 85 percent of their costs. This is important information to recognize when you're establishing minimum price formula, that must take into consideration both the producer and the processor costs of making the product.

Going back the testimony, page 7. As clearly demonstrated by the table in Exhibit F, when taking a look at the broad -- taking a broad look at the financial picture in 2009, rather than focusing simply on one side of the industry and one report from CDFA, and viewing that data in the context of Sections 62062 and 62076 of the Food and Ag Code, it would be inappropriate to grant CDI’s request to reduce the Class 4A minimum by 35 cents.

Now, I recognize -- I’ll kind of summarize the next paragraph. I recognize that in the past this hearing panel and the Secretary have decided to grant make allowance increases in response to reports about unrelieved marketing of milk production that exceeds capacity, that sort of thing. While that may have been the situation in 2007, the last time this was reviewed, the industry data since then shows a much different picture. In the three calendar years since that hearing the California milk production has increased or decreased by 1.28 percent, negative 4.1 percent, and 2.21 percent. In fact, the 40.3-billion pounds of milk produced in 2010 was less than the annual production in 2007. It’s certainly not been a time of unrestrained growth. Further, the stories of distressed milk leaving California at discounted prices and milk leaving the farm without being processed are a thing of the past. In other words, the picture as we stand here in 2011 is much different than the picture we saw in late 2007.

And we heard some testimony on this earlier about milk leaving the state. I think before that -- those facts should be relevant for this discussion we need to know where that milk was going. Was it going to a place that needed milk and paying a premium for that milk? It's very likely it was non-distressed milk, so I'd just note that.

The reasons behind this change on the producer side are easily understood. Our state's dairy families rely largely on purchased feed. Over the years low feed prices allowed our dairies to enjoy competitive advantage over other regions of the country. This has changed dramatically in the past several years. Feed prices have skyrocketed to record levels since 2007 and the outlook for the future indicates more of the same. The production cost advantage that California dairies enjoyed in the past is gone and we no longer produce the lowest priced milk in the country. Being a low price leader in a high cost environment is simply unsustainable.

And I think that the last point that I'd make, since it looks like I’m running out of time, is we need to do a better job in the state of value-added products. We need to find ways to get more money out of the milk that we’re producing and, fortunately, this is starting to happen. We’re seeing evidence of this. Despite a make allowance that was “too low” according to our butter/powder manufacturers, I've been able to review multiple statements provided to our owners of CDI and those statements demonstrate CDI was able to distributes 39 -- roughly 39 cents per hundredweight or approximately $66-million last year to their members, given the numbers I have available. That’s great and we encourage more of that. But that’s how we’re going to survive as an industry, getting that money out of the marketplace, generating profits from the market in value-added products, not from higher regulated make allowance.

So I submit the rest of my testimony as written.

HEARING OFFICER MAXIE: Thank you. Questions from the panel?

MS. GATES: Well, I’m going to go right to the end of your testimony so we can get that on the record. You state here that MPC supports both CDI and LOL’s proposals for the adjustment of f.o.b. adjusters.

I’m going to ask it as a question so that you can go ahead and get that on the record.

MR. VANDENHEUVEL: Yes, yes.

MS. GATES: Okay?

MR. VANDENHEUVEL: And on the make allowance -- on the make allowance request we are opposing any adjustments to the make allowance given the evidence I presented earlier in the testimony.

MS. GATES: Did you want to say anything more? Did you want to say anything more to the (indiscernible) adjusters?

MR. VANDENHEUVEL: You know --

MS. GATES: Or probably -- okay.

MR. VANDENHEUVEL: -- I think it’s been talked about. Yeah. We are supporting those. And I’d like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER MAXIE: Granted.

MR. VANDENHEUVEL: Thank you.

MS. GATES: Let them go ahead (indiscernible).

MR. EASTMAN: (Indiscernible). So, in essence you're saying that you're opposing make allowance changes for all three commodities, for butter, powder, and cheese, but you are supporting f.o.b. adjusters for both the butter and the cheese.

MR. VANDENHEUVEL: That's correct. And not unlike some other testimony that was given earlier today, there's a recommendation that these prices are being set on products that are being sold in Chicago, cheese and butter, and so it does seem appropriate to make adjustments when there's data to support those adjustments. But, you know, in terms of the make allowance, given what the code dictates we did not have that same view on the make allowances.

MS. GATES: Okay, I found it. On the last, Exhibit F, that you had on others.

MR. VANDENHEUVEL: Yes.

MS. GATES: The average price.

MR. VANDENHEUVEL: Yes.

MS. GATES: Prices paid or received by producers.

MR. VANDENHEUVEL: Yes.

MS. GATES: Was that a price that included bonuses or was that just --

MR. VANDENHEUVEL: That was the reported -- that overall blend price.

MS. GATES: Blend price, okay. Thank you.

MR. VANDENHEUVEL: Now, I will note on -- going back to Hyrum's question, if I could. One of the things I said is on page 8 there, is new manufacturing data will be published in the coming months. Market dynamics are constantly changing. We’re not opposed to reexamining this down the road, but at this time we do believe that any make allowance adjustment would be inappropriate at this time.

HEARING OFFICER MAXIE: No more questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you, Mr. Vandenheuvel.

The next witness is Steve Kluesner from Nestle. If you would state your name -- state your name and spell your last name for the record.

MR. KLUESNER: Sure. Steven Kluesner, K-L-U-E-S-N-E-R.

HEARING OFFICER MAXIE: Thank you, Mr. Kluesner. You handed us a copy of your testimony. Would you like that entered into the record as an exhibit?

MR. KLUESNER: Yes, please.

HEARING OFFICER MAXIE: Very good. It will be entered as Exhibit number 56.

(Thereupon, Exhibit 56 was received and entered into evidence.)

Whereupon,

STEVEN KLUESNER

was sworn and duly testified as follows:

MR. KLUESNER: Thank you. My name is Steve Kluesner. I am Procurement Manager for Fluid Dairy and Butterfat for Nestle Business Services and today I'm represent Nestle USA. In my role with NBS I'm responsible for milk and dairy ingredient procurement for Nestle brands in the United States and Canada. This includes procurement relationships with individual farms, cooperatives, priority handlers -- proprietary handlers and manufacturers. I developed today's testimony in cooperation with Nestle staff and present it today with authorization from Nestle executive staff.

Nestle USA's primary California operations include its Carnation evaporated milk plant, two Dreyer's and Haagen-Dazs ice cream plants, and a prepared foods factory, along with distribution centers and business offices.

I testify today in support of the CDI proposal. As in the past, we support cost-justified adjustments to both manufacturing allowances and f.o.b. adjusters. CDI's proposal is consistent with past methodologies, which endeavor to reflect the California costs and actual prices paid for California products.

We have no position on the LOL proposal or alternate proposals, as we do not manufacture cheese. However, we would encourage the Department to consider the possible implications to ongoing plant capacity concerns in California when making decisions about minimum regulated pricing. As always, we encourage the Department to allow the marketplace to work above government regulated prices and not set minimum prices too high. We believe that low regulated prices with ample room for premiums encourages the most logical allocation of milk and promote product innovation.

Thank you for the opportunity to express my -- the views of Nestle. I welcome any questions.

HEARING OFFICER MAXIE: Very good. Any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: No questions. Would you like to file a post-hearing brief --

MR. KLUESNER: Yes, we would.

HEARING OFFICER MAXIE: -- if you choose to do so?

MR. KLUESNER: Yes, I choose.

HEARING OFFICER MAXIE: Very good. All right. If I didn’t say it, your testimony is entered into the record as number 56, Exhibit number 56.

All right, the next witness will be Scott Hofferber from Farmdale Creamery. Thank you.

All right, if you'd each state your names and spell your last names for the record.

MR. HOFFERBER: My name is Scott Hofferber, H-O-F-F-E-R-B-E-R.

MR. SHOTTS: I'm Michael Shotts, S-H-O-T-T-S.

HEARING OFFICER MAXIE: All right. You've handed us a document here that appears to be a copy of your testimony. Would you like that entered into the hearing record?

MR. HOFFERBER: Yes, please.

HEARING OFFICER MAXIE: All right. That will be entered as Exhibit number 57. And you can both answer simultaneously.

(Thereupon, Exhibit 57
was received and entered into evidence.)

Whereupon,

SCOTT HOFFERBER and MICHAEL SHOTTS

were sworn and duly testified as follows:

MR. HOFFERBER: Good afternoon Mr. Hearing Officer and members of the hearing.

I am Scott Hofferber, the Controller at Farmdale Creamery, and I am here at the direction and on the authority of our board of director who, in turn, are represented today by Michael Shotts. Mike is a third generation owner and General Manager of our family-owned and operated dairy processing facility near the diminishing Chino Dairy Preserve in Southern California. With 70 employees, Farmdale processes around 25-million pounds of milk and cream per month into block jack and cheddar cheeses, sour cream, buttermilk, and butter. We are grateful for this opportunity to provide Farmdale's perspective on the matters before the panel.

We're here today in full support of the Department's proposal to conform the language in the security trust fund, then we'll take the rest of our time to talk about other stuff.

Farmdale opposes the petition for California Dairies, Inc., CDI, to increase the 4A make allowance. Even though the flow-through effect of the proposed 4A adjustment on Farmdale's Class 2 price might benefit us in the short run, we are wary of the motive behind and the collateral effects of this change. We also oppose the Land O'Lakes petition and Western United Dairymen's alternative proposals to decrease the 4B make allowance and add a variable whey factor to the pricing structure. We are also breaking ranks with the Dairy Institute of California's position in their alternative proposal with respect to the inclusion of a variable whey factor in the formula. Such a construct proved to be devastating to us in 2007 and we cannot suffer the same penalties we did during the ’03-’07 period when the last variable whey component was in effect. We refer you to our testimony from the ’07 public hearing record for the details and incorporate that testimony herein by reference. As to the f.o.b. adjusters, we defer to Dairy Institute’s expertise and analysis on this, and support their no-change at this time position.

Generally we don’t get it. IN ’09 there was a hearing that resulted in a temporary enhancement to producer revenues, ostensibly in reaction to prolonged low market prices relative to producer production costs. Coincidentally, our service charge was increased to the identical level at the time the temporary measure expired. Since that time prices have strengthened, are holding at near all-time highs, and supply seems to be matching processing capacity and market demand. Isn't this what we’ve been striving for? If it ain’t broke, don’t fix it.

The implication then is that the system is somehow broken and needs these fixes. This is an unsupportable premise to Farmdale and the other small manufacturers -- cheese manufactures we talk with. The motivation really seems to be that the producer community wants greater participation in an assumed lucrative whey products business available primarily to the larger processors. However, persisting in their misunderstanding of government’s role in managing minimum price structures, they want regulation to achieve this goal. By pushing a minimum price higher and higher, we perpetuate and exacerbate a fundamental flaw in our system; that of muting market pressures from influencing production levels through normal supply and demand mechanics. This isn't necessary.

The producer community already has the machinery to selectively extract additional revenues from those processors who actually make the higher valued whey products through the service charges. The simplest solution would be to let producers handle the disparity between whey processors through the application of varying service changes based on arm’s length negotiations between the parties. Using government and regulation to deal with this situation in a broad application is not an appropriate use of the system.

Referring to the attached two exhibits reporting pounds of milk processed into cheese for

February through May 2011, Exhibit 1, and May through August 2007, Exhibit 2, we can infer that 4B utilization has declined by 2.3 percent, 26.3 to 25.7-million pounds per month per plant, and the industry has lost a net three cheese makers in that time frame. Mr. Vandenheuvel's testimony talking about F&A Cheese and Saputo's acquisition requires a whole lot more analysis because it's our understanding F&A didn't sell because they were such a profitable entity but, rather, that they were very distressed at the time following the '07 hearing, didn't actually recover from the dramatics of that time.

While the recession certainly may be reflected in these numbers, we don't believe it is the sole explanation for the decline. Competition from out-of-state processors is intensifying. California continues to be a comparatively more difficult business environment in which to operate, let alone expand or invest in a new business. It doesn't seem reasonable to be discussing further damaging the health of California's 4B processing community.

We have been able to manage our business around the current fixed factor formula over the last few years and changing it to a variable factor, or some other thing that raises our cost of raw product, is not justified at this time. If the Department decides, however, that it wants to grant the producer community access to the revenue streams of the class of high-end whey makers, then we must respectfully request to be excluded from that class. To this end we suggest the Department exempt the first one million pounds of milk used for 4B processing per processing day from any whey factor, variable or fixed. This can be accomplished simply and it will take the small cheese makers, including Farmdale and 47 or so other small plants representing about 16 percent of all 4B milk being consumed, right out of the discussion.

In CDI's presentation, Dr. Erba similarly spoke for a credit for small cheese makers, and we offer this construct as a possible implementation. And we can talk about that and a lot of surrounding implications of how that would actually be implemented in a post-hearing brief if that's necessary.

With regard to make allowances, we take exception to the proposed 4B make allowance adjustment at this time, as we see it as something of an insult to our community effort to sustain this industry during recent years of low prices and high production costs. For years during which the Department studied cost-based make allowance steadily grew, implementation of these increases was deferred, delayed, and consciously forestalled by the processor community in deference to the plight of the producer community during periods of relatively low end-product prices compared with producer costs.

The following chart indicates the dollars to Farmdale left on the table by delayed make allowance adjustments. This has the most impact to Farmdale in the Class 4B arena because of the larger volume of milk being processed in our Class 4B operation. The October 1 Implementation chart at the right gives a more practical result to this analysis in that it reflects a reasonable amount of time elapsing prior to implementing the prior year’s studied number. Whichever way one looks at it, Farmdale has not received the full value of the intended cost-based make allowance. To be sure, the minute the 2010 values are made available, we will look to filing a petition to get the make allowances adjusted accordingly.

The 2009 studied cost figures have been out for months now. If it is so important to get this piddly adjustment passed, what took so long to bring it to the table? The strange timing for petitioning for this hearing process through the 4A arena causes us to be suspicious of the real motive. Nonetheless, considering (a) the 2010 cost figures are just around the corner, (b) the 4A numbers are suspect because of the handling of facility startup costs in the 2008 and 2009 figures, and (c) the weird timing of the hearing, we strongly urge the Department to take no action at this time with respect to the make allowances.

The whey factor: Where do we start? How about with the 2007 4B hearing and the emergency petition that we believe saved 75 percent of the California cheese makers' businesses from going broke that year. It certainly rescued our 4B business, but others weren't as fortunate, like F&A. In short, we cannot support the inclusion of a variable whey factor based on a product we don't make. The Land O'Lakes petition and both alternative proposals are advocating a variable whey factor based on dry whey, a product almost no one in California makes.

I'm supposed to do it from there to this.

Oh yeah. In Mr. Marsh's testimony he made the comment that practically everyone else is making higher value whey and we want to take exception to that comment. I think the fair statement is that practically most of the -- and when I say practically, maybe 20 percent of the cheese makers in the state are making the higher valued whey. There are charts in the hearing workshop materials that indicate who’s making what kind of whey and certainly not everybody is making higher valued whey. Anyway, you want to look at it.

End-product 4B pricing is predicated on finding the lowest common product as the base: cheddar cheese. This was done at a time when cheddar was made in abundance and traded in volume on the CME, creating a fairly stable, measurable base from which to work. There is no similar common product in the whey processing world. Further, by choosing a product of relatively high value as the base, processors may be driven toward making inappropriately risky investments in higher valued whey processing plants, putting more of that product into the market and likely lowering the market price due to oversupply. And I’m thinking about Mr. Rumiano’s testimony from this morning. If all of a sudden we decided to go make an organic isolate thing, what would happen to his market? You know, I mean there’s so much more information to be learned about what these markets are and, you know, how insensitive they are to volumes of product on the market. We just -- we can’t get a take on it from our viewpoint.

The variety of whey products alone is an indication of just how frail supply and demand relationships are as whey processors continue to fish around for buyers of the various products.

Really, 25 cent a hundredweight overvalues the lowest common product, which arguably is liquid concentrate for animal feed. We found ourselves in the position of having to give that away recently because our sole customer for popcorn whey decided they had an oversupply and cut us off. We scrambled to find alternatives to that customer and did, and that situation has been resolved. We also went away from our primary popcorn whey make for a time. We were able to get a minimum revenue stream off the liquid whey when the cost of gas for drying and feed corn prices are high. Whey product prices went up, our dry whey price went up, so our animal feed price followed that. Just on extent we're able to switch back, gas went down, this and that and other things happened. We're trying to be as flexible as we can with it, with the infrastructure that we have built but it remains a real guessing game and real struggle to move the whey out, really.

Even then we are competing with other food processing waste and byproducts in the animal feed space. Generally our best effort is to make a roller-dried popcorn whey for animal feed. The revenue stream from this product defrays much of the costs of disposing of the whey stream, but certainly does not make it a profitable enterprise for us. The Department is aware of these costs and revenues through information gathered during the cost studies.

Our whey stream is at a level of about 800-thousand pounds per processing day, substantially less than the one million pound level, as was estimated in 2007, necessary to justify the cost of building a whey processing facility capable of making the big bucks these petitions and proposals are going after. If the LOL proposal had been in place since the 2007 establishment of a fixed 25 cent per hundredweight factor, the result would have cost us an additional 7-1/2 cents per pound of finished cheese. Using full absorption costing methods, this would have put our cheese operation in a loss situation for each of those years.

Our cheese business is not of the specialty variety the producers believe is the magic salvation for the smaller cheese maker. Our cheese products are sold at prices closely tied to the commodity market used to set the milk price. We have nowhere to go but away from the 4B world should the whey factor materially change from its current level.

Mr. Wegner posed a couple of questions in his presentation and I think I talked a little bit about that when I described our varying methods of trying to get rid of our whey stream. His question was, what are people doing since ’07 to mitigate -- maybe better themselves in terms of the whey world. We’ve taken a look a couple of times at spending $10 or $12-million necessary for us to put in a whey processing facility for our whey stream. We’ve looked at shipping it the distances necessary; we’re not living with the 30 or 40 miles he’s talking about. We’re more in the 200 mile kind of a world which creates problems with spoilage and freight costs and every other sort of thing.

The other question Mr. Wegner posed was what about competition for milk. And I would take that discussion back to the whole service charge argument. And that is, if suppliers want us to push more product through our plant they can incent us by cutting service charges. If we find a reason to want to run more and find a market that can actually generate those revenues, we can go ask for the milk and they can offer it to us at a greater service charge, and the Department doesn’t have to do a thing about it.

When Land O’Lakes was in the cheese business in California, they argued against a variable whey factor. Now that they're out of the cheese business, or substantially out of the cheese business, they want the factor back. It seems disingenuous to us that producer groups have moved away from cheese making toward powder, lowering the overall return to the pool, yet still feel entitled to the benefits cheese processors derive from taking the risks of capital necessary for cheese and whey production.

Lastly, following the 2007 hearing decision, I participated in a Department-organized whey review committee that met for a number of months to evaluate both the producer and processor communities -- what did I say? Along with many -- let’s see -- to evaluate whey -- sorry, let me start that over since I have time to do it.

Lastly, following the 2007 hearing decision, I participated in a Department-organized whey review committee that met for a number of months to evaluate whey economics in California. Along with many smarter than me colleagues from both the producer and processor communities, we sliced and diced the issue with the goal of making a recommendation for pricing the whey stream. We couldn’t come to an agreement at that time, knowing and noting the inevitability of further contentious hearings like this one. One notion discussed in that committee that garnered serious bilateral attention was to deregulate 4B milk to some degree. It seems to me that holding the minimum regulated price at a real minimum level and letting services charges sort out the disparity in whey processing practices practically accomplishes the same thing.

And with our request for the ability to submit a post-hearing brief, this testimony is respectfully submitted by Farmdale Creamery.

HEARING OFFICER MAXIE: Your request is granted. Are there questions from the panel?

MS. REED: I just have one just for clarification somewhat, and it’s on page 3.

MR. HOFFERBER: Okay.

MS. REED: The part where you're talking about eliminating the first million pounds from any type of whey factor so that that would take out the small cheese companies. What effect do you think that will have on the larger cheese companies? I mean, there would be no whey factor for anyone at that point. So if they make under a million there’s nothing, no 25, no nothing.

MR. HOFFERBER: Yeah, I --

MS. REED: And then --

MR. HOFFERBER: Okay.

MS. REED: Yeah.

MR. HOFFERBER: If you want to take a look at Exhibit 1, which is my page 7, I asked myself that same question. In the written testimony I make the statement that it would -- cutting 47 cheese makers out, 16.1 percent of the 4B milk being clear of any kind of a whey factor. Of course, that doesn’t consider however many pounds would come off the larger guys as well.

So at the bottom of that page in the lower right-hand corner there’s also a calculation there that if you extended that same million to everybody you're talking about maybe 37-1/2 percent of the 4B milk would end up being excluded.

MS. REED: I see.

MR. HOFFERBER: When you take all 58 cheese plants into account --

MS. REED: Right.

MR. HOFFERBER: -- in the 4B world. Now, my guess would be then you would slide the scale slightly different if you're targeting a certain amount of revenue for sharing --

MS. REED: Right.

MR. HOFFERBER: -- you know, you're going to end up with some other sliding scale, yet the smaller guys.

Now, the other thing that enters my mind, and I'm going to anticipate this question, and that is so what keeps a large cheese maker from running out and getting 15 handler numbers and becoming 15 small plants.

MS. REED: Okay.

MR. HOFFERBER: And I think the real answer to that is, is the economies of scale necessary to even afford the whey plant in the first place. I don't really see that that would happen. I could be completely wrong and it would be something that could be up for discussion as we go forward considering some kind of a small plant exclusion. You're going to run into that argument whether you take a credit, as Mr. Erba suggests, or this kind of an approach, whatever. That same kind of thing is going to come up, but you somewhat face it anyway to a certain extent.

But understanding how much juice has to go into actually getting a high-end whey plant going, it's hard for me to know the exact answer to that. It's definitely a concern. I get it. But I think it can be mitigated.

The other one answer would be looking at tax law. There's this thing in tax law called the rules of attribution. If the same cats owned 10 companies, all small companies, they all get thrown together to decide whether or not they need a pension plan. So, I mean, that whole kind of construct could be thrown at this thing as well. If it's the same community of people who own all 10 of those smaller plants for tax avoidance purpose, you know, regulate that.

But we're looking -- we're looking for a personal exclusion that would put us out of being taxed for the whey stream.

MS. REED: Okay, thank you very much.

MS. GATES: I have a question. Did you give consideration for your exemption piece here as an alternative proposal?

MR. HOFFERBER: Ran out of time, frankly. This idea came to me at about 4:30 on Friday afternoon, about a half an hour after the alternative proposal time limit expired.

MS. GATES: Okay. It's just kind of hard for other people to speak to it.

MR. HOFFERBER: Well, anybody who's testified, of course, can speak to it in a post-hearing brief and I would certainly welcome seeing all that commentary because I think this notion's going to come back. As long as there's 47 small cheese makers in the state, most of whom are not making higher valued whey, this problem's not going to go away.

MS. GATES: Okay, thank you.

MR. HOFFERBER: And, of course, the hearing goes on for another day or so, so if anybody else wants to sign up and talk about it.

MS. GATES: Okay.

HEARING OFFICER MAXIE: Any more questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you very much.

The next witness is Kevin Abernathy from California Dairy Campaign. Thank you.

If you would state your name and spell your last name for the record.

MR. ABERNATHY: My name is Kevin Abernathy, A-B-E-R-N-A-T-H-Y.

HEARING OFFICER MAXIE: Thank you. And you handed us a copy of your testimony. Would you like that entered into the hearing record?

MR. ABERNATHY: Yes, please.

HEARING OFFICER MAXIE: Very good. It will be entered as Exhibit number 58.

(Thereupon, Exhibit 58 was received and entered into evidence.)

Whereupon,

KEVIN ABERNATHY

was sworn and duly testified as follows:

MR. ABERNATHY: Thank you. Mr. Hearing Officer and members of the panel, my name is Kevin Abernathy. I currently serve as the Executive Director of the California Dairy Campaign. CDC is a member organization of the California Farmers Union, which represents more than 1,400 farmers and rancher members statewide. CFU is also a state chapter of the National Farmers Union on the national level, which represents 250,000 farmers and ranchers nationwide. The testimony that I will present today is based on positions adopted by the CDC board of directors during its most recent May board meeting.

Interesting note, despite higher prices for producers, dairy families throughout the state continue to face challenges today due to record feed costs and increases in other input costs. According to the most recent Department of Agriculture economic research service report 2011/2012, corn is projected at records of $6.00 to $7.00 per bushel. As many of our producer members expect corn silage this year to reach nearly $50.00 per ton in the field, leading many experts to predict that the average cost of production could rise to over $18.50 per hundredweight. There is literally no end in sight to these high feed prices, so each and every penny earned is essential in order to continue to cover our growing costs of production. It’s critical that dairy producers are paid a fair price based on true market demand, because unlike processors and retailers they’re unable to pass on their higher input costs.

We support the Land O’Lakes petition to incorporate a higher whey value in the 4B pricing formula because it will pay producers a whey value that is based on market demand. We oppose the proposal put forward by California Dairies, Inc., to increase the 4A manufacturing cost allowance and f.o.b. transportation adjuster. Instead of increasing make allowances to generate revenue, dairy processors should take advantage of their ability to capture greater value from the market.

Although prices paid to producers are substantially higher, it’s very important to recognize that given the high cost of feed, the outlook for producers remains precarious, at best. Under the current system plants are able to cover their cost of production while producers do not have that ability. The gap between farm and retail price is near an all-time high, which shows that consumers do not benefit from the current system either.

As Congress debates the dairy title of the next farm bill, there is a major push to deregulate Class III cheese, which could lead to lower prices in the federal orders and, in turn, lower here in California. The stakes in the next farm bill debate are high for California dairy producers and under deregulation the California dairy landscape would look much different than the one that exists today. It could become even more concentrated and consolidated as more risk is shifted to the dairy producer sector. The dairy sector could soon resemble the poultry and hog sectors of our agricultural economy, where competition is virtually nonexistent and producers are at the mercy of processors and integrators. We urge California policymakers to take an active role in shaping the upcoming farm bill to foster greater competition to ensure that dairy producers receive a fair price in the future.

We testify in support of Land O'Lakes proposal to increase the amount producers are paid for the value of whey. Adoption of the Land O'Lakes proposal will be an important step in the right direction towards making the 4B pricing formula more market oriented. Today, while California dairy producers receive a fixed whey value of just 25 cents per hundredweight, dairy producers in the federal marketing orders receive more than $1.40 per hundredweight for the whey they produce. The significantly lower amount of California dairy producers receive for the whey does not adhere to the requirement of Section 62062 of the California Food and Agriculture Code that CDFA maintain producer prices that are in reasonable and sound economic relationship with the national value of manufacture milk products. The adoption of the Land O'Lakes proposal would increase producer prices by more than $1.00 per hundredweight on all 4B milk and put California prices in a more reasonable relationship with those in surrounding states and federal milk marketing orders.

On many occasions the California Dairy Campaign has testified before CDFA calling for the establishment of a variable make allowance. The Land O'Lakes proposal would establish a variable whey value based on market demand for whey. For this reason, the whey value formula included in Land O'Lakes petition, in part, achieves our longstanding goal of making California's dairy pricing system more market oriented. The Land O'Lakes petition incorporates a meaningful value for whey based on market conditions that will lead to more than $1.00 increase in the 4B price that dairy producers across the state well deserve and need.

We call upon CDFA to deny the California Dairy, Inc., petition to raise the manufacturing allowance and the f.o.b. adjusters on 4A milk. The cost studies CDI utilized to justify their call for increasing the manufacturing cost allowance reflect higher costs than the actual costs to manufacture butter and powder. The 4A cost studies were taken when many butter/powder plants were not at full capacity and, as a result, the costs are inflated. Under the CDI proposal, dairy producer prices would decrease by more than 40 cents per hundredweight. Give the corresponding decrease in the Class II and Class III prices that would result, 45 percent of the milk that is pooled in the state would drop by more than 40 cents per hundredweight.

It is important to recognize that an inflated manufacturing cost allowance not only decreases the amount that dairy producers are paid, but it can also lead to plants offering discounts on their products. These discounted prices can actually lend to lower prices that are factored into the pricing formulas. So not only could the increase in the manufacturing cost allowance cost producers more than 40 cents today, it could potentially lower producer prices in the future due to discounts.

It’s also important to question why CDI is calling for an increase in the manufacturing cost allowance when earlier this spring its producer-members received substantial dividends, indicating the profitability of CDI overall.

The California dairy pricing system has allowed plants to be profitable and expand processing to the lowest value products regardless of true market demand, because producers covered the cost of the plants. Adoption of the CDI proposal would increase the 4A manufacturing cost allowance, which would further exacerbate the situation.

As long as the manufacturing allowance is fixed at the processor cost plus a return on investment, and is paid for by the dairy community, the processing segment of the industry will be unconcerned with true market signals. We need a system that works with the marketplace at all levels: the producer, the processor, the wholesaler, the retailer, and the consumer to provide an equitable, stable, and viable economic environment for all segments of the dairy industry.

In conclusion, we urge CDFA to adopt the Land

O'Lakes petition to decrease the manufacturing cost allowance on 4B milk and to change the 4B pricing formula so that producers are paid based on the value of whey in the market. We commend Western United Dairymen for putting together or putting forward a proposal to incorporation a whey value that is more relevant to the value of whey in the marketplace today and consistent with the prices that are paid to producers in the federal milk marketing orders.

We oppose the Dairy Institute's proposal to increase the manufacturing cost allowance. The Land O'Lakes proposal will enable dairy producers to capture greater value from the market than the Dairy Institute proposal, which includes a price floor.

Adoption of the Land O'Lakes petition will be a good first step in making the 4B dairy pricing formula more equitable for producers by capturing more accurate value for whey in the 4B formula.

We also support the Department's administrative changes in the milk producer security trust fund.

Finally, CDC would like to remind members of the CDFA panel that although dairy producer prices have improved substantially since the disaster that we've all felt in 2009, the future for dairies across the state remains far from certain. In 2010, again, 37 dairy facilities statewide closed due to financial trauma that continued after this historic collapse of ’09. Those dairy operations that remain continue to struggle to make up for unprecedented losses of equity that all the producers in California suffered. It is extremely difficult for producers to secure credit as banks and other financial institutions continue to tighten credit and other requirements on all dairy operations, along with the environmental cost associated. The future for dairy operations around the state, again, is far from certain and it is critical that CDFA consider the impact of today’s petitions on producers who have already endured tremendous hardships over the last few years.

California Dairy Campaign would like to thank the Department again for an opportunity to present our testimony today, and would like the opportunity to submit a post-hearing brief.

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

Questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: Your lucky; no questions. All right, thank you very much.

The next witness would be Justin Freiberg. Thank you. If you would state -- if you would state your name and spell your last name for the record.

MR. FREIBERG: Justin Freiberg, F-R-E-I-B-E-R-G.

HEARING OFFICER MAXIE: Thank you, Mr. Freiberg. You handed us a document which looks like your -- looks like some exhibits. Would you like these entered into the hearing record as an exhibit?

MR. FREIBERG: Yes, please.

HEARING OFFICER MAXIE: Very good. They will be entered as Exhibit number 59.

(Thereupon, Exhibit 59 was received and entered into evidence.)

Whereupon,

JUSTIN FREIBERG

was sworn and duly testified as follows:

MR. FREIBERG: Mr. Hearing Officer and members of the panel, my name is Justin Freiberg. I’m a consultant with Commodity and Ingredient Hedging, LLC. Most people know us as CIH.

CIH is a company of 35 professionals that educate and consult with agricultural producers and businesses in North America, Central America, South American, Southeast Asia. Since 1999 CIH has provided margin management services to agricultural producers.

We work with dairy farmers across the United States with several clients here in California. I work on the dairy team in CIH and specialize in providing milk feed price management assistance to dairy farmers, which brings me here today.

A client of ours who is a dairyman in California asked me to present you with some information that we have looked at together in the past. And the reason I am here today is to offer our knowledge on the effect dry whey pricing formulas have on the California dairy producers' ability to manage risk.

As we all know in today's volatile markets, dairymen need more effective tools to manage their forward profit margins. CME Class III futures are settled against the federal Class III milk price.

Back up just a second. Class III futures and options are viable margin management tools. However, in order for them to be an effective tool, there must be a high correlation between the price at which a dairyman receives for his milk and the Class III futures price itself.

A significant difference between how federal Class III and California Class 4B are priced is the fixed whey portion of 4B. The fixed price in 4B decreases the correlation between the two prices and, when you reduce the correlation, you reduce the effectiveness of the margin management tools that are available to these dairymen.

If all of you could please maybe take a look at Figure 1. So in this graph that you're taking a look at is historical federal and California whey factor prices from April 2005 to current. In black you have Class III whey factor, in red you have Class 4B whey factor. And what we’re looking for here is a good relationship between those two lines. Prior to 2008 you can see those lines moved pretty close together. After 2007 the correlation between them was reduced quite a bit.

Also kind of remember that figure as we kind of go through these next couple.

There’s three different proposed changes to the why formula. We’re going to start with Dairy Institute of California, their whey formula proposal that’s Figure 2. What we did here is we applied their proposed formula to historical NASS whey prices as laid out in their proposal. The idea was to see if this formula had been in place how well California whey factor prices would have related to federal and you can see -- (indiscernible) I think the graph speaks for itself.

We will turn next to Figure 3. Same idea here with Land O’Lakes. Took their proposed whey formula and applied it to history Dairy Market News Western Mostly Dry Whey prices back to 2005. In black you have the Class III whey factor, and red you have the kind of “what if” analysis with Land O’Lakes proposed formula. You see the lines move pretty well in sync with each other beginning with kind of January of 2008 and give or take through maybe December 2010. However, what you have with Dairy Institute of California and Land O’Lakes, both formulas what they somewhat have in common is a minimum and a maximum structure whereby not -- once whey prices get to a certain level that it becomes fixed.

And kind of the reason, I think, we’re here today is because of the lack of correlation, the correlationship between the current fixed value of whey and that of the federal. Remember, if the two lines can move together you have a better relationship, the risk management tools that are available to you become more effective. Whenever a minimum or maximum whey factor is introduced, there is a potential for a significant disconnect between both prices.

Now, again, this is kind of a “what if” analysis going backwards, you know. This is not to say that whey prices are going to go above or below; I don’t know.

Figure 4, Western United Dairymen, so a little slightly different formula that’s been proposed by them. You here -- here you see really from 2005 through current these prices have a pretty high correlation with each other, they have a pretty good relationship with each other value wise. I think that chart in itself does speak for itself.

You know, what this boils down to, if we can just take a look at Figure 5. This graph actually kind of helps me with my conclusion, kind of wrapping it all together. What you're looking at here is federal Class III and California Class 4B historical prices. These are the announced price, you know. When we’re looking and we’re talking whey factor, whey contributes to these prices. It’s one piece of the final price.

You can see -- I mean, if you kind of look at it, sometimes these are hard to read, but before 2008 you saw a pretty good relationship between Class III and federal -- I’m sorry, federal Class III and California Class 4B. Post-2007 you start to see a disconnect.

I’m not going to say that that disconnect that you guys were looking at, you know, after 2007 is only attributed to the whey factor as it is today, but I would say with a pretty good degree of confidence that it has contributed to that.

In closing, dairy producers need effective tools to help them manage margins. The closer California whey values track with federal whey values the more effective risk management tools are.

That concludes my testimony. Thank you.

HEARING OFFICER MAXIE: Very well. Would you like the opportunity to file a post-hearing brief?

MR. FREIBERG: Please, if necessary.

HEARING OFFICER MAXIE: Very good. Any questions from the panel?

MR. EASTMAN: I have a question. When you look at Figure 1 of your testimony it shows how that prior to the implementation of the 25 cent fixed whey factor there was some sort of relationship, that correlation between the whey values in both systems. The question I have is when you look at that prior to the implementation of the fixed factor, do you think that that relationship corresponded to risk management tools being effective in general? Was that period of time -- did the effectiveness of risk management produce those? Was it better then than it is now, or was that not good enough, or how would you read it?

MR. FREIBERG: Yes. The approximate correlation between federal Class III in this time frame, April 2005 to December 2007, between over base and federal Class III was approximately 97 percent, approximately 97 percent correlation. And I want to say between Class 4B and Class III from April 2005 to December 2007 it was about 96 percent. So, to answer your question, yes.

MR. EASTMAN: Okay. And you mention -- now, did you say that your company has been around since ’99 or so or --

MR. FREIBERG: That’s correct.

MR. EASTMAN: Okay. And then did you have producers that worked with you in California prior to ’07, before that change in the whey values?

MR. FREIBERG: In 2007 and 2006 a handful, not too many. I didn’t join the company until after 2007.

MR. EASTMAN: Gotcha, okay. I think that kind of --

HEARING OFFICER MAXIE: All right, very good. Thank you.

The next witness will be Greg Dryer from

Saputo Cheese. Thank you. For the record, if you would state your name and spell the last name.

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

HEARING OFFICER MAXIE: And you handed us a copy of your written testimony. Would you like that entered as an exhibit in the record?

MR. DRYER: Yes.

HEARING OFFICER MAXIE: Very well. It will be entered as Exhibit number 60.

(Thereupon, Exhibit 60 was received and entered into evidence.)

Whereupon,

GREG DRYER

was sworn and duly testified as follows:

MR. DRYER: Mr. Hearing officer and members of the hearing panel, my name is Greg Dryer. I’m Executive Vice President of Industry and Government Relations for Saputo Cheese USA, Saputo. Our company, Saputo, has 15 manufacturing facilities across the United States, five of which are located here in California. Four of the five California plant purchase milk for the manufacture of cheese. The fifth plant utilizes cheese from our own plants and form that of other companies for further processing and packaging.

We employ over 1,000 people in the state and purchase a substantial portion of the state’s milk production both directly from farmers and from farmer cooperatives.

I’m here to testify in opposition to the Land O’Lakes, Inc., Class 4B proposal filed with the Department on May 24th, 2011, as well as the alternative proposal submitted by Western United Dairymen dated June 10th, 2011.

With regard to the manufacturing cost and f.o.b. adjuster elements of the proposal, we support and defer to the testimony submitted by the Dairy Institute of California on behalf of its constituent members.

Our position relative to the whey portion of the Class 4B formula is that no change is warranted. This topic was thoroughly vetted at the October 2007 hearing, after which the hearing panel recommended a fixed when factor of 10 cents per hundredweight. The Department’s final decision stated the following: “Replacing that highly volatile dry whey factor with a fixed whey value of 25 cent per hundredweight will provide a fixed value to producers and will help avoid the negative consequences of volatile prices that impacted small cheese processors in 2007.” Because the decision was controversial, the Secretary appointed a whey review committee comprised of 14 dairy industry members, seven producer and seven processor, to review the issue. The committee studied the issue for seven months and recommended no change by the Secretary to the 25 cent fixed factor.

Since the whey factor was implemented in December 2007 and for the ensuing 42 months ended May 31st, 2011, 17 months resulted in a higher price to producers than under the old formula, and 25 months were lower. It wasn’t until February 2011 that the cumulative average difference between the two formulas crossed over into negative territory due to the recent high market price for dry whey. For the 42 month period, the cumulative average difference amounts to 10 cents per hundredweight. The tradeoff, of course, is that producers bear no risk of either operating losses due to low markets or capital losses due to technical obsolescence. Whey processing requires massive capital investment and markets are rapidly evolving.

Now, I've included a column chart showing the difference between the fixed whey factor and the old variable weight factor in the 4B formula, and you can see from the columns that 17 of the first 19 months were position, and of the ensuing months most of those have been negative. But the cumulative effect, which is shown by the line on the graph, crossed over into negative in February and is not at an average of 10 cents per hundredweight for the period.

It should be noted, however, that the latest, the 2006 CDFA manufacturing cost survey released in September 2007 pegged the dry whey powder manufacturing cost at 30.99 cents per pounds. If the dry whey manufacturing cost allowance in the variable whey factor were updated to that most recent cost, then the analysis would show that producers received an average of 15 cents per hundredweight more than they would have under the old revised formula. An equal number of months would be positive as the number of the months that were negative.

For those who would argue that the California whey manufacturing cost was too high, I would submit that the total cost of producing cheese and whey for any plant is objectively known and indisputable. However, since many of the costs of cheese and why production are joint costs and their allocation between the two process is arbitrary, a change in that allocation simply results -- results simply in reducing one cost while raising the other.

Attention has been drawn to the fact that the USDA whey make allowance was lower than that of

California. At the same time, the cheese make allowance is higher under the USDA than it is in California. The point is that the two costs are inextricably linked so that if the whey cost in California is too high, then by definition the cheese cost is too low.

And following I have the same chart showing what it would have looked like with the 30.99 cents make allowance, and it shows that the average difference between the two would be a positive 15 cents of price enhancement of 4B price.

If the Department were to conclude that change to the whey factor is justified, then Saputo would support the alternative proposal submitted by the Dairy Institute on June 10th, 2011.

In making the decision we would ask that the Department consider the following facts. The horrible farm economics that dominated 2009 and early 2010 have largely corrected themselves. The free market, when allowed to operate, will eventually correct imbalances and inequities, albeit not necessarily on the timetable or with the sensitivity that we would prefer. Efforts to manage outcomes, however, invariably produce unintended consequences and potentially undesirable long-term effects, such as discouraging future processing investment or threatening the viability of small plants. The following June 7th chart from Blimling Associates illustrates the history and forecast movement of overall producer margins. Margins above the red line typically signal growth conditions.

And I think you can see there’s a trend of improvement that has taken place since 2009.

Milk product in California has resumed its steady rise with year-over-year increases in each of the last 13 months. Most recently, May rose 3.7 percent or 5-million pounds per day. I have a chart there showing year-over-year growth in milk supply.

USDA’s Economic Research Service reported that California’s average cost of production declined by $4.19 per hundredweight from 2009 to 2010. More recently, costs have moved higher again but so too will prices with major commodities over $2.00. And I've included there a chart showing month by month of the California cost of production along with a comment that came from the California Dairy Information Bulletin.

When comparing California prices with USDA prices, note that fluid milk is a very local product and that cost structures vary considerably by region. According to the USDA’s Economic Research Service May 6th, 2011, report, California’s cost of production was

$4.11 per hundredweight below that of Wisconsin in 2010, and $3.31 below the national average. At the same time, the California all milk price was just $1.47 below Wisconsin's and $1.55 below the national average, suggesting a more favorable climate in California than in other regions.

While current feed prices have escalated dramatically, so to have forecasts for milk prices into the future. Exports are providing a significant lift to overall price levels. Since more than a third of California's milk solids are utilized in the higher priced Class 4A, farmers are receiving a much needed boost in the all milk price. Class III futures for the remainder of 2011 average over $3.00 per hundredweight more than the same period in 2010, and calendar 2010 prices averaged $3.00 higher than those of calendar 2009.

I noticed this morning the futures, the Class III futures for July are at $20.50.

California cooperatives have largely existed or avoided the cheese business, presumably because they found it to be insufficiently rewarding financially. It seems reasonable then to question the fairness of thereafter lowering the Class 4A butter/powder price while at the same time raising the 4B cheese/whey milk price.

Significant changes to basic price formulas after hundreds of millions of dollars have been invested can have a chilling effect on the potential for further investments. Apart from milk prices, California offers a challenging business climate with high costs of doing business relative to other regions.

The urgency for producer economic relief has long since passed and the same issues remain regarding the equitable valuation of the whey stream as did in 2007. We, therefore, ask that the Department reject the petitions filed by both Land O'Lakes and Western United Dairymen and make no further revision to the California Class 4B price.

That's my testimony and I would request permission to file a post-hearing brief if warranted.

HEARING OFFICER MAXIE: Your request is granted. Questions from the panel?

MS. GATES: I have one question. Which market do you think more accurately reflects the dry whey cost or prices received, the Dairy Market News or the NASS price? Do you have --

MR. DRYER: Well, I would suspect that the NASS survey price tends to be more reliable since it's audited, so --

MS. GATES: Okay, thank you.

MR. DRYER: I guess I’d make one further comment that the conjecture relative to the F&A situation is completely erroneous as evidence by the fact that they were in default on their producer obligations.

MR. EASTMAN: I have a couple questions for you. Do you produce dry whey outside of California?

MR. DRYER: Yes.

MR. EASTMAN: Is it possible -- I know you, in following up with Candace’s question, you sort of mentioned that you suspect that the NASS price series is more accurate of, like, prices of the dry whey. I was wondering if you could look at, in your post-hearing brief, look at your experience with the prices you get for dry whey and make some sort of general -- well, I mean, the (indiscernible) in the proprietary information, but make a statement. Because it appears that you're one of the few processors that actually makes dry whey both in California and the rest of the country so you may have some perspective there.

MR. DRYER: I can look at that.

MR. EASTMAN: Okay. And then I have another question. When I look at, on page 6 of your testimony, you show a chart of California cost of production and you reference it in your testimony. It looks like that you used USDA's cost of production calculations, is that correct?

MR. DRYER: I believe that's correct.

MR. EASTMAN: Was there -- the Department here also releases cost studies on the farm. Was there any reason why you would have used theirs compared to ours?

MR. DRYER: I think when I looked at the state's they were published on a quarterly basis and I was looking for monthly information, so the only place I could find that was USDA.

MR. EASTMAN: Gotcha. I guess I'd make one other comment, if I could, relative to milk being traded at below order prices. That situation comes and goes depending on the amount of excess milk on the market. And I'm referring back to my experience in the Midwest. But historically it's very often the case, in my experience, that milk is traded below class prices in the Midwest, maybe not recently because there's been an increase in capacity in the upper Midwest that's kind of outrun the existing supply in the short run. But in the long run it's pretty common, I would say.

MS. REED: I just have one question and actually I asked it earlier of another cheese plant.

But I’d like to get your take on -- over the past four years how do you feel that the value of and the cost of producing whey have changed?

MR. DRYER: Well, I think that the value depends on the product you're talking about. They don’t necessarily correlate exactly, so they move in different directions, because we have experience with many different whey products. But obviously the whey chart shows that the value of dry whey has been increasing. What I can say in general, value has been increasing and the costs have been increasing also. And one of the big costs, especially when you're manufacturing in California, much of the product has to move back east so you're transporting product long distances, and if you look at the cost of diesel from 2007 compared to today I think it’s something like double.

So, I mean, there’s a lot of costs that have increased at the same time.

MS. REED: Thank you.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Very good, thank you. The next witness will be Ervin Holmes from Challenge Dairy Products.

MR. HOLMES: First I'd like to -- excuse me -- I'd like to apologize to the panel for not having copies. If granted a post-hearing brief I'll submit written copies.

HEARING OFFICER MAXIE: Granted. All right, and if you would just state your name and spell your last name for the record.

MR. HOLMES: My name's Ervin Holmes, H-O-L-M-E-S.

Whereupon,

ERVIN HOLMES

was sworn and duly testified as follows:

MR. HOLMES: Thank you. Mr. Hearing Officer and members of the panel, my name's Ervin Holmes and I'm the President and CEO of the Challenge Dairy Products, Inc. We're a wholly owned subsidiary of California Dairies, Inc., who petitioned for this hearing. I'm here to testify in favor of the proposed Class 4A price formula changes.

Challenge Dairy Products is a marketing, sales, and distribution company headquartered in Dublin, California. It is responsible for the sale of nearly half of CDI's butter production; therefore, we sell roughly 10 percent of the butter produced in the United States. We also sell approximately a third of the U.S. butter exported.

Challenge distributes butter and a full range of dairy products to retail grocers in the Western U.S., to food service customers primarily in California, large food ingredient and food manufacturers across the U.S., and to export customers in over 20 countries around the world. Our business volume has grown significantly in recent years to both drive and accommodate the processing growth of CDI. This has included increasing our market penetration in all of our channels of distribution and expanding the markets we serve, most notably in export.

Our business growth is directly dependent on our parent company's ability to invest in new capacity and to invest in new technology and equipment in order to be able to produce new configurations and specifications of product to meet the varied and changing customer needs. These needs include packaging requirements, which differ by regions of the country, new products that offer consumers new and preferred product feature, and includes the global marketplace where the standard of identity for butter is different than in the U.S. The latter requires unique and dedicated capacity, testing, and quality control to meet international specifications.

All of this requires significant capital investment in plant and equipment as well as in operating expenses to develop and to manage an increasingly diverse and complex portfolio of products. Without support of this investment of capital and the ongoing and increasingly higher costs of operations necessary to compete in the world today, not only would we be unable to grow our butter business but it would also hurt our competitive ability to maintain market share because customers, consumers, regions, and countries demand the latest in product offering and specifications.

This cost of investment in growth capital, the cost of innovation and expansion, is significant and growing. Our growth and leadership position as a company and as a California dairy industry requires the compensation and coverage of these expenses be updated so that this growth and leadership can be pursued, and that our producers' livelihoods, as a result, can be sustained.

This background brings us to this hearing. As you know, the manufacturing cost allowance in the butter f.o.b. price adjuster for Class 4A have not been adjusted since 2008. My testimony has explained the drivers of higher manufacturing costs, and since 2008 data collected and published by the California Department of Food and Ag has indicated that adjustments are warranted. The results of that cost study were published in November of 2010.

We support the proposed changes by CDI as they are consistent with the objective the Class 4A formula should reflect the most currently available cost-justified changes. This applies to not only the manufacturing cost allowances for butter but also to the f.o.b. pricing adjuster for butter as well. The manufacturing cost allowance should be consistent with the actual cost of processing and the butter commodity price should be adjusted by a factor which reflects what California plants actually receive for the products they produce.

CDI’s proposal simply amends the Class 4A formula by increasing the butter manufacturing cost allowance, the weighted average cost for the commodity as published in the November 2010 manufacturing cost exhibit. The Department’s data verifies that the cost to manufacture butter is 18.11 cents per pound, an increase of 2.51 cents per pound over the current manufacturing cost allowance for butter.

To be consistent with past practices, the Department should also consider adjusting the f.o.b.

price adjuster for butter at the same time that it considers the manufacturing cost allowance change. The Department’s data shows the difference was 4.85 cents per pound for the 24-month period ending June 2010.

That is my testimony. Thank you for your time. And I request the ability to submit a post-hearing brief.

HEARING OFFICER MAXIE: That has been granted. Any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: No questions? You're off the hook.

The next witness will be David Ahlem from Hilmar Cheese Company. When you're ready, if you'd just state your name and spell your last name for the record.

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

HEARING OFFICER MAXIE: And you handed us a copy of your testimony this afternoon. Would you like that introduced into the record as an exhibit?

MR. AHLEM: Yes, I do.

HEARING OFFICER MAXIE: Very well, it will be entered as Exhibit number 61.

(Thereupon, Exhibit 61 was received and entered into evidence.)

Whereupon,

DAVID AHLEM

was sworn and duly testified as follows:

MR. AHLEM: Mr. Hearing Officer and members of the hearing panel, my name is David Ahlem. I am the Vice President of Dairy Procurement and Policy for Hilmar Cheese. Hilmar is a cheese and whey products manufacturer with locations in California and Texas. In California Hilmar processes approximately 12-million pounds of milk per day, about 10 percent of the milk produced in California, and purchases milk from over 235 dairies. Finished products are sold to over 60 countries around the globe.

Hilmar Cheese Company was formed in 1984 by a group of innovative market-oriented 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 opposes the petition from Land O'Lakes and the alternative proposal from Western United Dairymen.

As a member of the Dairy Institute of California, we are supportive of their alternative proposal over the others, but express concern with any move towards a more intrusive regulated pricing. Hilmar Cheese believes in low regulated minimum prices that allow markets to efficient set high market-drive prices.

High regulated prices encourage supply growth and discourage investment in capacity. Just a few years ago California experienced an extended period of time when milk production exceeded the states' manufacturing capacity. Excess milk had to be shipped out-of-state or dumped on the ground at a significant cost to producers.

After a decline in milk production in 2009, due to extremely poor farm level economics, California milk production is once again growing. Our internal projections suggest processing capacity growth has not kept pace with the growth in supply. Processors were already stretched to process available milk this spring. Hilmar shipped milk out-of-state for a period of time during the spring flush due to limited available processing capacity. With no significant expansions in capacity on the horizon, we expect supply to exceed processing capacity next spring if growth continues at its current rate.

It is imperative that California establishes regulated prices that are low enough to allow surplus milk the clear the market. An artificially high minimum price in California will encourage continued over-supply and prolong periods of low prices during over-supply conditions. This is exactly what California experienced in 2008 when milk went to the ground without a viable market. The regulatory system should be activated to clear the market, not create the market.

Recent history also indicates that the states' cheese processors have not had financial incentive to expand in California. In fact, the opposite appears to be true. National American cheese production and processing capacity within the state has fallen during the past five years with two large cooperative-owned cheese plants closing their doors: DFA-Corona and LOL in Tulare. This is clearly not the picture of a California industry with great financial incentive to expand.

The story outside of California is much different. National American cheese production and capacity has grown in recent years. In the fall of 2007 Hilmar Cheese Company participated in this out-of-state growth with the opening of our facility in Dalhart, Texas. Although milk supply was available in

California, we chose to invest in a region where we could operate outside the constraints of regulated pricing and, thus, be better positioned to complete with our primary domestic and international competitors.

Milk supply is again approaching processing capacity and national American capacity in the state is declining. This is not the right time to raise the regulated minimum price and discourage investment in capacity.

Regulated prices distort market signals. Regulated prices and the resulting component values assume all milk is the same. Hilmar Cheese Company pays for milk on a component yield formula that results in significant value above the minimum price. These premiums are based on levels of milk protein, yield, and milk quality, which are all very important to a cheese plant. A low regulated price allows us to pay high market-drive prices and send those premium dollars directly to the producers who have invested in the facilities, genetics, and management practices that generate the high value milk the marketplace and Hilmar Cheese desires.

Minimum regulated prices do not stop processors from paying more than the minimum prices.

Let me say that again. Minimum regulated prices do not stop processors from paying more than the minimum price. Producers and their cooperatives, who control 85 percent of the milk in the U.S., can negotiate for more when the market dictates. If allowed to function, the marketplace will drive premiums and establish a value for milk above and beyond the regulated price, which often occurs today.

Increasing the regulated price will effectively pool premium dollars being paid by handlers, creating a further disconnect between the marketplace and the price signals a producer receives. This inhibits our ability to send price signals directly to the producers who produce the type of milk the market demands.

If we increase the regulated minimum price, our producers will lose. The value they have created will be redistributed through the pool to others who have not invested in producing what the market wants. In our rapidly changing global marketplace, it is essential that we do not mute these market signals and continue to incentivize processors and producers to produce the products and milk the market wants.

High regulated prices stifle innovation and new product development. Regulated minimum pricing formulas stifle innovation and new product development. These formulas discourage processors from producing new products by introducing considerable risk when the price of the products they process or produces deviate from the products used to set the regulated price. Increasing the whey factor contribution will further contribute to this risk. This impacts business decisions and Hilmar Cheese and others consider further investment in California. This disconnect was one of the key reasons our company decided to invest in a facility outside of California where we had the opportunity to opt out of the regulatory system. It also tends -- it also tends to lead the risk averse to over supply the market with products it does not want and further decrease the value of milk.

Furthermore, artificially increasing the minimum price of milk does not increase the real value of milk. The only sustainable means of increasing real value in the global marketplace is to develop products the marketplace demands. Our industry remains weak in terms of value creation and innovation. This has been to the detriment of dairymen.

Instead of creating value, many in our industry have been trained to go to the regulated system to get more out of milk. Attempting to extract value from those processes who still have viable business propositions via an increase in the regulated price is not the solution. Instead, we must develop a regulatory system that incentivizes processors to invest, innovate, and develop new products which increase the value of milk long term.

Competitive environment: California cheese processors compete with out-of-state cheese manufactures in unregulated markets. The proposed minimum price increase puts California cheese processors at a further disadvantage to our primary competitors in unregulated markets, both domestically and abroad. Outside of California most cheese and whey processors operate, or have the option to operate, outside the confines of federal price controls. In the unregulated markets, our competitors are not obligated to pay minimum prices or pay for milk according to their end product pricing formulas.

Increasing the regulated minimum price and initiating a whey contribution that is indexed to an end product that most cheese manufacturers in the state don’t produce puts most of the cheese industry, including Hilmar Cheese, at a competitive disadvantage. I’ll add to that as well that it’s not just an issue of California versus the U.S. More and more we are competing every day and our products are being compared to every day global competitors as well. And they operate, such as Oceana, our competitors, Australia, New Zealand, operate outside of regulated systems such as ours as well.

Hilmar Cheese Company -- 4B make allowance decrease in regards to the Hilmar Cheese Company recommends the Department to leave the 4B make allowance unchanged. The current manufacturing cost data it out of date and doesn't reflect the current cost environment. Energy and raw material costs have risen considerably since 2009. If trends continue, we expect the new 2010 and 2011 data to reflect these increases. We request that we hold any 4B make allowance decision until the new cost data is compiled in just a few short months when we have more timely information.

And I would also echo -- it's not in my testimony here, but I echo support for Dairy Institute's thoughts on the f.o.b. adjuster. I do not -- we do not believe there is a fundamental change in the pricing relationship. It is an issue of market timing, the lag effect of pricing, as well as the extreme price cycles we see in that 24-month period. So we would recommend no change. And I think the next

24-month pricing series, which we'll see here in a few months will illustrate that as well.

And industry in transition: many in the industry are recognizing the limitations of regulated pricing and recommending a more market-oriented approach. California should not move towards a more intrusive regulated pricing mechanism at a time when our industry is considering a move away from end-product pricing as a means to price discovery.

Several years ago the CMAB commissioned McKinsey to evaluate the future of the California dairy industry. Their findings, along with the more recent Bain Report, concluded the U.S. dairy industry and California specifically had tremendous export opportunity. They both suggested that the industry adopt market-oriented policy initiatives that facilitate this approach and warned that failure to do so might compromise our competitive position long term.

More recently, Foundation for the Future, a major dairy policy reform proposal driven by National Milk Products Federation, recognized limitation of end-product pricing and is recommending a move to a competitive pay price with no minimum prices for manufactured products. The petitioner has publicly supported this plan and a more market-oriented approach.

More and more the industry is recognizing the disadvantages of our regulated minimum pricing formulas as we compete and create -- attempt to create value in the global marketplace. California would be wise to follow suit.

On behalf of Hilmar Cheese Company and its producer-owners I urge the state to reject the petition from Land O'Lakes and the alternative proposal from Western United Dairymen. 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 market-oriented approach and capture the opportunity that exists in our global marketplace.

Thank you for your time and consideration. I would be happy to answer any questions you may have, and I would like to request the opportunity to file for a post-hearing brief as well.

HEARING OFFICER MAXIE: Your request is granted. Are there questions from the panel?

MR. EASTMAN: I have a couple questions. You mentioned during the spring flush this year you had to send some milk out-of-state.

MR. AHLEM: Yes.

MR. EASTMAN: And so does Hilmar have a production base (indiscernible)?

MR. AHLEM: We do not have what I would call a base program, but we do have caps, contract caps on volume that we accept, and we have for a number of years.

MR. EASTMAN: And so if a producer were to meet that cap, what happens?

MR. AHLEM: We do not accept any milk over that cap.

MR. EASTMAN: Okay. So it’s just a -- it’s just a hard cap then.

MR. AHLEM: It’s just a hard cap. And our caps today are in full force and we have people that have asked to raise those caps and we have declined those for the remainder of the year.

MR. EASTMAN: So in essence because you were shipping milk out-of-state during the spring flush, would that mean that the caps on all the producers exceed your plant capacity or --

MR. AHLEM: Everybody’s bumping up against their cap. And it’s a seasonal dynamic so we have variable -- it’s not an ongoing situation right now but we look for it -- right now we seem to be relatively -- so at the peak seasonal flush you want to be bumping into the cap, you don't want to be doing that in the summer months. But we see going forward -- we're in balance now but that could change moving forward.

MR. EASTMAN: And then does your plant in Texas, does it also pay producers on the same sort of component scales as it does in California with premiums based on certain factors?

MR. AHLEM: Yes. It's different, a different market, but similar type of concept.

MR. EASTMAN: And then is that plant pooled in federal orders?

MR. AHLEM: No, it's not.

MR. EASTMAN: And has it always been a non-pooled plant then?

MR. AHLEM: Correct, yes.

MR. EASTMAN: That's all my questions.

HEARING OFFICER MAXIE: Very good, thank you very much.

MR. AHLEM: Thank you.

HEARING OFFICER MAXIE: At this point we would like to take a 10 minute break and so we'll go off the record.

(Off the record at 3:21 p.m.)

(On the record.)

HEARING OFFICER MAXIE: The next witness

scheduled is Joey Airoso from Airoso Farms.

MR. AIROSO: Good afternoon.

HEARING OFFICER MAXIE: Good afternoon. If you would state your name and spell the last name for the record.

MR. ARIOSO: Joseph C. Arioso, A-R-I-O-S-O.

HEARING OFFICER MAXIE: Thank you.

Whereupon,

JOSEPH D. AIROSO

was sworn and duly testified as follows:

MR. AIROSO: I'm here today as a -- representing many dairy families in this state. Our family's been dairying here since 1912 and on our farm today there's four generation. I just had a grandson born last year so it makes a fourth generation that's on the farm.

We're like a lot of families in this state, we're captive here. We love where we live, our whole family lives here. And unlike some of the processors or -- we don't want to leave, you know. We want to stay here. And we're dealing with the regulations and water, air, and animal wellness, and whatever issues come at us we're willing to deal with it because we like where we live.

But having said that, you know, it's been brought up that we’re on a world market, we’re competing against the people in Wisconsin, we’re competing against the people in Australia, we’re competing against the people in New Zealand, and we have to be able to compete. We respect that we need to take care of the environmental rules in our state and be better stewards of the land, but we cannot be disadvantaged by not getting paid at least close to what the Midwest does or, you know, other countries. We have to be on a competitive playing field.

And today I come here. I ship my milk to Land O’Lakes. I’m supporting them today. I’m also supporting Western United on the whey part of it. I really -- although I commend Land O’Lakes for taking a step forward, I think Western United’s actually -- Western United’s proposal on the whey formula actually gets us closer to being able to compete with the people in the Midwest.

And, you know, as everybody knows here that’s milking cows every day, this ethanol thing’s kind of been a game changer for us in the dairy industry. It’s changed, you know, the costs of our production. My costs in May were $10.50 just to feed my cows. Five or six years ago I could have survived getting $10.50, and now that’s what it costs me to feed my cows.

And so, you know, today there’s been something that I hear, I've been to two or three hearings and always hear questions about the amount of milk supply and concern about being able to pick all the milk up. I think it’s important for the Department to understand that from 1995 to 2005 we had a bubble in this state where a bunch of people, dairy farmers that love what they're doing, live down in Chino, they had to move and move of those guys moved up into where I live, Tulare County, and in the Central Valley here. And they created a bubble. I mean, it was a tremendous amount of milk that came on line for about 10 or 15 years.

And in all honesty, I think the processors got spoiled with that amount of milk that came in and they just got used to the tremendous amount of milk every year, more and more and more. And I've come to the conclusion that they take what we do for granted. I really believe that. Because, in all honesty, the cost makes the whey. The cow is making the product. They're extracting it and I respect that we need each other, but sometimes I feel like they take us for granted. Because when you look at what happened in 2009, we had a hearing here just for 30 cents, I think, for three or four months. And I was upside -- myself, I was upside down $5.00 a hundredweight in July. You can’t cut out enough stuff to get your financial situation in order. I mean, we lost a million dollars that year.

And most -- I've had the opportunity to serve on the Farm Credit West board for the last five years. And so if it was just me, I would just say I wasn’t a good businessperson, I made some bad maneuvers. But I get to see not people’s individual financial data, but about 300 dairies that we finance, and I get to see how the regulators are looking at our industry. And it’s pretty sad when you go to a meeting and the only commodity -- and Farm Credit West is probably one of the most diverse commodity, they have the most diverse commodity groups of any farm credit in the United States, you know, with the commodity diversity here in California. And they only commodity they want to talk about is dairy, how volatile it is, and how, you know -- you get the regulators to come out here from Washington DC and all they want to talk about is dairy and they're concerned about, you know, how we’re getting paid in our state.

And so I think, you know, there’s some real concerns. And I just want -- the last thing I’ll say is I think the growth in this state is going to slow down to almost a crawl. In our area we're seeing, instead of dairies moving in we're seeing investors come in and take out sections of ground and put almonds in. And it's, you know -- now to dairy in the state you have to have X-amount of acres and land is extremely expensive. I just don't see the growth. And I know the processors keep throwing this growth thing at you guys, but I really don't see it. I think, you know, God may give us a little growth, you know.

They talk about how much milk we had this May. We had the most beautiful spring we've ever had since I've been alive and dairied, so Mother Nature gave us a lot of milk this spring. But we're not going to have that every year. And I think, you know, you guys will agree that the regulations in this state -- we've got the dairy industry down to where we're not going to have a lot of growth and so to have concerns about, you know, being able to handle this milk I think is not fair to the dairymen. And besides, I think if you look at the last couple of years CDI and Land O'Lakes both put in base programs, and I think Hilmar had one, too. And you know what, they worked. They were able to plan and settle the flow of milk down.

And so I think it's really our job to, you know, manage that and -- I think as most dairy farmers we just want to get treated fair. That's what we want. We know that we need each other. I can't dairy without Land O'Lakes, Hilmar, all of them. We all need each other. But at some point, you know, there's a saying that I seen the other day: there's only one thing greater than having advantage and that's when you should give it up, you know, knowing when to give it up.

And so I'll just kind of leave you with that note. And I support Land O'Lakes' proposal and I'll leave it at that. Thank you.

HEARING OFFICER MAXIE: Thank you. You don't get off that easy. No, are there any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: I guess you do. All right, thanks a lot.

Next witness is Barry Murphy from BESTWHEY Consulting. Thank you. If you'd state your name and spell the last name for the record.

MR. MURPHY: I'm Barry Murphy, M-U-R-P-H-Y.

HEARING OFFICER MAXIE: Very good. And you handed us a copy of your testimony. Would you like that entered into the record as an exhibit?

MR. MURPHY: Yes, please.

HEARING OFFICER MAXIE: Very good. It will be entered as Exhibit number 62.

(Thereupon, Exhibit 62 was received and entered into evidence.)

Whereupon,

BARRY MURPHY

was sworn and duly testified as follows:

MR. MURPHY: Okay. Mr. Hearing Officer and members of the hearing panel, my name is Barry Murphy and I have worked in California’s dairy industry for the past 21 years in senior manage, corporate environment, and for the past 12 years as a consultant to the whey industry. My background includes Dairy Science and Business post-graduate degrees, technical and operations management, sales and market management, and green field project development and financing. I live in San Francisco, California.

My position on the petitions and alternate proposals: BESTWHEY, LLC, opposing the petition from Land O'Lakes and the alternate proposal from Western United Dairymen. BESTWHEY support the Dairy Institute of California’s alternate proposal, but believes that the current 4B whey factor should remain as is.

Everything stated in my testimony of October 10th, 2007, regarding the 4B whey component pricing and its impact on the state’s cheese industry remains valid today.

The 4B whey component factor continues to be the most critical milk pricing issue and concern facing the future growth and forward planning of California’s cheese industry. Only the largest of California’s cheese companies have entered the whey business via substantial investment.

More than 80 percent of California’s cheese manufacturers fall below the one million pounds per day of raw whey required before a breakeven or a modest return on investment would be considered. Whey economies begin with greater than one million pounds of whey per day.

For the smaller producers, whey disposal costs range from $4.00 to $16.00 per hundredweight. Not one company in California has invested in a new whey powder plan in over 10 years. Whey protein is an option above one million pounds of whey per day, but no one would consider drying the byproduct, whey permeate or lactose, which represents more than 85 percent of whey solids, with less than four to six million pounds per day of whey since the investments are extremely large and the risk is high.

The current 4B whey component pricing for whey of 25 cents per hundredweight of milk provides a fair return to milk producers, is a reasonable price for the small cheese manufacture who cannot realize a return from whey, while providing a reasonable return on investment -- on whey plant investment for large volume cheese makers.

To maintain a balanced distribution of milk into the various milk classes, while maintaining a healthy balance between co-ops and private enterprise, and to attract investment into California’s cheese industry as we become a key exporter to Asia and the Americas, it is important that we maintain the current whey component 4B milk pricing formula.

As a consultant I work with several investment groups considering large scale new cheese project investments in California, and if the Land O'Lakes proposal were adopted then these projects would no longer be financially attractive relative to food industry investment standards. Over the long run, cheese plants have returned more dollars to producers than butter/powder, and cheese plants may attract private equity while butter/powder plants will likely most not -- or will most likely not. Regulatory uncertainty reduces cheese plant investment potential.

The Land O'Lakes proposal states that

“changes would result in a more equitable sharing of the whey’s market value.” And, as an example, I’m going to draw or four data points from the LOL proposal.

So I've laid out a table here that shows the LOL proposal, with the first column is the AOM for the Western dry whey, so ranging from 25 cents up to 38-1/2 cents. And then the proposed 4B value per hundredweight to the producers, beginning with 25 cents, which we currently have. And at that level of -- at that particular level where the whey market would be 24.49 cents, the producer would bet 4.3 cents for his whey while the plants, based on make allowances, would probably lose something in the order of 6 or 7 cents.

And then as it moves up through these four points I've laid out, up to the 38-1/2 cents at $1.00 per hundredweight to the milk producer, the net effect is that the milk producer were received 86 to 92-1/2 percent of the incremental margin realized as, you know, within this tech table.

And I guess my main point is, you know, for the -- you know, an average whey plant is going to be, depending on milk volume, but the base cost for a million pounds a day whey plant’s going to be $20-

million just to take out the protein, 20-million at the very least all the way up to maybe $100-million for perhaps a 6-million pound a day plant.

And this proposal, which is similar to the federal order, proposes that the producer receives from 86 percent to 92 percent of that return and I find that -- that's not fair.

So my points on this are that the LOL proposal is not equitable; two, the LOL proposal is too aggressive and puts a significant and inequitable burden on all cheese plants; three, LOL's proposal will eliminate or significantly reduce adding cheese plant expansion in California.

My conclusions are, one, that the most equitable way forward is to maintain an expansionary cheese industry and to attract private equity investment. The equitable ways to achieve this is to maintain the 4B whey component pricing. Conclusion number two is that the Land O'Lakes proposal would significantly -- will place significant financial strain on California's cheese industry. And my final point is that BESTWHEY supports the Dairy Institute of California's alternate proposal with respect to the 4B whey factor since it provides a credible middle ground.

Thank you. And I request permission to file a post-hearing brief.

HEARING OFFICER MAXIE: Your request is granted. Are there any questions from the panel? Mr. Eastman?

MR. EASTMAN: Mr. Murphy, I have a question for you. As a consultant in the whey consultation, so to speak, you mentioned you’ve been doing that for 12 years.

MR. MURPHY: Yes.

MR. EASTMAN: Have you been actually involved in the process with any plants either here in California, outside of California in their process to invest in whey processing? Have you played an integral part, so to speak, in establishing the plants --

MR. MURPHY: Yes.

MR. EASTMAN: -- or the details of that?

MR. MURPHY: Yeah, I've been involved in those 12 years. Well, actually a little more than 12 years because I was with a co-op prior to that. So a total of 10 or 11 (indiscernible) plants, whey processing plants. So in the last 12 years I've managed, I think, five completely, five projects. So I oversaw the entire projects from start to finish. So from evaluating the project and laying out the business plan, gathering up the financing, reviewing it, reviewing markets and making decisions on what processes to install.

MR. EASTMAN: And that was purely outside of California or have you done that inside as well? As you mentioned, you reside here in cal.

MR. MURPHY: No, I've done this in California also, yes.

MR. EASTMAN: That was my only question.

HEARING OFFICER MAXIE: Any other questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: Very well, thank you very much.

The next witness is Jonathan Kennedy from Farm Credit West. Thank you. If you would state your name and spell your last name for the record.

MR. KENNEDY: Jonathan Kennedy, that’s K-E-N-N-E-D-Y.

HEARING OFFICER MAXIE: Thank you. And you handed us your testimony this afternoon. Would you like it entered into the record as an exhibit?

MR. KENNEDY: Yes, please.

HEARING OFFICER MAXIE: Very well. It will be entered in as Exhibit number 63.

(Thereupon, Exhibit 63

was received and entered into evidence.)

Whereupon,

JONATHAN KENNEDY

was sworn and duly testified as follows:

MR. KENNEDY: Hello. My name is Jonathan Kennedy and I am the Senior Vice President and Branch Manager of Tulare Dairy Center of Farm Credit West. Thank you for allowing me time to speak today.

Farm Credit West has been financing the dairy industry in California for the past 90 years and currently has over $1.1-billion in outstanding loans to California dairymen. I was asked by some of the dairy operations that we finance to discuss the financial trends and impact of the past couple of years on the dairy industry and provide some testimony regarding adverse changes in financial position as a result of this past downturn.

I will share my observations from the end of 2007 to the present. To demonstrate the changes in financial position, I will discuss the changes to the balance sheet and the borrowing capacity of a fictitious dairy with a thousand cows located in a modern facility in Tulare County on 250 acres of farmland to represent the impacts of the economic downturn that started in 2008 and hit bottom in 2009.

As you are aware, there were significant operating losses in 2008 and 2009 as a result of increased feed costs and the significant drop in milk price. What you may not be aware of is the decline in other asset values related to the dairy business as a result of the economic downturn. To compound the problems caused by the operating losses and decreased cash flow, dairy livestock values declined significantly in 2009 and dairy facilities have also decreased in value and further complicated by more sellers than buyers of dairy facilities. The end result is that operations went from strong equity and financial positions -- strong equity and financial positions to many operations going out of business or operations that are significantly weaker financially today than they were at the end of 2007. I will discuss changes in the financial position between 2007 and 2009, and then from 2009 to 2010.

At the end of 2007 the dairy industry was continuing its trend of increased total cow numbers and production. As the result of good profits made in 2007, there was strong demand for dairy cattle and dairy facilities. Dairy cow replacements were worth in excess of $2-thousand a head and some as high as $25-hundred a head. Average values were in the range of

$21-hundred a head for replacement dairy cows purchased in 2007. In addition, strong demand also increased the value of existing dairy facilities to all-time highs. It was a good time to be a dairyman. In addition, agricultural lenders were competing for dairy financing and providing financing against steadily increasing livestock and facility and land value.

The balance sheet on the next page represents the operation having total assets of $9,883,000 and total liabilities of $5,100,000 for a net worth of $4,783,000. The operation has good liquidity with $638,000 in working capital. And from a lending perspective the banker has good collateral margins with an advance rate on the operating line being only 49 percent and a 54 percent advance rate on the land. At the time, lenders were typically providing operating financing up to 75 percent of advance rate on livestock, feed, and accounts receivable, and advance rates from 65 to 70 percent on mortgage loans. Due to the health of the industry and most borrowers, there was lots of competition at the time by lenders soliciting this business.

The next page just kind of shows some -- kind of a pro forma balance sheet, you know, and at the bottom kind of shows a borrowing-based collateral margins there.

In 2008 changes started occurring that started putting pressure on profit margins. The price of milk started trending downward while at the same time feed prices started increasing. By the end of 2008 the price of milk had fallen from $20.17 a hundredweight in December ’07 to $13.38 in December ’08. Fourth quarter feed expenses had increased to $10.43 from $8.53 the previous year.

Milk price continued to fall in 2009, reaching the floor in July of 2009 at an average of $10.01 a hundredweight. The cost of feed starting dropping slightly during this time period, but nowhere close to the drop in milk price.

In the San Joaquin Valley, a typical dairy lost $150 a cow in 2008 and approximately a thousand dollars a cow in 2009, for combined losses of $1,150 a cow. This was across the board, whether they were small operations or larger operations. For a thousand cow dairy, that was a loss of equity of $1,150,000.

During this time period, the value of dairy cattle dropped significantly from the high in 2007. By the end of 2009 cow values dropped from $21-hundred a head to $13-hundred a head. Heifer values also dropped. For a thousand cow dairy with replacements, livestock values decreased $1,160,000, further reducing their ability to absorb losses due to reduced borrowing capacity. Many operations resorted to borrowing against their real estate equity to continue operations.

In late 2009 the operations started to recover with milk price improving from the low of $10.01 to $15.56 in December ’09. At the same time, feed costs continued to decline and dropped to an average of $7.97 in the fourth quarter of 2009.

On the next page, the balance sheet represents the impact of operating losses as well as the devaluation of livestock values. In this case the operation borrowed an additional $600-thousand on its facility to carry on operations. Working capital had been depleted with a significant increase in accounts payable as a result of bank lines of credit reaching maximum levels and with banks unwilling to extend additional funds to the depletion of the collateral margin. In this case the operation lost $2.3-million in net worth, or $2,310 per cow. The dairyman’s financial position increased significantly from a debt to equity position of 1.07 to 2.34. The bank advance rate reached an unacceptable advance rate of 82 percent, and the advance rate on the land was also maxed out due to additional borrowings against the real estate.

During this time period many tenant dairies went broke as they did not have the secondary equity in real estate to borrow against. It was a time of herd liquidations from CWT and some bank-forced liquidations. For some operation bankruptcy became the only option. Lendable equity was depleted with many operations owing in excess of a hundred percent of assets with lenders having negative equity positions.

Okay. The next page is kind of an example of -- reconciles the drop in net worth from both losses in operations as well as asset devaluation due to livestock.

The recovery in 2009 (sic) was slight with better milk prices and lower feed costs, with average operation returning to profitability in 2010 and generating an profit of a hundred to $150 a cow. Although the situation had stabilized and operations were starting to have position cash flow, the financial duress continued. Many operations put their facilities on the market and some were foreclosed upon by lending institutions. Although profitability had returned, typical dairyman was in the situation of high debts and pressure by their lenders to increase collateral margins. There have been few real estate sales, but indications from current listings and market data, the facility values have declined from 10 percent to 50 percent from their peak values. The farmland related to these dairies has remained constant and may be improved some.

It’s not in the commentary, but that’s part of the result of the other commodity prices are doing very well and there’s demand for farmland.

The biggest impact has been on small dairies under a thousand cows, and large facilities in excess of five thousand cows.

The balance sheet on the attached reflects the change in position from the end of ’09 to 2010. The operation reflects profit from operations of $125-thousand, but the facility value has been decreased by $900 a head due to market conditions, for a total of $900-thousand decline in facility value.

Coming into 2011, operations remain financially stressed. Many operations are outside their borrowing parameters with their lenders and focus is to reduce debts and build margins to withstand the next downturn, which is not a matter of if, but when and how bad. Hopefully we will never see a repeat of 2009.

Thank you for your time. And any consideration that can help the milk prices and increase profitability of California dairymen to recover financially will be beneficial to the long term viability of the industry in California.

And at this time, just looking at our portfolio and some of the dairies, I estimate there’s 20 to 30 percent of dairy operations that really can’t withstand much adversity and they need profits here in the interim to build equity to withstand the next downturn.

And that’s kind of the end of my written commentary in terms of, I guess, us taking a position on the 4B and the proposals here. I think I don’t have enough expertise to say that and say for each, you know, action there’s going to be some sort of reaction and I’m not going to get into that. But in terms of some of the growth I think Joey Airoso alluded to earlier, right now we have no new construction going on in terms of dairies and there’s probably more concern of operations still potentially going broke if there’s a downturn. And, you know, we see more as a trend operations looking to leave the state versus coming to the state, so that’s kind of the -- really end of my comments here.

HEARING OFFICER MAXIE: All right, thank you. Questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: No question. Thank you very much for your testimony.

MR. KENNEDY: All right, thank you.

HEARING OFFICER MAXIE: Next witness is Glenn Wallace form Dairy Farmers of America. Thank you. If you'd state your name and spell the last name for the record.

MR. WALLACE: Glenn Wallace, W-A-L-L-A-C-E.

HEARING OFFICER MAXIE: Thank you. And you handed us a copy of your testimony. Would you like that entered into the hearing record?

MR. WALLACE: Please.

HEARING OFFICER MAXIE: Very well. It will be entered in as Exhibit number 64.

(Thereupon, Exhibit 64
was received and entered into evidence.)

Whereupon,

GLENN WALLACE

was sworn and duly testified as follows:

MR. WALLACE: Mr. Hearing Officer and members of the hearing panel, my name is Glenn Wallace. I am Vice President and Chief Operating Officer for the

Western area of Dairy Farmers of America, DFA. Our business address is 580 North Wilma Avenue, Suite H, Ripon, California. DFA is a Capper Volstead cooperative.

In 2010 DFA members in California represented approximately 20 percent of the farms in the state and 15 percent of the milk production. DFA owns and operates a cheese plant in Turlock, California, and a butter/powder facility in Hughson, California. We understand that dairy farming and all the associated processing, marketing, and distribution businesses contribute significant money to the California economy. Our members are very interested in these proceedings as they have sizable investments in both farms and plants within the state.

My appearance today was authorized by the Western Area Council at their regular meeting on June 27th, 2011.

We appreciate the California Department of Food and Agriculture responding to the industry requests for this hearing and for annually providing information for the industry to use in making proposals for change in milk marketing regulations. No state or marketing region in the country has better, more accurate, and timely data to work with in regulatory proceedings than California and we appreciate that very much.

The hearing petitions and proposals before the Department today include changes to the Class 4A and 4B price formulas. With regard to the 4B price formula we support the alternative proposal as offered by Western United Dairymen and should the Department not find for that proposal then we would support the petition offered by Land O'Lakes. We also support the proposals offered by the Department with regard to increases in the security trust fund charge.

Underlying the changes to the 4B formula that we support is the basic question of how CDFA will treat the contribution of whey in the pricing formulas. We believe the current position that limits the contribution of whey value to the 4B price to only 25 cents per hundredweight undervalues the economic benefits derived from whey marketing and must be revised to more appropriately reflect the value of whey.

DFA members are concerned that the health of the farm sector continues to be stressed by rising costs of mother-in-law production. Reviewing the CDFA cost of milk production studies, published quarterly and summarized annually, feed costs have increased strongly. In the 2010 annual cost survey, feed costs accounted for an average of 57 percent of total operating costs for the 2006-2010 period. However, by the fourth quarter of 2010 the percentage of total costs had increased to 58.7 percent and, for the first quarter of 2011, they represented 61 percent of total operating costs. On a per hundredweight basis, the first quarter average feed cost was $9.03 versus $7.66 in 2010, an increase of 17.9 percent.

In the pre-hearing workshop materials the Department summarized the quarterly feed costs data detailing both the dollars per ton of grain commodity mix and the milk cow hay prices. The first quarter of 2011 showed that the grain commodity mix prices to be the fourth highest of the 21 quarters reported. There is little indication from commodity markets that these costs will be reduced over the remainder of the year and have the potential to continue to rise. We urge the Department to consider this in its decision-making process.

We’ve review the Land O'Lakes study on plant capacity in California and feel the calculations of current average available excess capacity of 80 to 90 loads per day is a reasonable estimate. We feel today’s situation with regard to plant capacity is not the same as in 2008 when for several months we, and most other milk marketers in the state, were forced to send milk to out-of-state processors in order to find available manufacturing capacity.

Also, based on our experience in the field as a significant procurer of milk supplies, there are no new dairy farm facilities being constructed in the state, nor are we aware of any that have come on line in the recent past. Because of our position in the marketplace, we are in constant contact with real estate brokers who specialize in dairy farm facility transactions, and they confirm our experience of no new construction. Furthermore, since 2009 we and our dairy real estate network are aware of only three farms that have changed hands at what we would term an arms-length transaction; in other words, not being initiated by a lender. And thus far this year, none have been closed. Furthermore, where there have been attempts to market existing dairies, valuations have declined severely in the past 12 months.

Section 62062 of the California Food and Ag Code does direct the Secretary as follows: “In establishing the prices, the Secretary shall take into consideration any relevant economic factors, including but not limited to the following: the reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those class prices in relationship to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. In determining the costs, the director shall consider the cost of management and other reasonable return on necessary capital investment."

We encourage the hearing panel to broaden their historical focus in these types of hearings that has mainly centered on plant capacity issues to also be cognizant of milk production factors, and to make sure their decisions and recommendations with regard to price encourage that a more reasonable portion of the revenue stream accrue to the milk supply to maintain a sustainable milk supply in California.

The focus of this hearing is on pricing formulas. Generally the Department publishes the cost surveys; the industry considers the data and may or may not ask for a hearing. If a hearing is called, the Department considers the testimony and may or may not grant a change.

At the last hearing, the Department chose to change its past practice for determining the value of whey to be included in the 4B price. Due to a lack of processors manufacturing only whey powder and, thus, a lack of processing costs to survey, the CDFA hearing panel recommended a change in the way the whey contribution was computed in the price formula and suggested the whey contribution be fixed at 10 cents per hundredweight. The Secretary of Agriculture, in the Determinations, Finding, and Conclusions, and Order of the Secretary of Food and Agriculture, published in November of 2007, retained the fixed factor but set it at 25 cents per hundredweight. Since that time and more recently, it appears that the value as determined at that hearing has understated the value of whey in its contribution to the 4B price by a significant amount, and has resulted in a 4B price that is well below a reasonable level.

The spread between the California 4B prices using the 25 cents per hundredweight fixed whey factor and the federal order Class III price has been estimated by several hearing petitioners and by CDFA. Western United Dairymen has calculated the amount that federal order Class III prices exceed 4B prices over the period of January 2007 to date as $1.02 per hundredweight with 79 cents of that difference attributable to whey. Land O'Lakes reported for the period of January through April of 2011 whey values added $1.46 per hundredweight to the federal order Class III price versus only 25 cents per hundredweight of contribution to the CDFA 4B price.

The pre-hearing workshop materials noted federal order Class III prices were 97 cents per hundredweight higher than 4B prices for the period from 2006 through 2011, and the difference since 2010 averaged $1.31 per hundredweight higher in federal orders. The Department's analysis of the three submitted proposal narrowed this spread over the five-year period from 97 cents per hundredweight to 85 cents per hundredweight (that was the Dairy Institute's proposal), narrowed it to 23 cents per hundredweight in the Land O'Lakes proposal, and it narrowed it to 12 cents per hundredweight in Western United's proposal.

Section 62062 of the California Food and Agricultural Code directs the Secretary as follows: "The formulas shall be reasonably calculated to result in prices that are in the reasonable and sound economic relationship with the national value of manufactured milk products."

We consider this the guideline that directs the Department to regularly contrast CDFA prices with the comparable federal order prices. However, we do not think the Department's effective policy goal for

California farm milk prices should be to allow 4B prices to drop to a level that average 97 cents per hundredweight below federal order Class III prices.

We feel the Department should continue to following past practice of reflecting make allowance cost survey data in setting the make allowance level. To that point we endorse the reduction of the cheese make allowance from the current of 19.88 cents to the survey determined amount of 19.66 cents. We also endorse using the 24-month cost adjustor of negative .0018 as determined in the cost surveys instead of the current negative .0252 cents.

It seems reasonable for CDFA to consider a change in the whey component of the 4B price formula. We would support the Western United Dairymen proposal to use the federal order make allowance data in place of a CDFA cost survey determined factor. CDFA staff was consulted regularly by Dr. Mark Stephenson, then at Cornell University, when the federal order make allowances were determined by his study and presented as evidence at a hearing. In his testimony in July 2007, titled “Testimony on Cost of Processing in Cheese, Whey, Butter and Nonfat Dry Milk Plants,” presented at the Federal Milk Marketing Order Hearing in Pittsburgh, Pennsylvania, Dr. Stephenson noted that the methodology for collecting and summarizing -- summary of the date us used in compiling plants costs closely followed the industry accepted practices of CDFA. It would be reasonable to expect the survey methods used by Dr. Stephenson and by CDFA are similar in operation. As such, CDFA could, with confidence, adopt the federal make allowance data as a substitute for the California data it was unable to obtain.

Note that the Western United Dairymen proposed formula uses only 80 percent of the value resulting from the computation in determining the 4B price. This provides allowances for market variations and, should whey values rise unexpectedly, it creates a buffer for the industry to react appropriate but still allow for a more appropriate portion of the whey revenues to be reflected in milk price.

We also note, as shown in the Western United Dairymen’s testimony, that the proposal results track well with the federal order formulas. This is important for price alignment issues. Again we urge the Department to use this proposal to update the existing 4B price formula.

Should the Department not choose to use the Western United Dairymen proposal, we would endorse the Land O'Lakes proposal. It follows the same calculation with regard to the make allowance and cost adjustor as does the Western United Dairymen proposal. It offers a different approach to the whey computation portion of the formula. It proposes a bracket system to reflect the whey value component. Like the Dairy Institute proposal, it floors the contribution to the 4B price at 25 cents per hundredweight. The operation of the formula moves the whey contribution 5 cents per hundredweight for each 1 cent per pound movement in the whey price. We note that the prior CDFA formula in essence moved the price 5.8 cents per penny of whey price change and the current federal order formula moves 5.9 cents per penny of whey price change. So, as proposed, the Land O'Lakes option should be considered a less than full value incremental movement again leaving allowance for price variation and differences in individual plant efficiencies.

CDFA has already adopted a bracket system, but with only a single bracket. Thus, there should be no reluctance to the use of a bracket system. The LOL proposal offers a cap at one dollars per hundredweight contribution to the 4B milk price, of 75 cents per hundredweight more than the current level. One reason for the cap is to allow for some adjustment with extremely high whey prices and to allow the industry to respond to those higher than typical prices, possibly through a premium structure.

The results of the Land O'Lakes proposal would allow Class 4B prices to lag the federal order prices by 23 cents per hundredweight over the 2006 to 2011 period as measured by CDFA versus the current formula that allows 4B prices to fall 97 cents per hundredweight short of the federal order values. Again, our view is that 97 cents per hundredweight spread is far too wide and a spread of a lesser magnitude is appropriate.

Lastly, we oppose the Dairy Institute proposal as presented. For reasons noted above, we can support a bracket system and agree with their proposal that floors the contribution at 25 cents per hundredweight. However, the full effect of the proposal as reported in the pre-hearing workshop data noted that the 4B prices would still lag federal order prices by an average of 85 cents per hundredweight over the five-year period measured and the annual variation would be more than one dollar per hundredweight in three of the five years measured. We cannot support a public policy that institutionalizes a spread of this magnitude between California and federal order prices as a reasonable solution.

In the future, we urge the Department to study additional methods to develop make cost for the production of whey, whey protein concentrate, and whey protein isolates. We could then revert to the traditional make allowance methodology for computing regulated milk prices.

We would like the opportunity to file a post-hearing brief.

Thank you for listening to our views and I will attempt to answer any questions you may raise.

HEARING OFFICER MAXIE: Thank you. Your request regarding the post-hearing brief is granted.

Are there questions from the panel?

MS. GATES: Mr. Wallace, would do -- did DFA have a position on (indiscernible) proposal?

MR. WALLACE: No, we do not have a position on that. We would encourage the panel to review all the data as related to startup and efficiencies of facilities when they make their determination.

MS. GATES: Okay, thank you.

HEARING OFFICER MAXIE: Other questions?

MR. EASTMAN: Mr. Wallace, yeah, you mentioned that you do have a cheese plant in California and so, as a processing cooperative making cheese, how do you view changes in the Class 4B formula affecting you as a processor or marketer of cheese?

MR. WALLACE: Well, as a marketer of cheese, I mean, it will affect us, you know. It will increase our cost in milk for our facility there but, you know, we still have a good market for our whey product and it is a profitable return that we receive from that.

MR. EASTMAN: Okay. And then there has been some discussion of milk production, how milk production has been coming back especially the last number of months and in the current year. Have you had problems or has DFA have problems with handling the milk supply, for example, through the spring flush time?

MR. WALLACE: There have been periods of time where we had some challenge, was not really related to our capacity but more related to particular downtime that occurred at customers potentially. So, you know, we have not moved any raw milk out of the State of California as a result of any of that.

MR. EASTMAN: So those problems, I guess you could say, were mostly just based on seasonality or temporary issues with plants' customers.

MR. WALLACE: Right, that's correct.

MR. EASTMAN: How do you envision milk production going into the future, say over the summer and the rest of the year, if you could guess? If you could.

MR. WALLACE: Pure speculation. I mean, dairymen today their feed costs are up dramatically. Most of their feed contracts ran out in the early spring and today they're buying their feed hand-to-mouth. They're not contracting feed because of the fact that it’s very difficult to bring yourself to contract $6.00 or $7.00 corn when you traditionally have bought that for $2.00 or $2.50-$3.00. And so they're going hand-to-mouth.

So there’s a lot more risk out there that exists today, there’s a lot more volatility. The banks are looking at how they put themselves in a position to eliminate their risk, where they have quite a bit of their portfolio -- you just heard Mr. Kennedy talk about their portfolios and the challenges that they have. So milk production will be driven milk prices and the margin associated with the difference between the price and the feed costs. And if feed costs stay where they're at, the milk price is going to have to stay up. If feed price recede, if we have change in ethanol policy, all those factors could impact the milk production.

MR. EASTMAN: And I just have one more questions in this series. How’ve you been handling your milk in terms of running into your plants and then also servicing your customers, have you been running your plants at full tilt, have they been running at capacity?

MR. WALLACE: Yeah, our cheese plant has run at capacity. It traditionally runs at capacity as demand customers, so it runs at capacity. Our butter/powder facility has ran at capacity probably for the last 90 days. But the first part of the year we were running at minimal levels there. So it’s really been a lot of change and volatility in milk production just as a result of, you know, the healthiness of the industry.

We’ve had members, kind of as a side note, but we’ve had members that in January, because of the forecast for milk price and whatnot, contracted milk at $14.50. Today that doesn’t look like a very smart decision but at that point in time it looked like that was probably a good decision.

So milk prices have gone up nicely and we’ve had good response from the production side of the equation. We will have another downturn and when we have that downturn I think we’ll have a more dramatic decline in the milk supply than we might anticipate.

MR. EASTMAN: Thank you.

HEARING OFFICER MAXIE: Ms. Reed?

MS. REED: Yes, I just have one question and it’s in regards to -- on page 7 basically just about your last paragraph where you're urging the Department to study additional methods to develop cost studies for different types of whey, like WPC or different things. What seems to be the problem is when the plants produce different varieties of WPC, it’s like there’s no consistency in the percentages and different things like that, 30, 34, 75, 80, all this. So what would be your suggestion when that exists? And that seems to be what’s going on everywhere.

MR. WALLACE: I don’t know as I would have a specific suggestion right here immediately, but in the post-hearing brief I could -- we could potentially put some additional meat on the bone, if you'd like.

MS. REED: That sounds good, thank you.

MR. WALLACE: You bet.

HEARING OFFICER MAXIE: Other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you very much.

The next witness is Rich Lewis from DairyAmerica. Thank you. If you would state -- well, if you'd state your name and spell your last name for the record.

MR. LEWIS: Rich Lewis, L-E-W-I-S.

HEARING OFFICER MAXIE: And you handed us copies of your testimony. Would you like that entered into the hearing record?

MR. LEWIS: Yes, please.

HEARING OFFICER MAXIE: We will do so. It will be Exhibit number 65.

(Thereupon, Exhibit 65 was received and entered into evidence.)

Whereupon,

RICH LEWIS

was sworn and duly testified as follows:

MR. LEWIS: Mr. Hearing Officer and members of the panel, my name is Rich Lewis and I'm the Chief Executive Officer of DairyAmerica, a cooperative marketing association located in Fresno, California.

I'm here today to testify in support of a change to the Class 4B pricing formula, specifically a change to the solids not fat portion of the formula. I support the change as petitioned by California Dairies, CDI, to the Class 4A in relation to solids not fat by increasing the make allowance in the amount of .0286 cents a pound. This change would increase the current make allowance from .1698 cents a pound to .1984 or 19.84 cents a pound.

This change is in line with the Department's own data verifying the cost to manufacture nonfat dry milk as published in the November 2, 2010, manufacturing cost exhibit for nonfat dry milk powder, bulk butter, and cheddar cheese.

The U.S. produce 1.8-billion pounds of nonfat dry milk/skim milk powder in the year 2010 and we are currently 3.83 percent ahead of that production through April 2011. U.S. demand is about 900-million to 1.1-billion pounds of nonfat per year, and California production provides about 50 to 55 percent of the total production of nonfat dry milk/skim milk powder each year.

Doing the math quickly helps us to realize the importance of powder manufacturing plants in California and keeping them viable to provide the important function of balancing the supply of California-produced milk to demand, now and in the future. The numbers also help us realize the importance of the international market to California for California-produced nonfat skim milk powder. I quote the following statements made by Stan Andre, CEO of the California Milk Marketing Board, made at the California Creamery Operators Association on Tuesday, June 28th. I quote, "Exports are a significant market.

California exported closed to 20 percent of its milk solids in 2010. California is the largest export state in the U.S., representing 39 percent of the export volume and 46 percent of the export value. Fonterra estimates that for the next 10 years the global demand for dairy products will grow annually by an amount equal to the size of the entire California dairy industry."

Our own experience in the international markets confirm the information provided by Stan in his CCOA presentation.

Therefore, making sure that California plants producing dairy products manufactured from California producer milk to remain viable is of the utmost importance. More importantly, our experience shows that providing the export market is more complex and expensive than providing dairy products for the domestic market.

Specifications for dairy powders for international markets, whether customer or country required, are much more complex. They require different tests, different specification for packaging, as well as information on the packaging, to name just a few, than powder produced for the domestic supply. Some of the county specifications, we believe, are nothing more than non-tariff barriers to trade. However, customer specifications are functional and are required to meet individual customer product portfolio. Whatever the reason, the complexity and higher costs associated with providing the international market are real. In order to meet these specifications, powder producers are making capital investments in equipment, personnel, as well as reducing run times above and beyond what is needed to meet the domestic market.

California production of dairy products meet and/or exceed specifications set forth by CDFA, USDA, FDA for human consumption, but the additional demands required for international markets put added cost on those plants who provide the valuable function of balancing supply and demand for California milk production.

For these reasons, and based on the fact that the Department’s own November 2, 2010, manufacturing cost exhibit for nonfat dry milk, bulk butter, and cheddar cheese, we support the change to the make allowance for nonfat dry milk detailed at the beginning of my testimony.

I’ll be happy to answer any questions from the panel and we’d like to request the permission to provide a post-hearing brief.

HEARING OFFICER MAXIE: Your request is granted.

Any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: Thank you very much for your testimony, Mr. Lewis.

MR. LEWIS: Thank you.

HEARING OFFICER MAXIE: Next witness will be Xavier Avila.

MR. AVILA: Hello.

HEARING OFFICER MAXIE: Good afternoon.

MR. AVILA: Good afternoon.

HEARING OFFICER MAXIE: If you would state your name and spell your last name for the record.

MR. AVILA: Xavier Avila, A-V-I-L-A.

HEARING OFFICER MAXIE: Thank you, Mr. Avila.

Whereupon,

XAVIER AVILA

was sworn and duly testified as follows:

MR. AVILA: Well, to tell you just a little bit about myself, I've been a dairyman for 19 years. I’m currently in a partnership with M&A (phonetic) Dairies. We ship to Land O'Lakes. I am on the Land O'Lakes board. I've been involved in other trade associations in the past. And I’m also, since tough times are so tough, I do not work on the dairy; I've taken a job outside our dairy and I sell semen to dairies.

So today I would like to talk a little bit about the testimony today, but mostly I want to focus on the plight of the dairy farmer, something that Joey Airoso talked about, from two different perspectives; one from a personal dairyman’s perceptive, the other from somebody that sells product to broke dairymen.

So, you know, just a few things I’d like to say today about the testimony. It’s a little inflammatory because when you see your neighbors going broke and they’ve been struggling for a couple of years now and, you know, one thing comes to mind. Here’s a group that was strong at one time and we’re successful. But now things aren’t. It’s obvious. You guys do cost studies, you know the milk price, you know what we’re up against. You heard John Kennedy talk about the equity lost. There’s no more room for any more equity loss. And so I’m kind of pleading to you, what group is at stake here? Is it this group that’s had equity loss or is it this group?

So forgive my words, all the crying in the room today, there’s a whole lot of crying out there. I see it every day on the dairies. The women that do the bills with a baby on their hip, I talk to them every day. They're 90 days to 120 days behind on their bills.

So another thing that’s inflammatory is when you hear this talk about costs or capacity or, you know, increased milk production, that’s at the expense of equity. That’s at the expense of Allied Industries, the grain companies, tractor companies, feed, farmers that supply that feed, semen companies, kindle companies -- I can go down the line. They talk about their employees, we have employees, too. We have milkers, feeders, breeders, and we have the people that buy supplies from all those things I just listed. They're under stress. This is not just us, it doesn’t just leave us. There’s many salespeople out there that have lost their jobs because of companies reducing employees because there’s no money to go around to keep them all in business.

So when I visit five, six, to ten farms a day and we don’t talk about the product, we talk about how bad the dairy industry and why nobody’s doing anything about it. Well, I’m proud to say as a board member and a shipper at Land O'Lakes I can go around since we’ve -- you guys granted and hearing, and give them a glimmer of hope.

So obviously I’m supporting our petition and I’d also like to say I support the Western United petition. And I would say this: I recommend going after what puts the most back into producers’ pockets. With that said you have small cheese plants here. I hear them. But, you know, there’s hundreds in the upper Midwest. They pay a couple of dollars more in premiums for that milk and they don’t have any whey drying capacity. That gets fed to animals. They're doing fine. They’ve been there for a long time.

You know, the ones that have cheese plants here in the federal orders, they're paying the full price for whey there, but yet when you listen to them today they sound like they're going to go out of business. So there needs to be a proper perspective with this. And I’m passionate about this because I see those hurting people every day. You know, how would you like to listen to this every day, but it’s real, you know. My brother-in-law killed himself a few years ago because of bad financial stress, and another friend, a person I know, dairyman, Land O'Lakes shipper killed himself, too.

So if I want to make any point here today it’s that. So that really needs to be considered, not just dairy families, the stress that’s going on. At night we coined a phrase, it’s called watching the ceiling at night, that means wondering how you're going to pay those bills tomorrow when you’ve got five people that supply you supplies and you don’t got a check for them and they say I can’t bring your “A” unless you have a check.

Now, my company is called Sierra Desert Breeders. We tell they hey, if you can’t pay us this month we’re not going to cut you off, pay us when you can. Not every company can do that.

So think about these people at night, at the end of the month they owe 20, 30, 40, $50-thousand and, yeah, maybe milk prices are up, profitability is up, but that hole that was dug in 2009 is not gone. It hasn’t even been started to be filled yet. And all we need is one more downturn and they're done.

So this whey value, you know, 40 cents on over base from Land O'Lakes, that has an accumulative effect. Dairy families need that equity right now to start building back, filling in that hole before they even can get even again. The common thing I hear is, you know, yeah, I bought a herd of cows, my own, they were paid for and I had to go mortgage them again.

Anyway, I could go on all day. I think you get my point. Thank you for the time.

HEARING OFFICER MAXIE: Thank you. Are there any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: No questions. Thank you for your testimony.

All right, we'll try and squeeze one more person in. Again, we need to have the room cleared by 5:00 o'clock.

So the next witness is Mike McCully from Kraft Foods. Thank you.

MR. McCULLY: The one everybody's been waiting for.

HEARING OFFICER MAXIE: Very good. If you would state your name and spell your last name for the record.

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

HEARING OFFICER MAXIE: Thank you. And you've handed us a copy of your testimony. Would you like that entered into the record?

MR. McCULLY: Yes, please.

HEARING OFFICER MAXIE: We will enter it into the record as Exhibit number 66.

(Thereupon, Exhibit 66 was received and entered into evidence.)

Whereupon,

MIKE McCULLY

was sworn and duly testified as follows:

MR. McCULLY: Thank you, Mr. Hearing Officer and members of the hearing panel.

My name is Mike McCully. I am Director of Dairy Procurement at Kraft Foods in Glenview, Illinois, with responsibilities for U.S. milk and dairy commodity procurement as well as dairy policy issues. Kraft owns a multi-product dairy plant in Tulare, California. This plant produces parmesan and other Italian cheese, dry whey powder, Knudsen cottage cheese and sour cream products, and Athenos Greek yogurt.

Kraft opposes the petition for Land O'Lakes and the alternate proposal from Western United Dairymen. As a member of the Dairy Institute of California, we support their alternate proposal but note some policy concerns regarding it.

To accommodate milk supply growth in the state each year, it is imperative for the continued success of the California dairy industry that the state fosters and builds additional manufacturing capacity. In the last few years, two large cooperative-owned cheese plants have closed. Cooperatives have invested in butter/powder operations but not cheese, and new investment in cheese manufacturing has been limited. Without significant new investment in plant capacity, the California dairy industry will find it increasingly difficult to handle the growth in future milk supplies.

It was less than four years ago that we were talking about the lack of plant capacity in the state, milk being hauled out of the state, or at last resort being dumped on farms. That situation may return within the next year if the current trend in milk production growth continues.

If California's dairy industry is to remain competitive in a domestic as well as growing global market, it is imperative the regulated pricing system foster, not impede, the development of new processing capacity. This new plant capacity will provide a much needed boost to the state's economy by providing jobs and tax revenues.

On whey issues, the addition of a whey factor to the 4B price formula has a long and contentious history. Before 2003 whey was not included in the price formula for 4B milk. In early 2003, in a period of low milk prices, they whey factor was added to the formula, breaking from longstanding Department position on this issue. The hearing panel report noted, "For years the Department has made policy decisions not to include an explicit pricing component for whey in the Class 4B formula. Based on testimony and relevant data, this position has been reaffirmed at each of the hearings that would have been open to recommendations for including a whey pricing component.”

After it was added, numerous problems arose. The hearings in 2005, 2006, and 2007 went into detail on the whey manufacturing allowance, CDFA’s manufacturing cost survey data, and other whey issues. At each hearing the panel’s recommendation was the same: remove the whey component from the 4B formula.

The hearing panel’s report from February 2005 detailed the problem. “As was reported in the January 2003 hearing determinations, the incorporation of a pricing component to the Class 4B pricing formula to reflect the value that cheese operations earn from their skim whey stream, the residual of cheese production, has not been easy or straight forward. The skim whey stream has historically been a waste byproduct of the cheese making process. As the cheese industry has matured and environmental regulations have become more stringent, the development of whey byproducts have become more commonplace by necessity. Still, the investments required to process skim whey stream into value-added products are significant and the financial risks for processing the whey stream into a value-added product are considerable.”

The panel’s recommendation was to remove the whey factor in the 4B pricing formula and was concisely summarized as follows: “The panel is mindful of using a manageable pricing formula. It seems clear from the positions taken by producer and processor witnesses that incorporation a factor for the value of the whey stream appears to be intractable. Given the testimony and evidence before the panel, it would be far wiser to simply remove the skim whey factor from the Class 4B pricing formula than to continue to expand this factor in an inconsistent manner with the butter, and nonfat dry milk, and cheddar cheese pricing formulas.”

Following the June 2006 hearing, once again the panel’s recommendation was to remove the whey factor from the formula for the same reasoning as the prior hearing. “As a result of reviewing the testimony and for the reasons outlined above, the panel continues to support the removal of the whey factor in the 4B pricing formula as it did in the 2005 hearing determinations.”

Unlike cheese, butter, and nonfat dry milk, there is not one standard whey product that is appropriate to use in pricing formulas. The panel’s reports from both 2005 and 2006 hearings detailed this problem. “Whey is one of the biggest reservoirs of food protein and can be made into a wide variety of both food and non-food products. In the food category it can be used in baby food, diet supplements, bakery products, salad dressing, beverages, and confections. It can be made into pharmaceutical products, yeast products, and industrial products. Unlike cheddar cheese, butter, and nonfat dry milk which have defined standards of identity and fairly uniform processes, each of these whey usages require their own unique processing equipment, processing procedures, with vastly different associated costs. While economies of scale are critical in successful whey operations, the panel is mindful that an inappropriate decision on this factor can inadvertently make previously profitable whey enterprise a losing proposition should it over stimulate the production of a particular whey product.”

An editorial by John Umhoefer from the Wisconsin Cheese Makers Association in the August 3rd, 2007, Cheese Market News -- and I've attached that as Appendix 1 -- provides additional documentation of the problem of attempting to value the whey stream.

Of the 90 plants that replied to the WCMA survey, 91 percent did not produce dry whey. About 42 percent of the plants performed minimal processing and received minimal payment for their product. Those plants that sold wet skimmed whey earned 10-20 cents per pound in June 2007 compared to the NASS price of 72 cents a pound -- sorry it was per pound -- 72 cents per pound price for dry whey powder. Most of the remaining plants, 42 of them, performed various combinations of ultrafiltration, reverse osmosis, and/or evaporation to separate whey components and condense whey.

Following the October 2007 hearing, the Secretary appointed a whey review committee with the goal of developing a long term method for valuing whey that was market-based and would signal a proper value for whey that allows both California producers and processors to earn a favorable return from their investments and enterprise. After six months and numerous meetings, the whey review committee could not reach a consensus on a new method, so the fixed whey factor of 25 cents per hundredweight was continued.

The decision to value the whey stream at 25 cents a hundredweight has benefitted dairy farmers for most of 2007 -- I’m sorry -- 2008-2009 when compared to the prior 4B formula. While whey prices increased in 2010 and 2011, it wasn’t until March 2011 that the cumulative break-even point was reached. In other words, the decision in December 2007 to use a fixed 25 per hundredweight whey factor benefitted dairymen for those 40 months when compared to the prior formula.

While noting these policy concerns, Kraft believes the Dairy Institute’s alternate proposal on valuing whey strikes a balance between the needs of dairymen and the competitiveness of cheese makers in the state.

Dairy policy at a crossroads: for the past decade I have spoken about the need for a change to the regulated pricing structure of the California dairy industry as well as in the federal orders. Regulated pricing systems in California and the federal orders were established many years ago with vastly different market dynamics than exist today.

The dairy markets have evolved from local to regional to national to global in nature. Several years ago dairy farmers, through the California Milk Advisory Board, commissioned a study by McKinsey and Company on the future of the California dairy industry. Nationally the strategic consulting firm Bain conducted an extensive of the U.S. dairy industry. Their recommendation was for the U.S. to become a consistent exporter and highlighted the need to update dairy policy to accommodate that vision. We should use those studies as a basis for developing a regulatory system that best serves the needs of today's dairy industry.

I believe the U.S. dairy industry has the potential to fill the growing world demand for dairy products. With 95 percent of the world's food consumers outside the U.S., the potential market is enormous. Unfortunately, outdated regulated systems are holding back the U.S. dairy industry from realizing the full potential of this opportunity. Other countries will eventually grab it if we don't.

Kraft has long believed in transitioning to a less restrictive regulatory environment and feel the U.S. dairy industry would benefit greatly from this change. The industry needs to work together to develop a long-term policy approach for the California dairy industry. Until the California dairy industry embraces more market-oriented policies, dairy producers will lose out on the opportunities in both the domestic and export markets.

The competitive advantage enjoyed by the California dairy industry over the past 25 years is gone. To compete in the marketplace of the future, the California dairy industry needs to adapt to these new realities or lose out.

In summary I would ask the Department to consider the ramifications of the proposals heard today on the future competitiveness of the California dairy industry. Of the petitions and alternate proposals presented, Kraft supports only the alternate proposal from Dairy Institute.

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

I will be extemporaneous for a minute. Before I get the question, maybe I'll answer it. There's been a fair amount of talk today about pooling and depooling in federal orders. As someone who's responsible for buying milk in federal orders, I can tell you that that is a real issue, has been for a long, long time, the ability for a milk buyer to buy milk under class to clear the market. It doesn't happen every day. On some of the earlier folks that testified about -- that there's certain times of the year, for example. Typically this next weekend, the Fourth of July weekend, is one when plants are down, that if milk has to move at distressed levels it will trade under class.

A similar in Memorial Day weekend, maybe Labor Day weekend, especially towards the end of the year when other plants are shutting down, demand is dropping off, milk can and will trade below class to clear the market.

There's also the issue of pooling in California, it's that you're locked in for the year. In the federal orders it's you move in and out every month. So there was some testimony that probably conflict, my statements will conflict with what they said, but that's our view of how things are in the rest of the country.

Another comment I'll add is several people talked about the need for risk management and how the different proposals, particularly on the 4B or specifically on the 4B will have an impact, try to improve the effectiveness of hedging with the Class III milk futures. It's great that we're having that discussion. This is something that we've talked about over the years is the need for more risk management tools and it's great that, you know, some producer groups have done a lot of work. I'll compliment Western United for putting on some educational seminars over the last several years.

Unfortunately, the proposals here today don't solve that problem. They may get it a little better. It still would be basis risk. There's basis risk now, there'll be basis risk tomorrow, there'll basis risk, you know, a year from now. But that’s not unique to California. If we were talking about the Southeast order with high Class I utilization, they have even greater basis risk. The Northeast order, where you’ve got 20 percent Class II utilization, 40-some percent Class I utilization, a mixture of all four classes, also a lot of basis risk versus Class III milk futures. So it’s not just a unique problem to California. This is something that other parts of the country have to deal with.

A solution, which a number of us have talked about for a lot of years, going back into the late 90s, is to allow forward contracting within the system. That happens within the federal orders, you eliminate basis risk because you're dealing directly with a milk buyer and you could contract for the full price so you don’t have as much basis risk or maybe zero basis risk as opposed to using futures.

The last thing I’ll add, and maybe there will be a small cheer go up, but corn prices were down to limit today. There was a USDA report that came out this morning. Corn acres were quite a bit more than expected and the corn stocks level was higher than expected. The July corn price was down 69 cents a bushel to $6.29, September and December were down 30 cents to $6.48 and $6.20 respectively, and 2012 average is $6.23. I can’t do the math per ton as everybody talks out here, but I’m a kid from Illinois, I've got to talk in dollars per bushel.

But my point of this is hopefully we’re not making decisions -- we’ve heard some earlier about what’s projections of corn prices, feed prices are going to be. Hopefully we’re not making decisions today based off of a point in time of what a projection could be. We go back a year ago, we’re looking at $3.50 corn. It turned out to be quite different. The point is we don’t know but a lot of things could change in the next six weeks in terms of pollination through the Midwest. So I just wanted to put that out there as kind of a latest market information today.

Thank you.

HEARING OFFICER MAXIE: Thank you. And your request for the opportunity to file a post-hearing brief is granted.

Are there any questions from the panel?

MR. EASTMAN: I have a question on the comment. Apparently everybody’s so tired there wasn’t any cheers on your corn statement.

MR. McCULLY: Maybe there are a bunch of corn farmers in the room.

MR. EASTMAN: I doubt that. You mentioned that you support the Dairy Institute’s proposal, and they proposed to use the NASS dry whey price series other than the Dairy Market News. And I know that you mentioned that you did produce dry whey in California. I assume you produce dry whey outside of California also?

MR. McCULLY: Yes, we have a plant in New York as well.

MR. EASTMAN: Okay. I wondering whether -- you may not have this off the top of your head but I suppose you can include it in the post-hearing brief or your thoughts on the appropriateness of those two price series, of how they reflect, do you think, whey values. Because obviously California dry whey prices are a subset of both of those, Dairy Market News and NASS, but however they're a small percentages, I suppose. If you could comment on that if --

MR. McCULLY: Sure.

MR. EASTMAN: -- unless you have it off the top of your head.

MR. McCULLY: No, I can tell you off the top of my head. As a general rule I do not like the Dairy Market News price surveys. They're interesting information to look at every week. I have the same concerns that the hearing panel’s had in the past and some other folks mentioned earlier. A phone survey is not a robust indication of the what the market is. An audited weekly report that comes from NASS I have a lot more confidence in. And you also see that that is, in my view, there’s more commercial transactions take place based off of the NASS report than the Dairy Market News survey.

MR. EASTMAN: Okay, good.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you very much for your testimony, Mr. McCully.

If I can go off the record just for a moment.

(Off the record at 4:56 p.m.)

(On the record at 4:57 p.m.)

HEARING OFFICER MAXIE: All right. Once again, that will conclude the testimony for today. We will reconvene tomorrow morning in this room at 9:00 o'clock. In the event that I failed to admit any document, all the documents that have been marked as exhibits so far are hereby admitted into evidence.

Any requests to file post-hearing briefs, if I failed to adequately respond, are granted.

We’ll see you in the morning.

Thank you very much.

(Thereupon, the public hearing was adjourned at 4:58 p.m.)

--oOo--

CERTIFICATE OF REPORTER

I, John Cota, an Electronic Reporter and Transcriber, do hereby certify that I am a disinterested person herein; that I recorded the foregoing California Department of Food and Agriculture public hearing; that it was thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said public hearing, nor in any way interested in the outcome of said matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 11th day of July, 2011.

JOHN COTA