STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

CONSOLIDATED 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 & AGRICULTURE

DEPARTMENT AUDITORIUM

1220 N STREET

SACRAMENTO, CALIFORNIA

JULY 1, 2011

9:00 A.M.

A P P E A R A N C E S

CDFA Panel

Bob Maxie, Hearing Officer

Candace Gates, Branch Chief
Dairy Marketing Branch

Hyrum Eastman, Agricultural Economist

Venetta Reed, Supervising Auditor

CDFA Staff

Amber Rankin

Karen Dapper

Also Present

José T. Maldonado
Marquez Brothers International, Inc.

Sue M. Taylor
Leprino Foods Company

Rob Vandenheuvel
Milk Producers Council

Leonard Vandenburg
Pacific Gold Milk Producers

I N D E X

	Page
Proceedings	1
Opening Comments	
Hearing Officer Maxie	1
Public Testimony	
José Maldonado	1
Sue Taylor	12
Rob Vandenheuvel	24
Sue Taylor	36
Leonard Vandenburg	38
Adjournment	46
Certificate of Reporter	47

E X H I B I T S

		Received
67	Testimony of José T. Maldonado Marquez Brothers International, Inc.	1
68	Testimony of Sue Taylor Leprino Foods Company	12
69	Testimony of Rob Vandenheuvel Milk Producers Council	24
70	Letter from Arthur Schuman, Incorporated 6/30/2011	45

P R O C E E D I N G S

9:00 a.m.

HEARING OFFICER MAXIE: Okay, if we can go back on the record.

Our first witness for the day is José Maldonado. Sorry we couldn't squeeze you in yesterday.

MR. MALDONADO: That's all right.

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

MR. MALDONADO: José T. Maldonado, the last name is M-A-L-D-O-N-A-D-O.

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

MR. MALDONADO: Yes, please.

HEARING OFFICER MAXIE: Very good. That will be Exhibit number 67.

(Exhibit 67 was received into evidence.)

Whereupon,

JOSÉ T. MALDONADO

Was duly sworn.

HEARING OFFICER MAXIE: Very good. You can proceed.

MR. MALDONADO: Okay. Hearing Officer and Members of the Hearing Panel, thank you for having me here. Good morning and thank you for calling this hearing of this very important issue that has effects on many cheese manufacturers like Marquez Brothers International. I am the financial Controller for Marquez Brothers International, Inc. I have worked for Marquez Brothers International for over 14 years. I am based in Hanford, California.

Marquez Brothers' position is to maintain the current 4b whey factor at 25 cents per hundredweight and we are opposed to the petition set forth by Land O'Lakes and the alternative proposal from United Western Dairymen. We are also against changes to the Class 4b Manufacturing Cost Allowance.

Marquez Brothers International's primary business focus is in the manufacturing and distribution of cheese products. Since the foundation of Marquez Brothers in 1981 we have grown our business as demand of our cheese products has expanded. Our particular cheese market demand is highly price sensitive and very competitive. We are in the business of manufacturing Hispanic-style cheese products such as Queso Fresco, Sierra Cremoso, Panela, which is similar to feta cheese, Requesón, Oaxaca, Quesadilla, Asadero, Cotija, Manchego and Menonita. We also manufacture mainstream-type cheeses such as Monterey and Mozzarella. In the cream category we also manufacture Hispanic style table cream and sour cream. These cheese products are very highly labor intensive to make.

I'm just going to pause for a second. Somebody mentioned yesterday in one of their testimonies that the cheese, the specialty cheese, they have a cost advantage. And I'd like to disagree with that notion because it is very labor intensive, it requires specialized packaging and it is not -- how can I say it? The volume, it's not like a cheddar cheese plant so we don't have the economies of scale. And so it's --

You can't compare, make that notion because it is not what you would say, comparable, in comparison to making cheddar cheese. It's not a huge amount of profit to be made there. It is a very tough product to make because it is very labor intensive. The Panela, we make that by hand. A lot of our products, the majority of them we make them by hand. So you, know, compared to a cheddar cheese plant. So I just wanted to, you know, clarify that and explain that to you.

Marquez Brothers reluctantly -- oh, let me finish the last part of the paragraph here. We also make and manufacture drinkable yogurts, smoothies and stirred yogurt products. And as I said, we are located in Hanford, California.

Marquez Brothers reluctantly invested in a whey plant in 2004 since the investment cost was more than any other investment Marquez Brothers has ever made. The decision was driven primarily by the rising environmental concerns with whey disposal and the cost of whey disposal, not the projected financial return. Furthermore, Marquez Brothers is in the cheese business and the whey business was outside our core competencies. We didn't know anything about the whey business. It's something that we got forced into to do it, to resolve an environmental issue we had. This was a necessary but unwanted investment decision. With respect to making whey-processing investments, within the industry it is generally acknowledged that a plant must produce at least one million pounds of whey per day in order to reach the economies of scale necessary for the whey plant investment to break even. Adoption of the Land O'Lakes petition will result in an extinction of California's small cheese producers. During the first three to four years of whey operations we did not see any profits. Even for companies like ours that have some whey processing capabilities, growth in cheese manufacturing and distribution will be severely restricted should we experience further losses in our whey processing business.

The financial impact of the whey component: Cheese whey disposal has always been a burden and an environmental problem, costing Marquez Brothers $1.5 million to dispose of the product with zero revenue value and no milk allowance in the 4b price to recover the whey disposal costs over the years. I repeat, there was no real recognition for our whey disposal cost losses in the milk pricing formula.

Historically, whey powder values compared to the whey protein concentrate values were similar when calculated on a price per pound of protein basis. This led us to a decision in 2004 to finance a whey protein plant only. This decision was driven by two factors:

The environmental problems associated with the whey disposal would be alleviated and Marquez Brothers International could focus on growing their business.

I want to just pause here for a second. We were getting, for example, 20 truckloads of milk. We had a final weight to dispose of of 18 truckloads of whey. It is very difficult, it's very challenging. So we couldn't focus on our business because we also had to focus on disposing of the whey and this was a solution for us.

The pricing history in 2003 indicated that the revenue stream from WPC-80-only would be similar to a whole whey powder plant and therefore justified as building the WPC-80-only plant, while disposing of concentrated permeate as animal feed.

Now should the Land O'Lakes petition be adopted, we will be in serious trouble because we do not dry the permeate fraction and don't have the ability to fund a $35 million permeate drying facility so we will be unable to capture revenues to keep up with the rising milk cost proposed in the 4b whey component formula. In time, when additional plant capacity is needed, the state's regulated milk pricing formula applicable to cheese plants will discourage investment in cheese plants and WPC plants and will make it difficult for some plants to continue operations.

I really do see that if we do implement those petitions that will kill the cheese industry. It will be a very sad moment in time here in California. We will not be able to see additional cheese plants grow. As it is I think it is a healthy balance to have more cheese plants come in and grow the cheese industry. And that's not happening.

As I mentioned earlier, Marquez Brothers International, Inc.'s primary focus is on cheese manufacturing and distribution. Prior to constructing the whey plant our cost to dispose of the whey component for the years 2000 to 2005 was approximately $7.5 million, or $1.5 million per year.

The whey protein plant was completed in August 2005 for an investment amount of approximately $20 million. Despite our multi-million dollar investment to alleviate the environmental problems associated with the whey we have not seen a return on that investment. Our total loss incurred from 2005 to 2007 mainly due to the whey component is approximately $7 million. To date we have not yet recovered from these losses and we are years away from ROI. Why? Not enough volume.

Cheese pricing at the consumer level has become much more difficult to price out to our customers because we can no longer gauge ourselves based on the CME cheddar cheese prices. The whey component distorts our margins and pricing mechanisms. The whey component factor in the 4b formula significantly increases the price of our number one raw material, milk, and whey prices have no correlation to the CME cheddar cheese prices. However, the cheddar cheese price has a direct correlation to our cost per pound of milk and cheese. We are in the cheese business, not the whey business, and our milk cost should be based on cheese.

Keeping the current whey component price in the 4b milk price will provide markings for cheese makers to invest the millions needed to keep plants operating, to invest funds in research and development that will lead to innovation, new products and expanded markets for cheese. It will also provide an incentive to maintain and increase cheese plant capacity.

Conclusion: Adopting the Land O'Lakes petition for 4b whey component pricing policy will discourage cheese plant investment and will near-term plant capacity at risk at a time when plant capacity growth is essential to the continued health of both producers and processors. Milk producers are not contributing to the investment required to process whey and alleviate the environmental problems associated with the whey. We want to see the whey component of the 4b formula unchanged unless the milk producer is prepared to contribute to the capital investment required to handle whey. We take all the risk in processing the whey, producers don't. We make the capital investment in whey manufacturing facilities, producers don't. We take all the losses in weak markets, producers don't.

In your role as regulators and policy administrators from the California Department of Food and Agriculture we are asking you for your assistance in maintaining an unchanged 4b whey factor. It is not sustainable for us to adjust to the Land O'Lakes petition and to suffer further financial losses. Compounding our problems due to the whey component in the Class 4b milk formula we are confronted with ever higher energy, labor, resin, petroleum-based packaging materials and worker compensation costs to operate in California, which has made it much more difficult to be competitive. For all these reasons we also do not support the changes to the Class 4b Manufacturing Cost Allowance.

Given the serious threat that continuation of the current pricing formula poses to California dairy farmers and cheese makers we implore the Department to leave the 4b prices unchanged. CDFA must protect the dairy industry; and the inclusion of the whey factor in the 4b price is a recipe for catastrophic disaster by threatening the ability for cheese manufacturers of all sizes to continue in the dairy business.

Thank you for the opportunity to be here today. I would answer any questions you may have and I would like to request an opportunity to file a post-hearing brief.

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

MS. GATES: When you guys put in the new whey processing plant.

MR. MALDONADO: Yes.

MS. GATES: And you were saying about a million pounds is what is needed to break even. I'm assuming you're kind of right there or right underneath it.

MR. MALDONADO: Right, that's right.

MS. GATES: And that's the issue?

MR. MALDONADO: Yes.

MS. GATES: Okay, thank you.

MS. REED: I have maybe a couple of questions for you. You mention in here prior to putting in the whey facility you were having disposal fees of about $1.5 million a year.

MR. MALDONADO: That's correct.

MS. REED: Okay. And then after you have gotten this -- and that's through sewage and, you know, all of those bills. How has having the facility affected that particular area of your expenses?

MR. MALDONADO: Well, obviously we're not disposing anymore, we're actually processing now.

MS. REED: Exactly.

MR. MALDONADO: Yes.

MS. REED: You're processing your whey but you're still having -- not disposal but your sewer and different things like that.

MR. MALDONADO: Yes, you're absolutely right, yes.

MS. REED: That's where --

MR. MALDONADO: We do have that expense. Obviously that whey water, it is continuing to go to the city.

MS. REED: Exactly.

MR. MALDONADO: So expenses are continuing to be really high, absolutely.

MS. REED: They are still up quite a bit.

MR. MALDONADO: Yes.

MS. REED: Okay. Let's see. You mentioned also about the investment that you made into, into the whey facility. I don't recall now what you said. And that you have not realized anything from your return to investment.

MR. MALDONADO: Right.

MS. REED: What about with your whey sales, how is that going? The whey that you are processing, are you making any profit from the sale or are you cutting even? How is that affecting the plant?

MR. MALDONADO: The losses we have incurred in the first four years, we have not been able to recapture. The profits we have been getting the last couple of years have not been enough to offset the losses from the first several years of operation.

MS. REED: Okay, okay, thank you.

MR. MALDONADO: Thanks.

HEARING OFFICER MAXIE: All right, thank you very much.

The next witness is Sue Taylor. All right, if you would state your name and spell your last name for the record.

MS. TAYLOR: My name is Sue Taylor, last name T-A-Y-L-O-R.

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

MS. TAYLOR: I would, please.

HEARING OFFICER MAXIE: Very good, it will be Exhibit number 68.

(Exhibit 68 was received into evidence.)

Whereupon,

SUE M. TAYLOR

Was duly sworn.

HEARING OFFICER MAXIE: You may proceed.

MS. TAYLOR: I am Sue Taylor, Vice President of Dairy Policy and Procurement for Leprino Foods Company. Leprino operates nine mozzarella manufacturing plants in the United States. Three of these are located in California, two in Lemoore and one in Tracy. We also process our whey into sweet whey or whey protein concentrate and lactose. All the whey from our California plants is processed into whey protein concentrates and lactose.

I am testifying today in support of the Dairy Institute of California's alternative proposal for the Class 4b formula. I fully support Dr. Bill Schiek's testimony presented at this hearing. I am also testifying today in opposition to the 4b formulas proposed by Land O'Lakes and Western United Dairymen.

Cheese Manufacturing Cost Allowance: Leprino supports the use of cost-justified manufacturing cost allowances in end-product price formulas such as the formulas used in the Class 4a and 4b formulas. Because the regulated pricing system starts with finished product values while establishing minimum regulated raw milk prices, it is important that at a minimum the manufacturing cost allowances cover the cost of converting raw milk into those finished products.

A review of the Class 4b manufacturing cost allowances less the weighted average manufacturing costs determined by CDFA over the five years immediately preceding the most recent cost study shows that on average the manufacturing cost allowance for cheese fell short of the weighted average CDFA study manufacturing cost by nearly 1.59 cents per pound cheese, equating to 16.24 cents per hundredweight milk converted into cheese over the period. And that is described on Attachment A. This disparity is the direct result of policy decisions that have not always been consistent with the weighted average cost and policy-making based upon lagged manufacturing cost data in a rising cost environment.

The most recently released manufacturing cost data for 2009 shows a cost that is two-tenths of a cent below the manufacturing cost allowance in the current 4b price formula. This represents a 1.3 cent decrease in manufacturing costs from 2008 on a weighted average basis. However, it is important to note that the average total cost increased by 1.05 cents across the higher cost half of the study group. The vastly different cost trends across the two groups necessitate that CDFA carefully dissect the cost data and utilize insights that may not be evident in the aggregated data while determining the outcome of the hearing.

Even if the Department reconciles the disparities across the two cost groups and embraces the weighted average cost from the most recent study, a change in the 4b manufacturing cost allowance is not warranted. The average manufacturing cost allowance in the Class 4b formula fell 16.24 cents per hundredweight short of the actual weighted average manufacturing cost over the prior five year period. Extending the analysis with the 2009 data still shows that the manufacturing cost allowance fell 13.16 cents per hundredweight milk short of the weighted average cost of converting raw milk into cheddar cheese in the Department's own cost studies over the six year period.

A reduction in the cheese manufacturing cost allowance is not justified and the Department should reject the Western United and Land O'Lakes proposals to reduce the cheese manufacturing cost allowance.

Cheese f.o.b. Adjuster: The cheese f.o.b. adjuster should not be changed as a result of this hearing. The market price trend was generally downward during the time period utilized in the most recent price survey released by CDFA. The CME average cheddar price started the period at 55 cents per pound higher than the end point. The pricing practices in the cheese industry range from pricing deliveries relative to the CME price as of the date of manufacture, order or ship. Within these pricing conventions the CME pricing period referenced can range from prior week, two weeks back, to prior month CME averages. These pricing conventions result in a lag in prices applied any given week and elevates survey prices relative to CME prices in downward markets and lowers them relative to the CME prices in upward markets.

This is not an anomaly unique to California cheddar prices. The NASS cheddar price similarly lags the CME on a national basis. Although the average NASS 40 pound block price over the last five years was six-tenths of a cent below the CME block price over the same period it was 1.9 cents above the CME during the period from July 2008 through June 2010, which is the period used in the Department's study. The NASS price has averaged nine-tenths of a cent per pound below the CME during the 11 month period since July 2010. The relationship is quite volatile with individual monthly spreads between the NASS price received by manufacturers and the same month CME ranging from NASS being 22.23 cents above the CME cheddar block price to 21.31 cents below the CME cheddar block price. I will not claim to be a statistician but quickly applied a regression formula to the historical CME data and compared the result with NASS prices and did not see anything indicative of a change in industry pricing behavior, including pricing levels relative to the CME, during the mid-2008 to mid-2010 period. The shift in relationship between the survey price and the CME appears to be explained by the downward market trend alone.

The California price data is not released in a weekly format that might illuminate the underlying pricing mechanisms being used by California manufacturers. However, the similarities between the NASS and California price behavior leads me to believe that the period analyzed by the CDFA price study similarly reflects the lags in prices rather than reflecting a change in ongoing price levels relative to the CME. As such, CDFA should reject a change in the f.o.b. pricing factors for cheddar.

Whey Factor: The direct pass-through of the full whey value in the Class 4b formula was replaced by the 25 cents per hundredweight fixed factor in December 2007. Many of the factors that made a full pass-through of the whey value untenable at that time remain today. The high capital cost associated with whey processing and high transport cost for dilute whey make the processing of whey from small operations non-viable. But the problems were not isolated to small cheese makers. The value attributed to whey through the formula outstripped the value captured in the market for more specialized whey products during parts of that period. Several witnesses at the 2007 hearing testified that they curtailed cheese production due to the poor whey economics. Three cheese manufacturers struggled to fulfill producer payment obligations and were placed on the ineligible list for the Producer Security Trust Fund.

The policy challenges associated with incorporating an explicit whey factor tied directly to market movements in a minimum regulated milk price that obligates businesses that may not have a viable mechanism through which to recover the whey value are no less today than in 2007. The Department must be careful not to create the financially tenuous environment that existed in 2007 and jeopardized both cheese processors and the outlet that they provide for California-produced milk.

The Dairy Institute of California proposal does the best job of balancing producer interest and market realities. I place the constituencies into three buckets: One, producers who seek to maximize the minimum regulated price; two, manufacturers who do not have any whey processing capacity and must rely on the revenue stream from other products to cover minimum milk price obligations attributable to whey; and three, manufacturers who have whey processing capacity and capture value from the whey stream but operate on slim commodity margins.

The solution for producers in the absence of concern for market outlets would logically be to tie the whey factor in the milk price formula directly to the net revenue from whey production as was previously the construct in the formula.

However, the reality for the second group is that they have a limited ability to pay and it is completely unrelated to the whey market. This argues for a fixed factor as is currently in the formula.

The third group also has a limited ability to pay because this group tends to be large manufacturers who compete in commodity spaces with very low margins. For this group it is important that the fixed factor not exceed the recoverable market value on a sustained basis.

As was noted in other testimony, the 25 cents per hundredweight that has been in the 4b formula since December 2007 in fact overvalued the whey stream on a cumulative basis until early this year. It is only the more recent strong whey market prices that have pushed the values to a level that exceed the 25 cents per hundredweight over the period. So history would argue that a fixed factor above 25 cents is untenable for those operating in the commodity space.

Given the combination of constraints in satisfying the constituencies the Dairy Industry proposal was the best solution. It balances producer interest in capturing whey value in the regulated price with the need to maintain viable plant capacity for the milk they produce. It offers a level of protection to producers through the 25 cents per hundredweight milk minimum whey contribution and it offers a level of protection for cheese manufacturers who do not have whey processing capacity or viable outlets for dilute whey through a 75 cent maximum whey contribution while also ensuring that those cheese manufacturers operating in the tight margin commodity space can recover the value in the marketplace within those brackets.

NASS Versus Western States Whey: CDFA should adopt the NASS whey price series for the purpose of determining whey value in the Class 4b formula. The NASS price series is more robust in both volume and methodology. The price is reported as a weighted average, which by it's nature is more precise than can be garnered through the collection of range data through phone conversations. The NASS price collection is subject to audit.

Use of Federal Order Whey Manufacturing Costs Allowances by Western United and Land O'Lakes: Western United explicitly uses the Federal Order manufacturing cost allowance and Land O'Lakes uses the Federal Order manufacturing cost allowance for whey to underpin its sliding scale. However, CDFA conducted whey cost studies four consecutive years using a proven and rigorous methodology. Discarding CDFA's own cost studies in order to utilize an estimation method with noted deficiencies would be wholly inconsistent with CDFA practices and would be poor policy.

The Cornell cost study that underpins the Federal Order whey manufacturing cost allowance was dominated by large whey plants in highly concentrated cheese manufacturing areas that consolidated whey from several cheese plants. These plants are significantly larger than the national norm and many of the operations received condensed whey from multiple sources. Dr. Stephenson acknowledged in cross-examination that the cost of condensing the whey at the originating plant and transportation costs, if not borne by the receiving plant, were not captured in his cost study.

Other Issues: Several witnesses have raised basis risk as it relates to price risk management under the existing Class 4b formula and any formula that does not move in parallel with the Federal Order Class III price is a concern. However, the tools for producers to use exist already, even under the current construct of the Class 4b formula. Under the current formula the ideal risk management strategy likely involves a combination of Class IV and cheddar futures. Must of the basis risk between Federal Order Class III and the California overbase price is rooted in the fact that the overbase price is heavily influenced by 4a. Class 4b can be best hedged using cheddar futures. The additional activity in those contracts that would be generated by their increased use by producers would improve the liquidity for all in the market.

Conclusion: The Department should adopt Dairy Institute's alternative proposal for the Class 4b milk pricing. It carefully balances the interests of producers with the market realities of cheese manufacturers, some of whom have whey processing capacity and some of whom do not. Additionally, it leave the manufacturing cost allowance and f.o.b. factor unchanged based upon careful analysis of the data and sound reasoning.

This concludes my written testimony. I appreciate the opportunity to provide input to the Department on these very important issues and respectfully request the opportunity to file a post-hearing brief.

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

MS. GATES: Ms. Taylor, I have a question for you. Since 2007 has anything changed in the landscape of your whey operation, whether it's the value received from the whey stream, costs associated with whey? You know, is that still the same as in 2007 or has there been any changes?

MS. TAYLOR: The finished product markets and the cost structure changes on an ongoing basis. The ultimate result in terms of net returns though, is largely unchanged.

MS. GATES: Thank you.

MR. EASTMAN: I have a couple of questions. On the back page of your testimony you have a table there that you were referencing. Just to make sure I understand the table. It appears what you have done is in that first column you're just taking what the average weighted cost for the study was for each of the data years on a calendar basis. You have costs from the cost study. And then you just look at the manufacturing cost allowance that was in place in the formula at that time in the second column then you're just taking the difference of the two. Is that --

MS. TAYLOR: That's correct, yes.

MR. EASTMAN: Okay. And then -- In your testimony you support the Dairy Institute proposal which implements a step by step sort of whey value with a table. Similar to the Land O'Lakes proposal but obviously with different values, so to speak. Do you feel that that table is a better option than say a fixed factor, even if the values of both were to yield the same on-average number over a period of time?

MS. TAYLOR: In the context of balancing the interests that are at play in this hearing, yes. If you offered me a fixed factor of 25 cents I would endorse a fixed factor of 25 cents. But if there is a belief that there needs to be greater revenue pass through in the regulated system when whey prices are higher then this is far superior.

Because, for example, if somebody were to say that the fixed factor based on current markets should move up to 40 cents a hundredweight or 50 cents a hundredweight that would put many cheese manufacturers into an untenable financial position when whey markets come back down. As much as we like to think that whey markets are going to stay strong there are many folks who back in 2007-2008 never thought we would return to the price levels that we did thereafter. And so I think there's a lot of risk in setting a fixed factor above the current 25 cents.

MR. EASTMAN: So in essence then the table is better for all the stakeholders in the industry. But for a cheese processor, for a cheese processor if you're looking at, say, a year business plan, then the fixed factor is less desirable just because when you're on the very up of the down markets the fixed factor is --

MS. TAYLOR: It depends on --

MR. EASTMAN: -- causing problems with your market --

MS. TAYLOR: It depends on where the fixed factor is. The fixed factor at 25 cents is not a problem. But elevating it above that level, which would mean that you were elevating it above what I think would be the sustained, long-term value for whey would be a fair amount of risk involved at that point.

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you.

The next witness is Rob Vandenheuvel.

MR. VANDENHEUVEL: I got to be sworn in again?

HEARING OFFICER MAXIE: No, we'll skip the formalities since you have already testified. But I will remind you that you are sworn to tell the truth.

You have handed us three documents. Would you like those entered into the record?

MR. VANDENHEUVEL: Yes, please.

HEARING OFFICER MAXIE: Very good. We'll enter them as one exhibit and that would be Exhibit number 69. Could you just quickly identify them.

(Exhibit 69 was received into evidence.)

MR. VANDENHEUVEL: Yeah, sure. The first exhibit is a chart. You can see that it's got a number of columns there that compare the Federal Milk Marketing Order dry whey factor to the California dry whey factor as well as looking at the CME prices versus the California weighted average price as reported by CDFA in your 24 month survey. I'll explain that in my testimony.

The second exhibit is an article by John Umhoefer, Executive Secretary from the Wisconsin Cheese Makers Association from June 3, 2011.

And the third is a page from the June 24, 2011 *Dairy Market News*.

HEARING OFFICER MAXIE: All right, thank you.

MR. VANDENHEUVEL: All right. Well thank you. I appreciate the opportunity to come up here. And unlike yesterday I will not be taking the entire 20 minutes. I was a little too wordy yesterday and so I didn't quite get to make all the points that I wanted to. But a couple of things and in particular responding to some things that were said later yesterday after my testimony as well as this morning.

I guess I'll start with the first exhibit that I handed out, which is that chart. And it was talked about yesterday in some of the testimony as well as the previous testimony from Ms. Taylor explaining why the f.o.b., --the 24 month comparison between the CME prices and the California weighted average cheddar price was different.

I submit this graph as a possible other

explanation for what the difference is. As you can see when you go back, in the last 24 months there were 9 months in that 24 where our dry whey factor of 25 cents was higher than the Federal Milk Marketing Order dry whey factor which was below 25 cents at 11.67 cents and in September of 2008 was a negative factor for the next seven months and then was 19.8 cents in May 2009 before shooting up into the range higher than the 25 cent fixed factor.

During those nine months our cheese -- our weighted average cheddar price here in California averaged a penny and a half higher than the CME. Our cheese makers were able to go out and get more money from the marketplace than even the CME price was reporting. Calculated in hundredweights that came out they were able to generate 15 cents a hundredweight more than the -- than the CME price, I would dictate. So in the other 15 months you saw the California price lagging behind the CME by 1.19 pennies and by 12 cents a hundredweight.

I am not going to claim that this is the only reason. I'm sure that there are lag issues that Ms. Taylor and Mr. Schiek mentioned but I submit this is some additional evidence that when our cheese makers are sufficiently motivated -- and I say paying a higher dry whey factor than their counterparts in Federal Order is sufficient motivation, they do have tools to go into the marketplace and generate additional revenue to cover those higher costs.

Secondly, yesterday in Mr. McCully's testimony he referenced an article by John Umhoefer from 2007 talking about dry whey. I wanted to submit a article from earlier this month -- actually it's July 1 so it's last month, June 3, 2011. This is an article by John Umhoefer and I submit this into the record. He's talking about all the success in the Wisconsin dairy and cheese making industry. On the back of that article, page two, is a expansive list of new, specialty cheese makers that have established since 2001. Not expansions but actually new cheese makers.

I remind the hearing panel that these cheese makers were able to invest in that industry paying the Class III. Plus it's very well-known that in the Midwest those plants have to pay a premium to secure an adequate milk supply. So these guys were building their plants knowing they had to pay the Class III at a minimum and perhaps a premium above that.

And that obviously includes a dry whey factor that previous testimony this morning said if we went anywhere near what the -- he said if we went towards the LOL proposal, which is not even all the way to what the Federal Orders have, that it would be the extinction of specialty cheese makers here in California. I submit to you that there's a list of cheese makers in the Wisconsin area, according to Mr. Umhoefer, that have made that investment knowing they may have a higher cost of their raw milk.

And then thirdly, I made some comments in my testimony yesterday about milk leaving the state and not knowing, you know, the story behind that milk. There were some claims that we had milk leaving the state.

The *Dairy Market News*, this is from the most recent version. You can see the area underlined there talking about Arizona's heat they're dealing with. "Some milk and condensed skim is being imported from California into production facilities to fill shifts." There are markets outside of our borders where we do on occasion need to export milk because there is a desire, they're paying for that milk. And so I submit that as evidence that you can't always take the fact that there is milk leaving our state and assume it's distressed milk that must leave the state.

And then if the hearing panel will indulge me I would like to just go through the very brief part of my testimony that I was unable to get to yesterday.

If you recall when I -- when I left off we were talking about the manufacturing cost allowance for 4a. I don't know if you guys have copies of the testimony or I can provide you with a copy. But it's on page seven.

All right, page seven. In reviewing information from prior CDFA hearings MPC recognizes that the Secretary and CDFA staff have chosen in the past to grant requested increases in the regulated make allowances. In justifying those reductions and the regulated minimum prices it has been noted by CDFA staff that the decision is partially based on the need for adequate processing capacity to ensure the orderly marketing of milk.

The CDFA hearing panel report in 2007, the last time these make allowances were adjusted, that, quote: "There is sufficient evidence that show that milk is not being marketed in an orderly manner as mandated by legislation." This is troublesome because one of the important foundations of the legislation governing the dairy industry is orderly milk marketing.

The panel report went on to state that: "The panel's concern that the milk is not being marketed in an orderly manner is evidenced by the problems California has experienced balancing the milk supply and distressed milk leaving the state at a discounted price -- by distressed milk leaving the state at a discounted price and milk leaving the farm without being processed. The problems balancing the state's milk supply is characterized by a milk production growth outpacing manufacturing growth."

While that may have been the case in 2007 the industry has since shown a much different picture in the last three calendar years, 2008, '09 and '10. The California milk production has increased or decreased by 1.28, -4.1 and 2.21 percent respectively. In fact, the production in 2010 of 40.3 billion pounds of milk was actually less than the annual production in 2007.

All right, that I think, is where I left off, left of yesterday.

The reasons behind this change on the producer side are very easily understood. The state's dairy families -- Our state's dairy families rely largely on purchased feed. Over the years low feed prices allowed our dairies to enjoy a 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 are gone and we can no longer produce the lowest priced milk in the country. Being a low price leader in this high-cost environment is simply unsustainable.

As an industry we absolutely must find ways to generate a higher relative price for the dairy products made from California milk. One of the ways the Department can assist the industry in doing this is by maintaining a system that incentivizes our manufacturers to generate additional revenue from the market.

Our Class 4a formula operates by using the lowest value product, basic nonfat dry milk and bulk butter as the end product. Therefore, if you are producing a product that carries a premium to standard nonfat dry milk and bulk butter the formula does not require you to pass those dollars along as part of the minimum price.

Fortunately, it appears that our state's butter powder manufacturers are getting much better at this and taking advantage of additional market revenue. It is well know that our state's butter manufacturers have made great strides in developing their butter marketing expertise. We began to see evidence in 2009 already when bulk butter made up only 39.8 percent of the total butter production versus 55.7 percent of the butter production in 2008. That according to the cost study done by the Department.

It has also been reported that much of our state's powder products are being -- much more of our state's powder products are being sold as skim milk powder, a preferred product that carries a premium in international markets. It is certainly our hope that this trend of producing more value-added butter and powder products will continue in the years to come. As was highlighted in a March 31, 2009 forum hosted in Modesto by our fellow dairy producer trade association, Western United Dairymen, one of the keys to success for the California dairy industry will be our ability to take advantage of value-added products in generating much needed additional revenue. As on-farm costs continue to -- As on-farm costs continue to find new records each year, this additional revenue will be an absolute necessity in order to attract a sustainable milk supply. We can no longer afford to have a pricing structure in California that provides guaranteed, generous profits to manufacturers of bulk, relatively low-value, commodity dairy products.

While CDI is quick to pout out the Manufacturing Cost Exhibit published by CDFA, they are purposely not acknowledging the additional revenue they are generating from their greatly improved ability to attract higher market prices for their value-added products. Despite a regulated make allowance that they are claiming in this hearing to be too low, they were able to generate significant profits for their owners from their operations last year. I have had the opportunity to review multiple statements provided to dairy/owners of CDI and those statements demonstrate that CDI was able to distribute about 39.4 cents per hundredweight in operation profits for their owners in 2010. And as I noted in my testimony yesterday, at 17 billion pounds of milk that comes out to about $66.9 million distributed to their membership.

MPC applauds CDI and any other manufacturers that have taken the steps to generate additional market revenue by manufacturing more value-added products. This not only applies in the 4a, but as we heard this morning, smaller cheese plants are doing the same thing, providing value-added products to the marketplace. This is exactly what our producer and processors need to become a sustainable industry capable of generating profits in an environment with constantly escalating feed costs. With that backdrop the Secretary is unfortunately being asked now to take a huge step backwards for our industry by creating a 4a formula that provides guaranteed, generous profits for making low-value, commodity dairy products. Not to mention mandating a multi-million dollar transfer of wealth from debt ridden dairy farmers into the pockets of our state's Class 2, Class 3 and Class 4a manufacturers.

It is for all these reasons that MPC strongly urges the Secretary to reject CDI's proposal for an enhanced make allowance for butter and nonfat dry milk at this time. New manufacturing data will be published in the coming months and market dynamics in the dairy industry seem to change constantly. We are certainly willing to discuss this issue further, taking into account updated versions of all economic indicators above, at a future date if necessary.

On a similar note, LOL has proposed an adjustment to the make allowance in the Class 4b formula for cheddar cheese. While this proposal from LOL differs from CDI's proposal both in its impact, it would actually increase revenue for producers not decrease, and its size. It amounts to about a 2 cent per hundredweight increase in the 4b price. MPC believes that now is not an appropriate time for the Department to make any changes to the regulated make allowances in either of the Class 4 minimum price formulas.

Finally, in their hearing petitions both CDI and Land O'Lakes have proposed changes to the f.o.b. price adjusters for butter and cheddar cheese. These price adjusters are included in the Class 4b formula -- these price adjusters are included in the Class 4a and 4b formulas to account for the fact that the daily spot prices reported by the CME for both butter and cheddar are not necessarily the prices being received by our state's manufacturers for their products.

In prior hearings on the issue, CDFA has opted to use a 24 month average of the differences between the CME spot prices and a survey of prices received by our state's manufacturers to determine these f.o.b. price adjusters. In examining the latest information released by the Department it appears that the current f.o.b. price adjusters in the 4a and 4b formula are no longer representative of how our state's bulk butter and cheddar cheese manufacturers are faring when compared to the price reported by the daily spot markets for these products on the CME.

In order to crate a more localized value for these products in our minimum price formula it seems like a reasonable request to make the changes to the f.o.b. adjusters when the information available supports that decision. Therefore, MPC supports both CDI and Land O'Lakes proposals to adjust the f.o.b. price adjusters for both butter and cheddar cheese to reflect the most current information provided in CDFA's analysis.

One last point that was brought up this morning and it's an important point. Dairy farmers fully recognize that there is a new cheddar futures market out there to use for risk management. It is relatively new, it has been developed in the last year or two.

The problem is there is simply not the liquidity and volume there needed to be able to participate on any large scale. They average approximately, I believe, five or six trades a day and those are, those are blocks of 20,000 pounds. That's the size of a contract for cheddar cheese. And so a Class 4 suffers from a similar, a similar lack of liquidity in volume and that's why you see the Class 3 most often referenced as the tool used by dairy farmers.

You obviously -- when you take a position on one side of a futures market or a futures price you've got to have somebody take the opposite position on the other side so you need the liquidity and the volume to be able to take those positions. That was mentioned this morning, I wanted to just add that point.

So thank you and that concludes my testimony. I've already asked for an opportunity for a post-hearing brief yesterday.

HEARING OFFICER MAXIE: Any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: No questions.

MR. VANDENHEUVEL: We've worn you out.

HEARING OFFICER MAXIE: That's right. Thank you very much.

All right, the next person signed up is Sue Taylor.

(Laughter.)

MS. TAYLOR: Well, this morning when I saw that Rob signed up behind me I busted on him for not allowing me to be the last person. But truly, this is not just to get the last comment. I will refrain as much as I would like to rebut some of Rob's comments I'll refrain from doing that.

The purpose of me coming back up here is to clarify the answer to a question that I believe Ms. Gates asked. And that question was regarding whether the -- I believe it was whether the prices received and the cost conditions on whey have changed from 2007.

I believe I answered that those continue to evolve but largely the net returns are the same. And I'd like to clarify that to say that obviously with a fixed factor our net returns on a monthly basis on the whey side of the business are quite volatile. But on a long-term basis, as was noted earlier, that 25 cents a hundredweight that's in the current formula essentially broke even with what we would have paid if it was a market-based formula as of early this year. So it's still representative.

Probably the more important response and what I was thinking about as I was making the response is I don't think that the market conditions that impact the policy decision-making have changed substantially from that time period. You still have the constraints in terms of a high barrier to entry for whey processing relative to scale. So a lot of small folks who can't afford to put in the whey processing capacity still have disconnects across the whey complex between sweet whey values and WPC and lactose. And at times sweet whey drives a higher value and sometimes the more differentiated complex drives a higher value. Those conditions in the marketplace that existed in 2007 still exist today. I just wanted to add that level of clarity.

MS. GATES: Thank you.

HEARING OFFICER MAXIE: Any questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: Very good, thank you.

The next witness is Leonard Vandenburg.

MR. VANDENBURG: Good morning.

HEARING OFFICER MAXIE: Good morning.

MR. VANDENBURG: I'm going to keep this real brief.

HEARING OFFICER MAXIE: First could you state your name and spell your last name for the record.

MR. VANDENBURG: Leonard Vandenburg. The last name is V as in Victor, A-N-D-E-N-B-U-R-G. And I'm here --

HEARING OFFICER MAXIE: And we need to swear you in.

MR. VANDENBURG: Okay, I'm sorry.

Whereupon,

LEONARD VANDENBURG

Was duly sworn.

HEARING OFFICER MAXIE: Very good. You may proceed.

MR. VANDENBURG: I am here representing Pacific Gold Milk Producers.

What I would request is a post-hearing brief that we could later on, in detail, explain exactly where our position is at.

Just in a nutshell. We currently oppose the 4a increase in the make allowance as it is presented and I'll explain in detail why. If you might have any questions feel free to ask.

We would be in favor of adjusting the whey factor but not necessarily as it is proposed. And again, we would put in detail and explain exactly what our position is in writing in a brief.

This make allowance, I think it's really -- sometimes it's viewed as, you know, we've got to cover costs. And I think sometimes the dairyman needs to view it as an investment and does it pay or doesn't it pay. And I think at times it does and then sometimes it doesn't. And I think in the last several years there has been some abuse on the make allowance. If that is supposed to be a balancing factor that hasn't taken place at all and I think everybody is aware of that.

And I think as a dairyman sometimes we have a tendency, and I've done it in the past, where, you know, we want to take and take and take. And I think we need to be aware there has to be a real balance between those that are processing it and demand and the supply that's out there and the cost of getting it done.

We just can't have such a make allowance where the only thing that's a driving force is supply. And I believe that's what happened in the last ten years. The make allowance has been established such where it only drives supply, supply and supply and really that's what has caused a lot of the problems that we have had here in the last three or four years. And it needs to be more market-driven. And I think we need -- slowly but surely we need to move forward into more market-driven industry.

Even though I have been a dairyman for most of my life, I represent dairymen and God bless them. But, you know, we sometimes surrender our own milk to everybody else and whose fault is that? It's the dairymen. And so I think we need to move more to a market supply. There's room for make allowance but not room for abuse.

And so with that I would request a post-hearing brief. And I would like to do that and explain in detail what that's all about.

HEARING OFFICER MAXIE: Your request is granted.

MR. VANDENBURG: Thank you. Is there a date.

HEARING OFFICER MAXIE: Yes, it's July 11th. Four o'clock on July 11th.

MR. VANDENBURG: Okay, thank you.

HEARING OFFICER MAXIE: Any questions from the audience? Not from the audience.

(Laughter.)

HEARING OFFICER MAXIE: Any questions from the panel?

MR. EASTMAN: By "audience" we meant the audience up here, sitting up here.

(Laughter.)

MR. EASTMAN: Technically speaking, a post-hearing brief is meant to clarify or just amplify what's been said at the hearing. So as a result I am going to ask you some questions that dig in a little bit deeper so that we can get kind of the sense of where you're going and then you can clarify that further.

MR. VANDENBURG: Sure.

MR. EASTMAN: The first thing you mentioned is that you oppose any changes to make allowances on the 4a side, on butter/powder. And in general what would be your opposition, your main reason or your -- in a nutshell.

MR. VANDENBURG: If you go look at in the last maybe couple of years, and we're still working on that. But if you look at the sale of nonfat milk in the state of California, historically the last week of every single month the volume of sales was much more than the previous weeks and all those for less money. Why? And every producer that is not a member of that particular co-op suffered the price.

Was it because they had to meet milk checks? What was the reasoning for it? They couldn't get a line of credit. If that is the case -- I hope that isn't the case. But if it's the case why should everybody pay the expense and the brunt of it? I think there should be almost an investigation on that. And it was almost, you could almost predict every single month in the last week of the month where that price was going to be and the volumes that are going to be sold.

And so I've got some real questions about, you know, are we funding a make allowance because of mismanagement? Inefficiencies? Because of some problems that they had at plants that they spent twice the money they should have? Is that everybody else's problem? I don't think so. So I'll explain -- you know, we'll explain that in detail and have some figures and numbers.

MR. EASTMAN: So you feel that the volume of milk going through those plants, say at the end of the month or during the month, were uneven, which would cause the cost to process say powder for example --

MR. VANDENBURG: I think some --

MR. EASTMAN: -- that it ought to be even during the course of the month. Is that what you're saying?

MR. VANDENBURG: It appeared some inventory was built up and had to be dumped.

The other reason why too is if you look at CME, the CME powder price or the NASS powder price or the Western

Mostly or the CWAP and you compare those prices for the last, let's say five year trend. Why was the CWAP for the most part always lower than all the other prices? It tells me that somebody is not doing their job. And if somebody is not doing their job why does somebody got to pay that price that is not a member of that company?

MR. EASTMAN: Now did you oppose make allowance changes for both butter and powder or just one over the other?

MR. VANDENBURG: Right now just strictly the powder.

MR. EASTMAN: Okay. What about the f.o.b. adjuster for butter? Do you have any statement? Are you going to oppose, support or just be silent on that?

MR. VANDENBURG: I'd be silent on that.

MR. EASTMAN: Okay. Then that leads us to the other class involved with this hearing. Do you have any opinions on the cheese make allowance or the cheese f.o.b. adjuster? Would you be silent, opposing, supporting it?

MR. VANDENBURG: I probably would oppose that currently.

MR. EASTMAN: And do you have any high level reasons why?

MR. VANDENBURG: I think there's enough, there's enough opportunity to extract dollars out of the cheese.

The other reason why too, if you look at the cheese yields. I mean, there's so much stuff added to cheese that you begin to wonder, you know, what's really going on there. Is the producer getting an advantage of that? No. And so I think the manufacturer is already getting advantage by doing some of those activities in the cheese plant so we would oppose that.

MR. EASTMAN: And then the other proposals, the petitioners and proposals, alternative proposals have proposed changes to the way that whey -- the manner in which whey is valued and the 4b formula. Do you have a position on that? You kind of mentioned something about that, striking a balance. It was a little vague.

MR. VANDENBURG: Yeah. You know, I'll try to be a little bit more specific. It's relatively a new market, in all fairness. I think two years ago, you know, the market could crash and then it could rise. And so was there real stability in it? No. For those that invested they put out a lot of risk for that investment, not knowing where the market is they just kind of bet on it.

Is it getting more stable? It appears to be. But it is basically that private industry has been making that investment, not producers. And should the producers get some of that money? We believe they should, we do believe they should. But there should be a fair balance between what the producers ultimately get additionally against what the processors have invested, took quite a bit of risk, and what they get.

MR. EASTMAN: That was my questions. I think that gives us a good start so you can amplify that on a post-hearing brief.

HEARING OFFICER MAXIE: Any other questions from the panel?

(No audible response.)

HEARING OFFICER MAXIE: Thank you very much.

MR. VANDENBURG: Thank you.

HEARING OFFICER MAXIE: That's the last witness we have signed up. If there are no other witnesses we need to call Amber back up to the witness stand.

And again we can skip the formalities.

MS. RANKIN: All right.

HEARING OFFICER MAXIE: Proceed.

MS. RANKIN: All right, good morning, Mr. Hearing Officer. I am entering an additional letter from Arthur Schuman, Incorporated dated June 30, 2011 and signed by Ralph Hoffman, Vice President of Risk Management, as an exhibit into the hearing record. There is a copy of this letter in the back of the room for review.

HEARING OFFICER MAXIE: All right, thank you. This will be entered into the hearing record as Exhibit number 70.

(Exhibit 70 was received into evidence.)

HEARING OFFICER MAXIE: All right, if there are no other witnesses I would like to remind you that post-hearing briefs will be due by 4:00 p.m. on Monday, July 11th by 4:00 p.m. That would be at the Dairy Marketing address of 560 J Street, Suite 150, Sacramento, California, 95814.

Does anyone have anything else that they would like to testify to?

(No audible response.)

HEARING OFFICER MAXIE: Not seeing anyone else, all persons present and desiring to testify have done so. And with no additional evidence to be presented this hearing is now closed on July 1, 2011.

(Thereupon, the public hearing was adjourned at 10:06 a.m.)

--oOo--

CERTIFICATE OF REPORTER

I, JOHN COTA, an Electronic Reporter, do hereby certify that I am a disinterested person herein; that I recorded the foregoing California Department of Food and Agriculture 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