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June 8, 2012 78977.00002

VIA COURIER AND FACSIMILE (916) 900-5341

Ms. Karen Ross
Secretary of Agriculture
California Department of Food & Agriculture
Executive Office
1220 N Street, Suite 400
Sacramento, CA 95814

Re: **Posthearing Brief Regarding California's Class 4b Milk Pricing Formula**

Dear Secretary Ross:

Paul Hastings represents California Dairies, Inc., the Dairy Farmers of America – Western Area Council, Land O'Lakes, Inc., the Security Milk Producers Association, the Milk Producers Council, the California Dairy Campaign, and the Alliance of Western Milk Producers (collectively, the "Coalition") – the members and representatives of which testified in support of the Coalition's Petition for an amendment to California's Class 4b milk price during the May 31 and June 1, 2012 hearing. We submit this post-hearing brief to amplify and explain a few key points raised during the hearing, *see* Cal. Food & Agric. Code § 61903, namely that: (1) the unprecedented size of the community of milk producers supporting the Petition militates in favor of amending the Class 4b milk price; (2) the current price is inconsistent with California law, which requires that the Class 4b milk price bear a reasonable and sound economic relationship to the national value of manufactured milk products; and (3) that none of the speculative testimony offered by the cheese processors should preclude the Department from adopting the Coalition's proposed amendment to the Class 4b milk price.

I. THE COALITION'S PETITION IS SUPPORTED BY THE GREAT MAJORITY OF CALIFORNIA'S DAIRY PRODUCERS WHICH HAVE SUBMITTED AMPLE COMPELLING TESTIMONY TO SUPPORT THE FACTS AND THE LAW WHICH UNDERLIE THE PETITION

A. The Majority of California's Dairy Producers Support the Petition

In unprecedented unity, the overwhelming majority of California's dairy producers are completely aligned in support of the Coalition's suggested amendment to the Class 4b milk price. The Coalition represents about 64 percent of the state's eligible milk producers and approximately 78 percent of the state's total milk production. *See* Slide 2 of D. Melby's Power Point Presentation (attached hereto as Ex. 1).

B. The Department's Decision Appropriately Turns on the Facts and the Law; The Dairy Producers Have Provided Both

The Hearing Panel heard testimony from representatives of the Coalition, Western United Dairymen ("WUD"), and many individual dairy producers, some of whom traveled great distances, announcing full and enthusiastic support for the Petition. For example, members of the dairy community provided testimony and documentary evidence of the negative and severe impact of the Class 4b price on the day-to-day running of their businesses, giving concrete examples based upon personal knowledge of the actual harm they are suffering. The California dairy associations' representatives presented a great deal of real data in support of the fact that California's cheese producers have reaped the awards of the current milk price (that penalizes dairy producers). This evidence is concrete, extensive, and conclusively demonstrates that California's dairy producers have not only lost significant revenues because of the current pricing system but are losing the very businesses which have provided their livelihood. *See* Letter to K. Masuhara from E. Gallagher (President of DFA Risk Management of Dairy Farmers of America), dated May 29, 2012 ("*the divergence of the CDFA 4-b and the United States Department of Agriculture's (USDA) Class III prices* (see exhibit G-2), largely due to CDFA's whey pricing policy, *has contributed to a loss of income on California's dairy farms*") (emphasis added). In contrast, processors have not produced sufficient hard data documenting the harm they speculate may occur in the future if the Department adopts the Coalition's proposed amendment to the Class 4b milk price. The processors have not offered, nor can they offer, similar evidence.

In summary, the great majority of the State's dairy producing community supports the proposed amendment to the Class 4b milk price. Without action, California's dairy families will continue to suffer significant loss of revenue (nearly $26 million per month has been averaged over the last 12 months), more dairies will shut down, dairy farms will incur even greater debt, and California's dairy industry will continue to diminish. A significant incentive to continue production in California will disappear.

II. THE COALITION'S PETITION IS SUPPORTED BY CALIFORNIA LAW AND THE LAW MATTERS

During the hearing, the Coalition's representatives offered testimony regarding the statutory framework through which the Department should evaluate the current Class 4b milk price and the Coalition's Petition. The Hearing Panel appropriately acknowledged its interest in gathering facts, including data and other detailed information offered on behalf of the Coalition with respect to the economic impact of the status quo milk price. Importantly, however, the law must be emphasized, with the full recognition that the requested reasonable changes fit squarely within the California Legislature's statutory mandate.

In California, the legislature has authorized the Department to formulate stabilization and marketing plans. *See* Cal. Food & Agric. Code § 61805(c) (attached hereto as Ex. 2). However, the director's discretion in structuring these plans is limited by statute. *Id.* (authorizing the director to formulate stabilization and marketing plans "subject to the limitations prescribed in this chapter"). Specifically, the director must take into consideration all relevant economic factors impacting the designation of prices. *See* Cal. Food & Agric. Code § 62062 (attached hereto as Ex. 3).

Here, the current Class 4b milk price formula does not comply with the law governing the formulation of stabilization and marketing plans because it results in prices that have no "reasonable" or "sound economic relationship with the national value of manufactured milk products." *See* Cal. Food & Agric. Code § 62062 (Ex. 3). Testimony at the hearing provided ample evidence of this lack of a reasonable and sound economic relationship. Testimony also provided abundant evidence that the FMMO Class III price is the optimal benchmark price in making the comparison to the "national value of manufactured milk products."

This statutory requirement is not merely a guideline or suggestion, but a binding directive. *Id.* The legislature mandates that the Department "shall" set a price that bears a reasonable or sound economic relationship to the national value of milk products. *Id.* The California Food and Agricultural Code precisely defines "shall" as a "mandatory" term. *See* Cal. Food & Agric. Code § 47 (attached hereto as Ex. 4). Because the statute contains mandatory language, governmental noncompliance with the requirement implemented by the California legislature invalidates any governmental action inconsistent with the requirement. *See, e.g. People v. Superior Court (Small)*, 159 Cal. App. 4th 301, 308 (2008). Therefore, the Department must ensure that the Class 4b milk price is "reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products." *See* Cal. Food & Agric. Code § 62062 (Ex. 3)

Similarly, the Department shall take into consideration the income derived from the milk prices "in relation to the cost of producing and marketing market milk for all purposes" as well as "the cost of management and a reasonable return on necessary capital investment." Cal. Food & Agric. Code § 62062(a) (Ex. 3).[1] Here, the Coalition produced substantial evidence that the costs of producing and marketing milk have substantially reduced the producers' revenues and net income. *See* Testimony of E. Erba (attached hereto as Exhibit 5) at p. 4 (chart showing increasing cost of production for California dairy producers). Therefore, the Department must also consider the extent to which the California Class 4b milk price does not bear a "reasonable or sound economic relationship" to the FMMO Class III price to resolve the fact that producers are not obtaining a "reasonable" return on their investments.

While the processors have argued that the most important factor for setting milk prices is the "orderly marketing" of milk, this is far from the only consideration that must be made by the Department.[2] *See* Testimony of W. Schieck on behalf of the Dairy Institute of California, at p. 2.

[1] Attempts to misconstrue the language of the law by processors do nothing to alter the clear and unambiguous language and intent of the California legislature.

[2] Furthermore, this section of the Food and Agricultural code is a statement of legislative declarations and policy directives, not mandatory requirements of specific factors for the

For example, the statute cited by the cheese processors for this proposition also states that it is "the policy of this state . . . to eliminate economic waste, destructive trade practices, and improper accounting for market milk purchased from producers." *See* Cal. Food & Agric. Code § 61802(e) (Ex. 6). Further, the overall goal of the Food and Agricultural Code, with respect to the stabilization and marketing of milk, is to "[e]nable the dairy industry, with the aid of the state, to develop and maintain satisfactory market conditions, bring about and maintain a reasonable amount of stability and prosperity in the production of milk, and provide means for carrying on essential educational activities." Cal. Food & Agric. Code § 61805(d) (Ex. 2). As demonstrated by the hearing testimony and by the Department's own economic data showing an average-sized dairy in California should have expected to lose $850,000 from calendar years 2007-2011, it is clear that none of the State's goals of orderly marketing, stability, or prosperity are being realized. Necessarily, the closure of California's dairy farms constitutes waste and a destructive trade practice; it also threatens instability in the dairy market.

However, the Coalition does not suggest that prices be set in a manner benefiting dairy producers at the expense of the cheese processors. The Coalition's proposal does not request that prices be set to match or exceed the FMMO Class III prices, but instead that the Department merely adjust the price to a reasonable level. *See* Testimony of R. Vandenheuvel (attached hereto as Ex. 7) at p. 1 (finding that if the proposed changes were applied to calendar years 2007-2011, the Class 4b price would be $15.13 per hundredweight, $0.42 less than the FMMO Class III price).

III. <u>THE CHEESE PROCESSORS HAVE FAILED TO ADDUCE EVIDENCE IN SUPPORT OF THEIR POSITION</u>

Throughout the Class 4b hearing, various cheese processors made blanket assertions, unsupported in most instances by documentary or other evidence, regarding the impact that a change to the Class 4b milk price would have on cheese production. The Coalition respectfully disputes the validity of these statements. To the contrary, the weight of the evidence, rather than the mere speculation of processors, demonstrates the need to revise the Class 4b milk price. The discussion below outlines certain key facts amplifying and explaining the Coalition's testimony at the hearing.

A. <u>The Pressing Need to Revise Class 4b Price</u>

At the hearing, processors suggested that immediate revisions to the Class 4b milk price were neither necessary nor urgent. This is unsupported and disproved by the facts and evidence. The current Class 4b milk price formula results in prices that significantly undervalue the milk produced by dairies, and as a result, California's dairies collectively lost approximately $300 million in Class 4b revenues (for 2011 alone). *See* Testimony of D. Melby (attached hereto as Exhibit 8) at p. 2; Testimony of E. Hollon (attached hereto as Exhibit 9) at p. 2; Testimony of R.

Department to consider in setting the Class 4b milk price. *See* Cal. Food & Agric. Code § 61802 (Ex. 6)

Vandenheuvel (Ex. 7) at p. 1 (over the years 2005-2011 an average 1,000 cow dairyman will experience a net loss of $850,000).

Indeed, Thomas Wegner (of Land O'Lakes, Inc.) introduced data regarding the significant increase in the gap between the Federal Milk Marketing Order ("FMMO") Class III minimum price and the Class 4b price. *See* Testimony of T. Wegner (attached hereto as Exhibit 10) at p. 1 (from September 2011 through April 2012, the FMMO Class III minimum price exceeded the Class 4b price by an average of $2.54 per cwt). Mr. Wegner then explained the difficult financial situation facing California's dairy producers and how the current discrepancy between the Class 4b milk price and FMMO Class III milk price (which discrepancy is attributable to the whey solids factor) leaves the producers struggling to respond to market milk volatility. *Id.* at p. 4-5. Similarly, Lynne McBride (of the California Dairy Campaign) described how 48 dairies went out of business last year, while in two counties alone, in the first half of 2012, 17 dairies have ceased operations. *See* Testimony of L.. McBride (attached hereto as Exhibit 11) at p. 1.

Furthermore, many of the Coalition's dairy producers presented compelling evidence regarding the pressing financial issues facing the dairy industry. Mr. Arie De Jong, who is involved with dairies in California, Arizona, Michigan, Indiana, Illinois, and Ohio described how throughout 2011, California's cheese processors received their milk deliveries and reaped significant profits, despite the fact that California's milk producers operated at a loss. Mr. Cornell Kasbergen, an owner of dairies in both California and Wisconsin, testified that the California Class 4b milk price is over $4.00/cwt. lower than the milk price in Wisconsin. *See* Testimony of C. Kasbergen (attached hereto as Exhibit 12) at p. 1.

Put simply, the overwhelming weight of the evidence suggests that the harm to California's dairy producers is substantial and ongoing, requiring immediate consideration and the adoption of the Coalition's proposed amendment to the Class 4b milk price.

B. <u>The Whey Price Cap Was Set Too Low</u>

As the Department is aware, California has adopted a "sliding scale" with a floor and a cap. As evidenced, the cap was set too low because it was grounded in the Department's historical view of whey prices. The Coalition now seeks a higher price cap (of $4.00 per hundredweight), which will better adjust to trends in the market.

The June 30 and July 1, 2011 Hearing Panel Report noted, ". . . it is more likely for dry whey commodity prices to fluctuate within the ranges of $0.20/lb - [to] $0.60/lb based on past experience." Since September 2011, whey prices have risen above that level and now are back within it. The use of the adopted whey factor sliding scale has fallen short of the goal of being market-driven due to the 65-cent cap placed on the contribution of whey to the Class 4b price.

The Coalition proposal supports the bracket system of setting a price as is done currently. However, the Coalition proposal reflects a market-oriented approach that emphasizes the link between milk prices and whey prices. For instance, the proposal places a much more market oriented whey price – milk price relationship than the status quo. Importantly though, it only contributes more value to the milk price when the value is present in the marketplace. If whey prices decline, the contribution to the milk price declines along with it; conversely, if whey prices increase, so too would the milk price. Using the Coalition's proposed method would eliminate the potential for undervaluing whey's contribution to the milk price.

C. FMMO Class III Price is the Appropriate Benchmark for California Pricing

The cheese processors urge that the FMMO Class III price is not the appropriate comparison for California's Class 4b milk price. However, California law requires the Secretary to ensure that the Class 4b milk price bears a "reasonable and sound economic relationship with the national value of manufactured milk products." Cal. Food & Agric. Code § 62062 (Ex. 3). As amply demonstrated by Mr. Hollon's testimony, the FMMO Class III price is the only appropriate standard to which to compare California's milk prices. *See* Testimony of E. Hollon (Ex. 9) at p. 3-5. Indeed, the cheese processors fail to identify what national standard, if any, to compare California's Class 4b milk price, if not to the federal standard. As the federal standard is a "national" standard applying to over 75% of the nation's cheese milk, and the cheese processors have not advanced any suitable alternatives, the Coalition suggests that compliance with the statute requires benchmarking to the FMMO Class III price.

D. The CME Group Cheese Contract is Not an Adequate Substitute for the Class III Contract

In response to a Hearing Panel question about other risk management tools, a cheese processor suggested that dairy producers could use the CME Group Cheese contract in place of the Class III contract. The witness, a cheese processor, noted his company used that contract for their hedge strategies. We would not agree with that blanket assessment.

The Class III milk price is a hedge tool for dairy producers to use since the Class III milk price value is derived from a formula using the values of SNF, butterfat and protein – all the components in the product price formula. In regards to California producers, a Class III contract correlates with their pay price but basis risk is much increased with the whey component. The Class III contract reflecting a higher value for whey than does the Class 4b whey price decreases the effectiveness of the hedge.

The CME cheese contract could be a viable hedge for dairy producers to use for hedging their milk if the dairy producer also put in place a viable hedge for the whey portion of the components. The cheese contract, allows the dairy producer to hedge only the protein and butterfat components of the pay price leaving the whey component un-hedged and open to market shifts.

Liquidity for the CME cheese contract has increased in the past year but still faces issues. The liquidity for the Class III contract far exceeds that of the CME cheese contract. Adding a whey hedge increases the complexity of the hedging process and the cost relative to executing two positions instead of one. Additionally, the CME whey contract faces more liquidity challenges than either the Class III or Cheese contracts.

The correlation of Class III to the over-base prices is stronger than the correlation of the NASS cheese price (times 10 to equate to a milk price) to the over-base price. The basis using cheese as a hedge is worse than using Class III. In our prior testimony, we indentified that the Class III and over-base basis was negative and had become more negative over the last 24 months. The average basis between the over-base price and cheese (times 10) is, on average, more negative than the basis between the over-base price and Class III. Simply put, using cheese as a hedge does not improve the basis situation for California dairy farmers.

E. <u>Impact on California's Cheese Plants Outweighed By Harm to Dairy Farmers</u>

Finally, the Coalition's suggested revisions to the Class 4b milk price would not cause the cheese processors to suffer undue harm. *See* Testimony of E. Erba (Ex. 5); T. Wegner (Ex. 10); E. Hollon (Ex. 9) at p. 10; and the Testimony of A. AcMoody (Ex. 13) at p. 6. Indeed, not all cheese plants manufacture whey but those that do already have benefited from a significant windfall due to the current pricing system. Even the small cheese manufacturers, accounting for a small percentage of cheese manufacturing, would not be unduly harmed if the Coalition's proposed amendment to the Class 4b milk price were adopted; in fact, a significant number of these plants do not process whey as they produce high-end cheeses, which command a market premium. *See* Testimony of D. Melby (Ex. 8) at p. 2.

IV. <u>CONCLUSION</u>

Based on the law and the facts presented by Dairy Producers all over California and beyond, including all of the evidence and testimony presented at the hearing on the Coalition's Petition, the Coalition respectfully requests that the Department adopt the proposed amendment to the Class 4b milk price. The current pricing system does not bear a "reasonable and sound economic relationship" to the national value of milk products and, for the reasons stated herein, such price is arbitrary, capricious, and lacking in evidentiary support.

We appreciate and thank you for the opportunity to present this post-hearing brief on behalf of the Coalition.

Sincerely,

Donna M. Melby

Donna M. Melby
of Paul Hastings LLP

PAUL HASTINGS

Enclosure

Cc:

Ms. Sandra Schubert
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California Department of Food & Agriculture
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June 8, 2012

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TAB 1

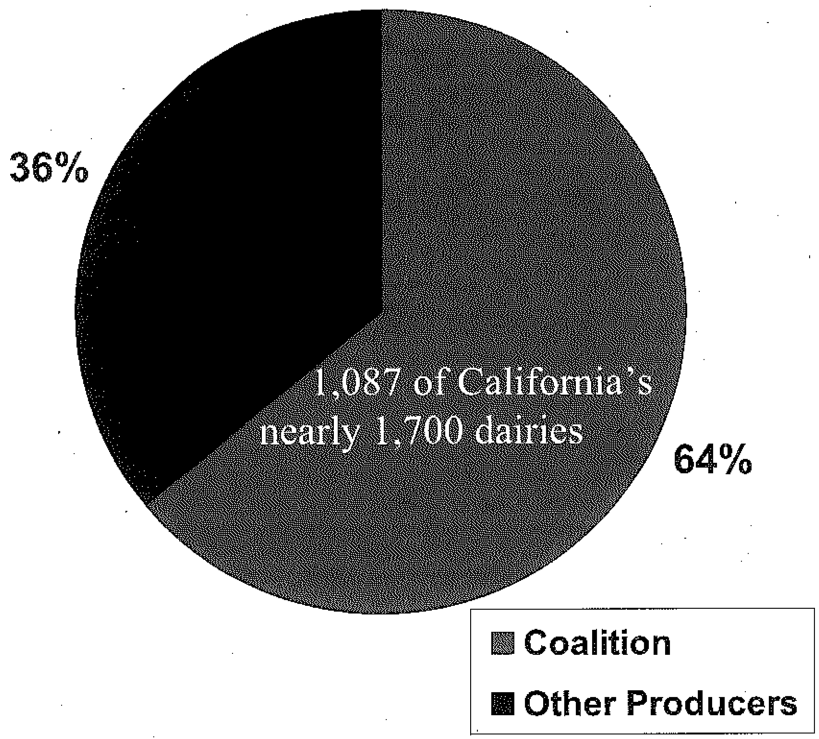
Paul *Hastings*

Hearing on Class 4b Petition

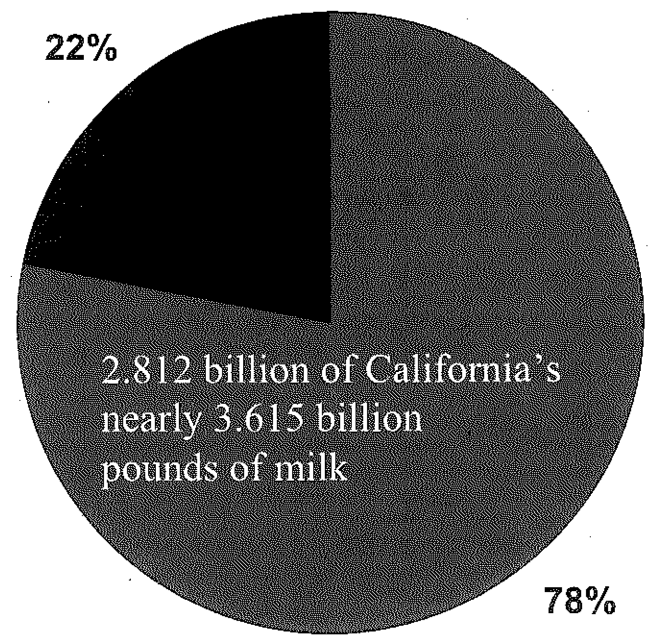
Presenter
Donna Melby

May 31, 2012

California's Eligible Milk Producers



California's Total Milk Production



Data on 2011 California Cheese Production

In 2011 alone, California cheese plants produced over 2,246 million pounds of cheese, including:

- Whole milk cheddar
- Whole, part and full skim milk Monterey
- Mozzarella
- Provolone
- Parmesan
- Ricotta
- Hispanic
- Farmstead
- Organic
- Cream Cheese
- And other whole and part skim milk cheeses

This production was accomplished by only 60 plants in 19 counties.

Source: March 2012, California Dairy Information Bulletin

Purpose of the Chapter:

Enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions, bring about and maintain a **reasonable amount of stability and prosperity in the production of market milk**, and provide means for carrying on essential educational activities.

Cal. Food & Agric. Code § 62062

Each stabilization and marketing plan shall contain provisions whereby the director establishes minimum prices to be paid by handlers to producers for market milk in the various classes. The director shall establish the prices by designating them in the plan, or by adopting methods or formulas in the plan whereby the prices can be determined, or any combination of the foregoing. If the director directly designates prices in the plan, **the prices shall be in reasonable and sound economic relationship with the national value of manufactured milk products**. If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products.

Cal. Food & Agric. Code § 62062(a)

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 prices 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**.

Suggested Language to Amend the Plan

Paul Hastings

Article III – Class Prices

Section 300(E): The minimum prices to be paid for components used for Class 4b shall be computed as follows, except as such formulas and procedures may be modified by Paragraph (H) of this Section:

(1) The Cheese hundredweight price shall be the price per hundredweight computed by the sum of the following:

(a) The price per hundredweight computed by the formula using the Cheddar cheese price, less an f.o.b. California price adjuster of two and fifty-two hundredths cents ($0.0152), less a Cheddar cheese manufacturing cost allowance of nineteen and eighty-eight hundredths cents ($0.1988), all multiplied by a yield factor of ten and two-tenths (10.2).

(b) The price per hundredweight computed by the formula using the butter price, less a manufacturing cost allowance of sixteen and thirty-five hundredths cents ($0.1635), less then cents ($0.10), all multiplied by a yield factor of twenty-seven-hundredths (0.27).

(c) The price per hundredweight for the whey factor value, corresponding to the monthly average dry whey price, based on the following schedule:

Questions?

TAB 2

West's Annotated **California** Codes
Food and Agricultural Code (Formerly Agricultural Code) (Refs & Annos)
Division 21. Marketing (Refs & Annos)
Part 3. Marketing Laws Regarding Particular Products (Refs & Annos)
Chapter 2. Stabilization and Marketing of Market Milk (Refs & Annos)
Article 1. Legislative Declarations (Refs & Annos)

West's Ann.Cal.Food & Agric.Code § **61805**

§ **61805**. Purposes of chapter

Currentness

The purposes of this chapter are to do all of the following:

(a) Provide funds for administration and enforcement of this chapter, by assessments to be paid by producers and handlers of market milk in the manner prescribed in this chapter.

(b) Authorize and enable the director to prescribe marketing areas and to determine minimum prices to be paid to producers by handlers for market milk which are necessary due to varying factors of costs of production, health regulations, transportation, and other factors in the marketing areas of this state. In determining minimum prices to be paid producers by handlers, the director shall endeavor under like conditions to achieve uniformity of cost to handlers for market milk within any marketing area. However, no minimum prices established or determined under this chapter shall be invalid because uniformity of cost to handlers for market milk in any marketing area is not achieved as a result of the minimum producer prices so established or determined.

(c) Authorize and enable the director to formulate stabilization and marketing plans, subject to the limitations prescribed in this chapter with respect to the contents of the stabilization and marketing plans, and to declare the plans in effect for any marketing area.

(d) Enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions, bring about and maintain a reasonable amount of stability and prosperity in the production of market milk, and provide means for carrying on essential educational activities.

Credits
(Added by Stats.1977, c. 1192, p. 3924, § 5. Amended by Stats.1982, c. 751, p. 2975, § 23.)

Editors' Notes

CROSS REFERENCES

Prices, consideration of purposes, policies, and standards, see **Food** and Agricultural **Code §** 62062.

RESEARCH REFERENCES

Encyclopedias

CA Jur. 3d **Food** and **Food** Facilities § 172, Prices--Stabilization and Marketing Plans.

Relevant Notes of Decisions (8)
View all 8

Notes of Decisions listed below contain your search terms.

Construction and application

The phrase "purposes of this chapter" within § 62186 (repealed) is explicitly defined in statute. Jersey Maid Milk Products Co. v. Brock (1939) 13 **Cal**.2d 620, 91 P.2d 577.

Unfair trade practices

The purpose of the Milk Control Act is to eliminate economic disturbances and unfair trade practices in the milk industry and to safeguard the public supply of fluid milk and cream. Knudsen Creamery Co. of **Cal**. v. Brock (1951) 234 P.2d 26, 37 A.C. 486; Marin Dairymen's Milk Co. v. Brock (1950) 224 P.2d 374, 100 Cal.App.2d 686; Ex parte Willing (1939) 86 P.2d 663, 12 **Cal**.2d 591.

Purpose of the Milk Stabilization Act § 61801 et seq. is to eliminate unfair, unjust, destructive and demoralizing trade practices in the producing, marketing, sale, processing or distribution of milk, which tend to undermine standards of quality without which milk would be unfit for human consumption. Emby **Foods**, Inc. v. Paul (App. 1 Dist. 1964) 41 Cal.Rptr. 365, 230 Cal.App.2d 687.

Purpose of the Milk Stabilization Act is to eliminate in the producing, marketing, sale, processing or distribution of milk, unfair trade practices which tend to undermine regulation standards of content and purity. Paul v. Wadler (App. 1 Dist. 1962) 26 Cal.Rptr. 341, 209 Cal.App.2d 615. **Food**🔑 5

One of the purposes of the Milk Control Act is to eliminate economic disturbances and unfair trade practices which in the milk industry threaten both the quality and adequacy of the supply of fluid milk and cream. Knudsen Creamery Co. of **Cal**. v. Brock (1951) 37 **Cal**.2d 485, 234 P.2d 26. **Food**🔑 2

Under the present law no injury can be done to a reasonably efficient distributor or producer unless someone operating in the same area sells at a price lower than the minimum at which he can do business or gives special inducements to customers which amount to an unfair practice.Challenge Cream & Butter Ass'n v. Parker (1943) 23 **Cal**.2d 137, 142 P.2d 737.

Function and powers of director

In promulgating minimum price orders, director of agriculture acts in quasi-legislative capacity and is vested with broad discretion. Emby **Foods**, Inc. v. Paul (App. 1 Dist. 1964) 41 Cal.Rptr. 365, 230 Cal.App.2d 687. **Food**🔑 4.5(1)

Director of **Food** and Agriculture does not have authority to prohibit market milk producers and market milk handlers from contracting for sale and purchase of market milk at prices which are above minimum prices established by director through stabilization and marketing plans. 74 Op.Atty.Gen. 63, 5-7-91.

West's Ann. **Cal. Food & Agric. Code § 61805,** CA **FOOD** & AG § **61805**
Current with urgency legislation through Ch. 14 of 2012 Reg.Sess. and all propositions on the 6/5/2012 ballot.

End of Document

TAB 3

West's Annotated California Codes
Food and Agricultural Code (Formerly Agricultural Code) (Refs & Annos)
Division 21. Marketing (Refs & Annos)
Part 3. Marketing Laws Regarding Particular Products (Refs & Annos)
Chapter 2. Stabilization and Marketing of Market Milk (Refs & Annos)
Article 9. Establishment of Minimum Prices and Provisions of Stabilization and Marketing Plans (Refs & Annos)

West's Ann.Cal.Food & Agric.Code § 62062

§ 62062. Minimum prices; payment by handlers to producers; designation or adoption of methods or formulas; criteria

Currentness

Each stabilization and marketing plan shall contain provisions whereby the director establishes minimum prices to be paid by handlers to producers for market milk in the various classes. The director shall establish the prices by designating them in the plan, or by adopting methods or formulas in the plan whereby the prices can be determined, or any combination of the foregoing. If the director directly designates prices in the plan, the prices shall be in reasonable and sound economic relationship with the national value of manufactured milk products. If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products.

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 prices 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.

(b) That prices established pursuant to this section shall insure an adequate and continuous supply, in relation to demand, of pure, fresh, wholesome market milk for all purposes, including manufacturing purposes, at prices to consumers which, when considered with relevant economic criteria, are fair and reasonable.

(c) That prices, including the prices of components of milk, established by the director for the various classes of market milk bear a reasonable and sound economic relationship to each other.

In establishing the prices, the director shall also take into consideration all the purposes, policies, and standards contained in Sections 61801, 61802, 61805, 61806, 61807, 62076, and 62077.

Credits

(Added by Stats.1977, c. 1192, p. 3924, § 5. Amended by Stats.1983, c. 383, § 3, eff. July 26, 1983; Stats.1993, c. 1112 (S.B.688), § 2.)

Notes of Decisions (21)

West's Ann. Cal. Food & Agric. Code § 62062, CA FOOD & AG § 62062
Current with urgency legislation through Ch. 14 of 2012 Reg.Sess. and all propositions on the 6/5/2012 ballot.

End of Document

TAB 4

West's Annotated California Codes
Food and Agricultural Code (Formerly Agricultural Code) (Refs & Annos)
General Provisions and Definitions (Refs & Annos)

West's Ann.Cal.Food & Agric.Code § 47

§ 47. Shall; may

Currentness

"Shall" is mandatory, and "may" is permissive.

Credits
(Stats.1967, c. 15.)

West's Ann. Cal. Food & Agric. Code § 47, CA FOOD & AG § 47
Current with urgency legislation through Ch. 14 of 2012 Reg.Sess. and all propositions on the 6/5/2012 ballot.

End of Document

TAB 5

California DAIRIES inc.

TESTIMONY PRESENTED AT THE MAY 31 – JUNE 1, 2012 WHEY FACTOR HEARING

Mr. Hearing Officer and Members of the Panel:

Good morning/afternoon. My name is Eric Erba and I hold the position of Senior Vice President of Administrative Affairs for California Dairies, Inc. ("California Dairies"), whom I am representing here today. California Dairies is a full-service milk processing cooperative owned by 420 producer-members located throughout the State of California and collectively producing almost 17 billion pounds of milk per year, or 43% of the milk produced in California. Our producer-members have invested over $500 million in large processing plants at six locations, which are projected to produce about 400 million pounds of butter and 800 million pounds of powdered milk products in 2012. On February 28, 2012 the Board of Directors for California Dairies voted unanimously to participate in the producer coalition in search of an upward adjustment in the whey portion of the Class 4b formula. California Dairies fully supports the position articulated by the producer coalition that testified earlier today. As a member of the coalition, I will be offering some supporting comments.

Introductory Comments:

As other witnesses have already done, we too thank the Department for calling this hearing and allowing us the opportunity to voice our concern about the manner in which whey is valued by the California milk pricing system. The disparity between whey valuation in federal milk marketing orders and in California is simply too large to ignore and has far too great of an impact on our member-owners' milk price. It must be addressed and corrected.

Whey Valuation

Participants from the 2007 hearing understood that when the Department adopted the fixed factor of 25-cents per cwt. to represent the value of whey in the Class 4b pricing formula, it was meant to be a placeholder until the dairy industry could agree on a more appropriate mechanism to value whey. A series of industry workshops was held to find an appropriate and widely supported substitute, but none was found. Consequently, the 25-cents per cwt. fixed factor was maintained for years, rather than a few months, as it was originally conceived.

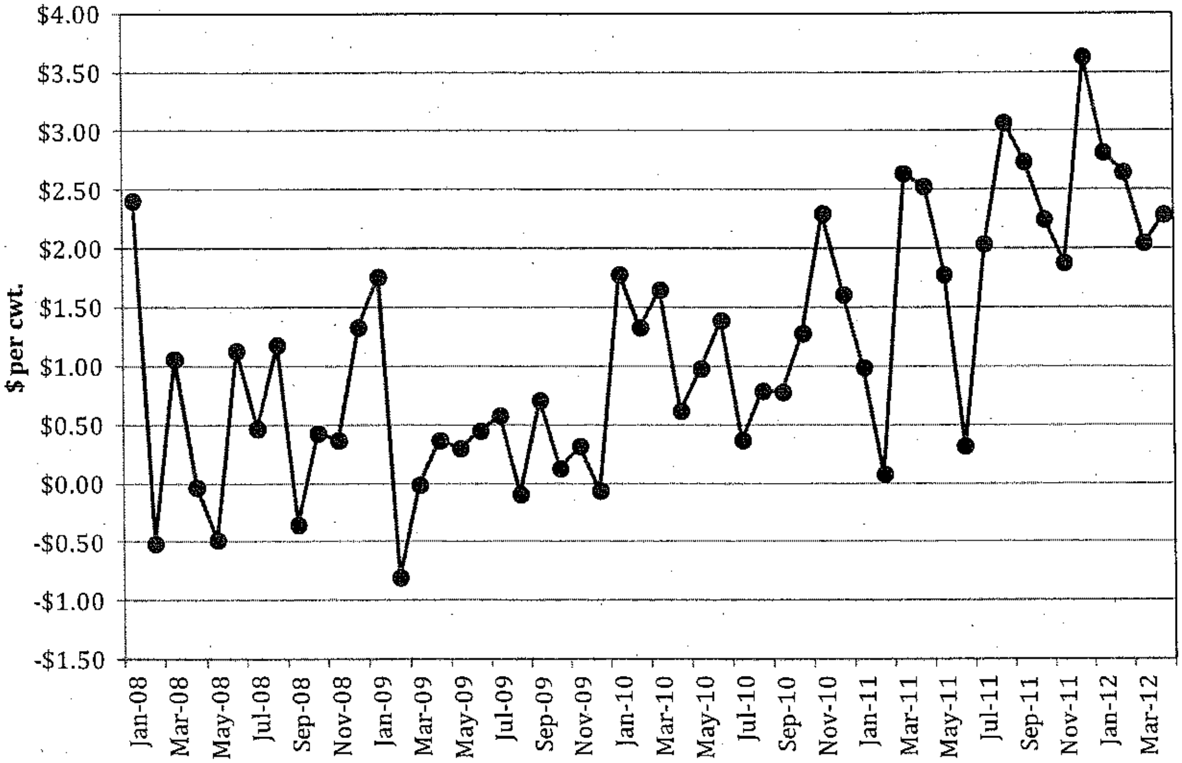
The decision from June 30, 2011 hearing provided a better solution, but it was one that did not go far enough. Even though the new approach adjusted the whey contribution to the Class 4b price according to market conditions, it was immediately "maxed out" upon implementation in September 2011. Furthermore, at only the very lowest market prices of dry whey does the contribution to the Class 4b formula resemble that of the federal order class III formula. As the dry whey price increases, there is a greater and greater disparity in the contribution of the value of whey toward the two cheese milk prices. Fortunately, the difference between the California and federal order formulas is identifiable, measureable, and reparable. It is precisely this valuation disparity that California producers see as an egregious inequity in milk pricing. The issue of proper whey valuation has galvanized California dairy producers like very few other issues have, and that is why we have unprecedented cooperation and agreement among the producer groups for this hearing.

California dairy producers have been patient throughout the decade-long process of getting the industry to accept the concept of whey being a part of the regulated pricing formula. We recognize that all cheese processors would be impacted by the proposal advanced by the producer coalition, whether or not an individual cheese plant further processes whey or not. Our support of a previous effort to provide a "whey credit" for all cheese plants was rebuffed by the Department in 2007. The disagreement stems from different interpretations of the California Food and Agricultural Code as to the authority bestowed upon the Department, i.e., does the Department have the authority to establish a "whey credit" system for cheese plants without specific authorizing language or not? It is unfortunate that no resolution to this general disagreement on Departmental authority has surfaced, and, therefore, dairy producer representatives are limited in trying to identify a solution. Basically, an appropriate mechanism to value whey must apply to either all cheese plants or none of them. Dairy producer groups are not trying to put cheese plants out of business. However, the issue of the whey contribution to the Class 4b pricing formula and the subsequent value to producers as a whole cannot be ignored any longer. Therefore, California Dairies supports the adoption of the producer coalition's revised sliding scale to adjust the whey contribution as contained in the Class 4b formula.

Pricing Formula Change is Quantitatively Justified

You have heard testimony on what a "reasonable relationship" means in the context of milk pricing, and I will not dwell on the Food and Agricultural code any further. There is something to be learned, however, about milk price equity, and I will devote some time to covering that issue specifically. Figure 1 shows the monthly difference between the announced California Class 4b price and the federal order class III price. The graph shows that there are pricing differences even when dry whey prices were relatively low (as seen in 2008 and 2009). As prices for dry whey surged in 2010 and beyond, the differences between the two formulas became much larger. A simple statistical analysis reveals that almost 80% of the change in the difference in the two milk price series is explained by the change in the value of dry whey. The meaning of the result is clear enough – the additional value of dry whey that is being captured by the federal order class III formula is not, for the most part, getting captured by the Class 4b formula. This phenomenon is a function of pricing formula construct and can be remedied easily by adopting the changes set forth in the producer coalition's petition and testimony. Doing so would improve the cheese milk price equity among producers in federal milk marketing orders and producers in California that is now absent.

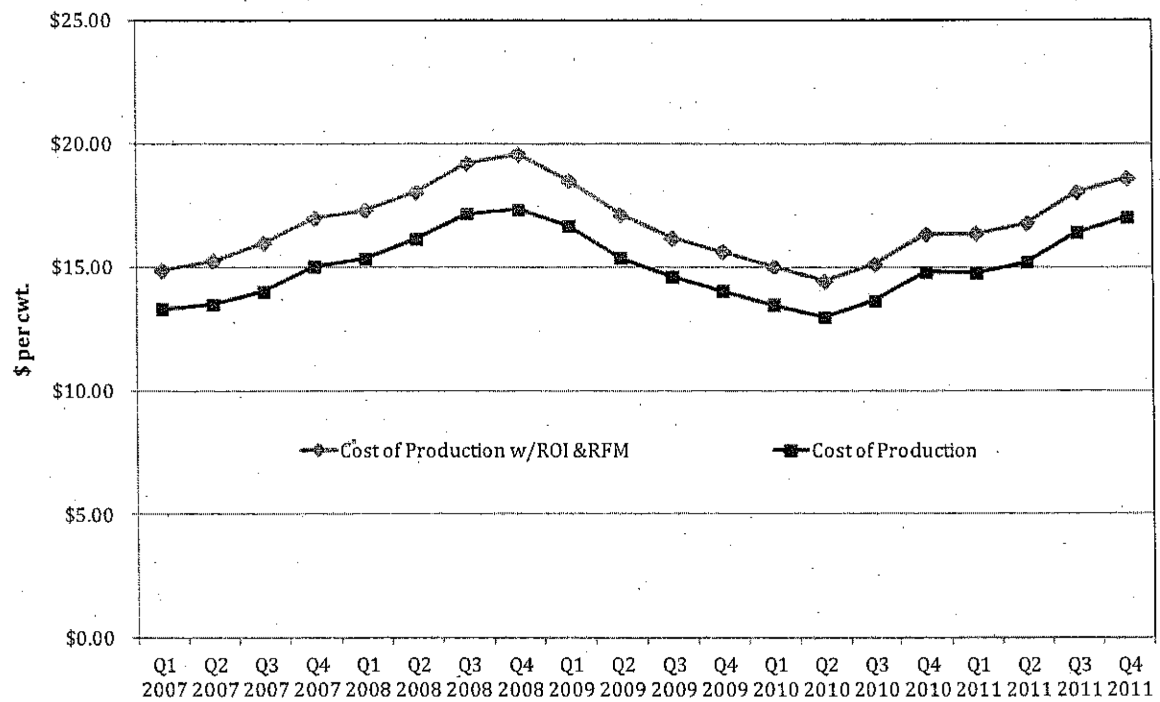
Figure 1. Difference of the Announced Class 4b price and Federal Order Class III Price, 2008 to 2011



The Reality of Higher Milk Production Costs

While the revised Class 4b whey factor table contained in the producer coalition petition is rooted in an argument for greater milk price equity, I would be remiss not the mention the extraordinary increases in milk production costs that have hit California dairy producers. These costs should not come as a surprise to the Department; the data that I will be citing has been collected and distributed by the Department. It is a well-known fact, particularly within the Dairy Marketing Branch, which collects the cost of production data, that California dairy producers are extremely vulnerable to feed cost increases, as most dairy producers must purchase a high percentage of their feed. Figure 2 shows two measures of the cost of producing milk in California obtained from the Department. The most recent data release shows that the current cost of producing milk is about 25% to 30% higher than either of the two lowest points shown – the first quarter of 2007 and the first quarter of 2010. Again, with reference to data made available by the Department, the driving factors of this result are elevated feed costs. The cost of milk cow hay price is 68% higher and the cost of milk cow grain mix is 50% higher than their respective low points over the past five years.

Figure 2. Cost of Production for California Dairy Producers, 2007 to Present

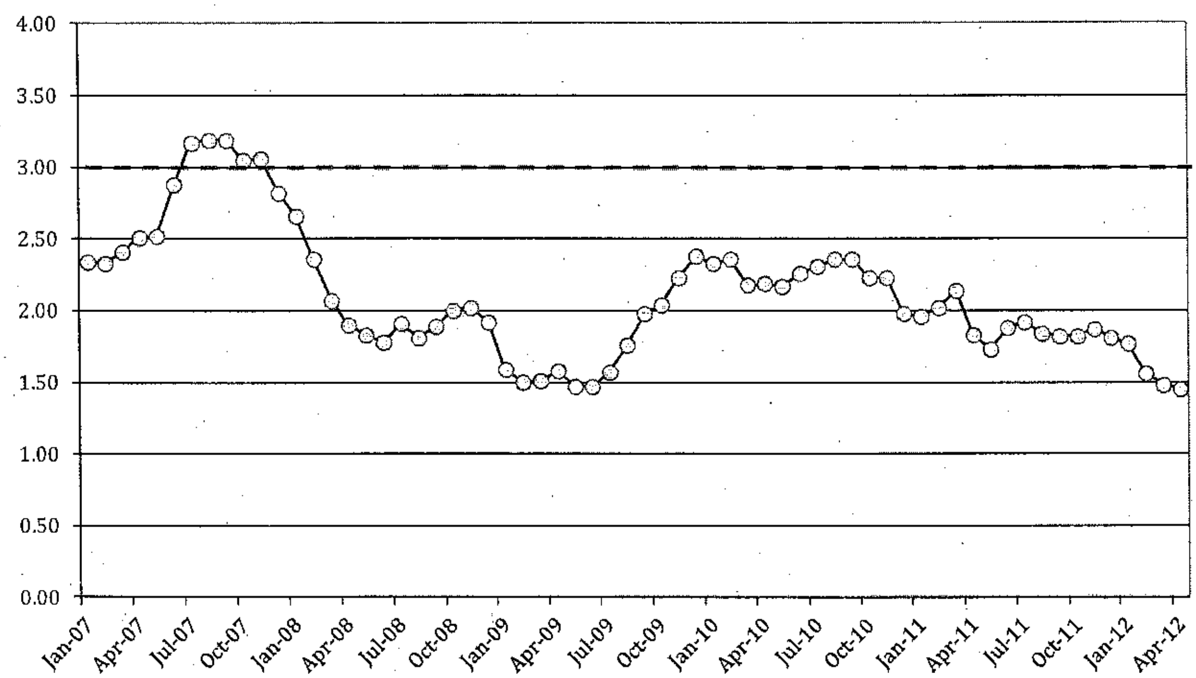


Survivability Has Replaced Profitability

By virtually any measure, the situation facing dairy producers today, especially in California, is dire. USDA's milk-feed ratio is widely recognized as a barometer of the health of the production side of the dairy industry. At one time, a milk-feed ratio of 3.0 was considered to be favorable for dairy producers. Figure 3 shows a stark trend away from the dashed line that highlights what would be considered a favorable ratio.

From the perspective of California Dairies, we are concerned about the health and survivability of our member-owners. One of the easiest measures that we have direct access to is number of members in the cooperative. Most analysts would agree that milk prices in 2011 were at least good, perhaps even very good. However, they were not good enough to keep 32 of our members from resigning. Nearly all of these resignations were from financial pressures, and those former members are now permanently out of the production side of the dairy business.

Figure 3. Milk-Feed Ratio, Jan 2007 to April 2012



<u>Continuation of the Class 4b and Class III Pricing Difference is not Defensible</u>

Part of the benefit to having close relationships within the dairy industry is that each group has a good idea of the statements that will be made by the other groups. Just as the cheese processors have anticipated what the producer representatives will say at today's hearing, we too have anticipated what may be submitted into the hearing record by cheese processors. We suggest that our statements and responses effectively parry any opposition to the producer coalitions' proposed changes to the Class 4b formula.

You may have heard or will hear that cheese makers need more time to adjust to whey pricing changes. We remind the Department that the issue of regulated milk pricing as applied to whey has been debated for more than a decade. During that time, the producer point of view has not wavered – producers are seeking to extract more money from the milk that goes into cheese because of the value that whey adds. Cheese makers have had ample time make their own operational changes such that more value can be achieved from a unit of milk and a higher price can be paid to dairy producers.

You may have heard or will hear that higher whey prices as part of the regulated milk price will devastate the California cheese industry. But cheese plants outside of California have been paying, on average, a higher price for milk for decades. More recently, they have had to pay a higher price for cheese milk as a direct result of the higher price for dry whey. Somehow, cheese plants in other states have found an answer for continuing to operate while paying a higher price for the milk used to make their products. We only ask that the California cheese plants be as resourceful as cheese plants in other parts of the U.S. and pay an equitable price for the milk they are buying to make cheese and other products.

Furthermore, we suggest that low regulated whey prices have not attracted cheese processing capacity to California, and, conversely, higher regulated whey prices have not discouraged cheese plants from being built outside of California. A simple enumeration of cheese plants built in the U.S. over the past few years verifies this statement. The obvious conclusion is that there are factors other than the price of whey that are affecting the decisions companies make on where to locate a cheese plant. It is not logical to suggest that keeping the whey component of the Class 4b milk pricing formula low can help to attract more processing capacity to the State. Dairy producers have endured undervalued whey for many years, and have no additional cheese plants to show for their patience. The whey valuation inequity must be corrected.

Finally, you may have heard or will hear that milk production is already too high, and establishing a higher minimum price by increasing the whey component will only make matters worse. It does not take much of an analyst or a historian to conclude that managing the State's milk supply by adjusting minimum pricing formulas once every 18 to 24 months is ineffective and inefficient. All of the major cooperatives and some of the proprietary plants arrived at that same conclusion years ago and adopted supply management programs that are actively managed and can adjust with market conditions. As far as I know, the cost of oversupply of milk is borne entirely by the producers, and not by any other entity. This statement applies to any of the supply management programs that exist today in California.

There is a matter of timing that should be touched on – specifically, timing of the hearing and timing of the cyclical nature of milk production. There are only a few months out of any year that potentially put a strain on plant processing capacity. Had this hearing been scheduled at a different time, say in February or in July, there would be few, if any, arguments suggesting that higher prices will lead to more milk being produced that cannot be processed in-state. Likewise, it seems counterintuitive to use the conditions faced during a two-month period to establish minimum prices that may persist for the next 18 to 24 months. Achieving efficiency means maximizing the use of assets at both the farm and the plant. Short-term oversupply may be the result of needing to keep plants at a more optimal level of capacity in the remaining months of the year.

Concluding Remarks

California Dairies has offered testimony today on behalf of our 420 member-owners to voice our collective concern about the manner in which whey is valued in the California milk pricing system. At a time when so many California dairy farmers are struggling to survive, the widely advertised disparity between whey valuation in federal milk marketing orders and in California is difficult to understand and even more difficult to accept.

We appreciate the changes that the Department made to the Class 4b pricing formula last year to begin to close the gap between California's Class 4b price and the federal order class III price. However, the pricing data show that there is still considerable work to be done to get the two minimum pricing series in closer alignment. The revised sliding scale for whey valuation as proposed in the producer coalition's petition is the next step in what has been a lengthy process to establish milk pricing equity. We urge the Department to adopt the revised sliding scale for whey valuation as presented earlier today.

Thank you for your attention. I am happy to answer any questions that you have, and I request the opportunity to file a post-hearing brief.

TAB 6

West's Annotated **California** Codes
Food and Agricultural Code (Formerly Agricultural Code) (Refs & Annos)
Division 21. Marketing (Refs & Annos)
Part 3. Marketing Laws Regarding Particular Products (Refs & Annos)
Chapter 2. Stabilization and Marketing of Market Milk (Refs & Annos)
Article 1. Legislative Declarations (Refs & Annos)

West's Ann.Cal.Food & Agric.Code § **61802**

§ **61802**. Legislative declarations

Currentness

The Legislature hereby declares all of the following:

(a) Market milk is a necessary article of **food** for human consumption.

(b) The production and maintenance of an adequate supply of healthful market milk of proper chemical and physical content, free from contamination, is vital to the public health and welfare, and the production, transportation, processing, and storage of market milk in this state is an industry affecting the public health.

(c) Because of the perishable quality of milk, the nature of milk production, the varying seasonal production and demand factors, and other economic factors affecting the milk industry, the potential exists for economic disruption, in the absence of regulation, in the production, marketing, and sale of market milk which may constitute a menace to the health and welfare of the inhabitants of this state and may tend to undermine sanitary regulations and standards of content and purity, however effectually the sanitary regulations may be enforced.

(d) Health regulations alone are insufficient to prevent economic disturbances in the production of milk which may disrupt the future supply of market milk and to safeguard the consuming public from future inadequacy of a supply of this necessary commodity.

(e) It is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of commodities necessary to its citizens, including market milk, and to eliminate economic waste, destructive trade practices, and improper accounting for market milk purchased from producers.

(f) It is recognized by the Legislature that the economic factors concerning the production, marketing, and sale of market milk in **California** may be affected by the national market for milk for manufacturing purposes.

(g) It is recognized by the Legislature that in recent years the supply of manufacturing milk in **California**, as defined in Section 32509, has consistently declined and continues to decline, and that market milk has virtually supplanted manufacturing milk for manufacturing purposes in this state, and that it is therefore necessary to conform the pricing standards governing minimum producer prices for market milk established under this chapter to current economic conditions.

(h) It is recognized by the Legislature that the levels of retail prices of milk and milk products paid by consumers are affected by a large number of economic and other factors apart from minimum producer prices for market milk established under this chapter, many of which factors are not within the power of the director to regulate or control, particularly since the Legislature repealed provisions concerning establishment of minimum wholesale and retail prices. It is further recognized by the Legislature that, in order to accomplish the purposes of this chapter and to promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that will promote the intelligent and orderly marketing of market milk in the various classes, and that minimum producer prices established under this chapter should not be unreasonably depressed because other factors have affected the levels of retail prices paid by consumers.

Credits

(Added by Stats.1977, c. 1192, p. 3924, § 5. Amended by Stats.1982, c. 751, p. 2974, § 22; Stats.1993, c. 1112 (S.B.688), § 1.)

Editors' Notes

CROSS REFERENCES

Pricing, consideration of purposes, policies, and standards, see **Food** and Agricultural **Code §** 62062.

RESEARCH REFERENCES

Encyclopedias

CA Jur. 3d **Food** and **Food** Facilities § 171, Prices.

Relevant Notes of Decisions (5)

View all 5

Notes of Decisions listed below contain your search terms.

Validity

Congress insulated **California's** milk compositional standards from Commerce Clause challenges by enacting section of Federal Agriculture Improvement and Reform Act providing that nothing in Act or "any other provision of law" should be construed to "preempt, prohibit, or otherwise limit" **California's** milk laws or regulations. Shamrock Farms Co. v. Veneman, C.A.9 (**Cal.**)1998, 146 F.3d 1177, certiorari denied 119 S.Ct. 872, 525 U.S. 1105, 142 L.Ed.2d 773. Commerce 60(2); **Food** 1.8(2)

California's milk pricing and pooling laws were exempted from Commerce Clause challenge by Federal Agriculture Improvement and Reform Act's prohibition against indirect limitations on laws, regulations, or requirements regarding **California's** milk standards; pricing and pooling provisions were essential part of **California's** plan to maintain its milk composition standards. Shamrock Farms Co. v. Veneman, C.A.9 (**Cal.**)1998, 146 F.3d 1177, certiorari denied 119 S.Ct. 872, 525 U.S. 1105, 142 L.Ed.2d 773. Commerce 60(2); **Food** 1.9(2)

California's milk composition standards and pricing and pooling laws did not violate Equal Protection Clause or Due Process Clause; **California's** milk laws and regulations furthered state's interests in maintaining stable and plentiful supply of wholesome milk. Shamrock Farms Co. v. Veneman, C.A.9 (**Cal.**)1998, 146 F.3d 1177, certiorari denied 119 S.Ct. 872, 525 U.S. 1105, 142 L.Ed.2d 773. Constitutional Law 3700; Constitutional Law 4283; **Food** 1.9(2)

Pricing formula

Director of Department of **Food** and Agriculture was not required to adopt manufacturing cost allowance that allowed all cheese manufacturers to recover their costs and return on investment at expense of producers in adopting cheese specific pricing formula while amending milk marketing plans pursuant to stabilization and marketing of market milk provision of Milk Stabilization Act. Golden Cheese Co. v. Voss (App. 4 Dist. 1991) 281 Cal.Rptr. 587, 230 Cal.App.3d 547, review denied. **Food** 4.5(4)

Setting cheese manufacturing cost allowance in establishing minimum market milk price of cheese specific price formula of 19.5¢ per pound was not arbitrary, even though average cost of producing cheese in state was 20.77¢ per pound, since higher manufacturing cost allowance would have upset reasonable and sound relationship between different classes of market milk. Golden Cheese Co. v. Voss (App. 4 Dist. 1991) 281 Cal.Rptr. 587, 230 Cal.App.3d 547, review denied. **Food** 4.5(4)

West's Ann. **Cal. Food & Agric. Code § 61802**, CA **FOOD** & AG § **61802**
Current with urgency legislation through Ch. 14 of 2012 Reg.Sess. and all propositions on the 6/5/2012 ballot.

End of Document

TAB 7

Testimony of Rob Vandenheuvel

General Manager, Milk Producers Council

California Department of Food and Agriculture Hearing on Class 4b Minimum Price Formula

May 31 - June 1, 2012

Mr. Hearing Officer and Members of the Panel, my name is Rob Vandenheuvel and I am the General Manager of Milk Producers Council (MPC). MPC is a non-profit trade association with office locations in Ontario, Bakersfield and Turlock, California. We represent a voluntary membership of dairy families throughout Southern and Central California. My testimony today is based on positions adopted by the MPC Board of Directors.

Economics of the California Dairy Industry

The last several years have been extremely challenging for California dairy producers. The California Department of Food and Agriculture's (CDFA) own numbers tell a sobering story about the financial state of the California producers. As we can see from the figures in CDFA's exhibit, the average cost-of-production in California from 2007 – 2011 was $16.77 per hundredweight. Compare that to the average price paid for milk during that time period of $15.96 per hundredweight. To put that in perspective, a California dairyman working hard for the past five years to run an average-sized 1,000 cow dairy and provide for his family can reasonably expect, according to CDFA's own analysis, to realize a net loss of over $850,000 during that extended time frame.

While today's hearing focuses specifically on the structure of the Class 4b formula and achieving equity with the national prices paid for comparable milk, it is important to recognize that the decisions made by the Secretary in this area have a direct impact on the overall economics of the California dairy families. Forty percent of the milk produced and sold in California is going to cheese manufacturers, and the regulated minimum prices that must be paid have a direct impact on the ability/inability of our State's dairies to generate a reasonable return on their investment.

Producer Petitions

Before us today are two producer-sponsored proposals for modifying the Class 4b formula – one from a Coalition of dairy producer organizations and cooperatives and another from Western United Dairymen. As previous testimony has already shown, these two proposals are identical. Milk Producers Council was involved in the development of the proposed changes to the Class 4b formula and strongly supports them as the only proposed changes that would result in a California Class 4b price that more reasonably tracks with the national value of milk being sold to cheese manufacturers.

While CDFA staff has included analysis in its hearing exhibit about the impact of this proposal on a per-hundredweight basis, I have included in Attachment A of this testimony a breakdown of the actual financial impact this proposal would have on California's pooled revenues. As you will see in the attachment, the difference between this proposal – which brings our formula in closer alignment with the national value of milk being sold to cheese plants around the country – and the actual Class 4b formula we've had for the past several years is absolutely astounding. Since December 2007, when the Class 4b formula was changed from having a variable dry whey factor to having a static $0.25 per hundredweight dry whey factor, the difference between this proposal and the actual formula equates to more than $582 million. In just the past eight months since the last time the Class 4b formula was modified, the difference equates to more than $212 million.

While these numbers alone tell a sobering story, it should also be noted how the proposed changes would have impacted the relationship between the California Class 4b price and the announced Federal Order Class III price – which as I will discuss in a few minutes is the optimal benchmark price for milk being sold to cheese manufacturers around the country. Looking at that same period from December 2007 to the present, the proposed changes would have resulted in an average Class 4b price of $15.13 per hundredweight, a $0.74 per hundredweight increase over the actual Class 4b prices that were announced during that time ($14.39 per hundredweight). During that same period, the average announced Federal Order Class III price was $15.55 per hundredweight.

The reason for pointing this out is to demonstrate that while producers are proposing a revised Class 4b formula that will more fairly capture the value of whey solids, it is worth noting that over the past five years, even our proposed Class 4b formula would have resulted in a minimum price that is $0.42 per hundredweight below the Federal Order Class III price. That difference is primarily tied to the differences in how the two formulas account for the value of cheddar cheese (i.e., CME vs. NASS, differing make allowances and California's f.o.b. adjuster). I point this out not to endorse this difference but to recognize that even under the producer proposal, our State's cheese manufacturers would have enjoyed a regulated minimum price that is on average $0.42 per hundredweight below the Class III benchmark price for milk sold to cheese manufacturers around the country.

California Food and Agriculture Code

CDFA is bound by law to implement minimum prices for each of the five classes of milk per the legislative instructions included in Sections 62061 – 62079 of the California Food and Agricultural Code ("Code"). While these sections collectively include numerous things the Secretary must "consider" when establishing minimum prices, Section 62062 lays out the most direct mandate to the Secretary in determining the minimum price for each class of milk. While the section provides broad latitude in how the Secretary establishes the prices (i.e., directly designating the prices or establishing methods/formulas to result in the prices), the statute is clear that, *"If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products."* So regardless of the methods/formulas that are used, the ultimate Class 4b minimum price that is announced shall be "in a reasonable and sound economic relationship with the national value of manufactured milk products."

Other testimony in this hearing, particularly from Coalition partners Land O'Lakes and Dairy Farmers of America who operate in both California and Federal Order areas, will devote more time to explaining why the Federal Order Class III price is an appropriate benchmark for establishing the "national value of manufactured milk products." I understand there is also written material being submitted into the hearing record by a dairy processing company that operates in Idaho, a market that is not part of a state or federally-regulated system. Collectively, that additional testimony will make it abundantly clear that in the case of determining the national value of milk being sold to cheese manufacturers, the Federal Order Class III price is by far the best benchmark to use.

The next question is how to define a "reasonable and sound economic relationship." In conducting research for this hearing, I came across a letter CDFA wrote to John Rossi, Chairman of the "California Floor Price Committee" on August 25, 2010. In that correspondence, CDFA cited Section 62062 as a justification for denying a hearing request. As background, the California Floor Price

Committee petitioned CDFA to hold a hearing to consider establishing a floor price of $14.50 per hundredweight for milk produced and sold in California. In CDFA's letter denying this hearing request (which is attached to this written testimony at Attachment B), Kevin Masuhara – Director of CDFA's Division of Marketing Services – stated that, *"Establishing a floor price for a two year period would result in prices that are not in reasonable and sound economic relationship with the national value of manufactured milk products, as required by Section 62062 of the Food and Agricultural code."*

The clear message in the letter was that limiting the ability of California raw milk prices to move with the market while no such limitation exists in other areas of the country would violate the legislative mandate outlined in Section 62062 of the "Code." I submit to the hearing panel that this characterization can be equally applied to our current Class 4b formula, which includes provisions that narrowly limit the range of possible dry whey factors to between $0.25 - $0.65 per hundredweight. It is clear that our current Class 4b formula must be changed in order to allow the monthly announced price to consistently be in a reasonable and sound economic relationship with the national value of manufactured milk products, as required by Section 62062 of the Food and Agricultural Code.

Importance of Maintaining a "Reasonable and Sound Economic Relationship"

Much of the raw milk sold in the U.S. is priced using formulas that utilize the market value of dairy products. This includes not only the California and Federal Order pricing systems, but also the contracts that are entered into in unregulated areas like Idaho. That type of formula allows supply/demand signals to be sent to dairy farmers through changes in the market values of products such as cheddar cheese, butter, nonfat dry milk and dry whey.

With that amount of market value flexibility already built into the pricing structure, there is no logical reason to further discount California's regulated price significantly below national values for comparable milk. We've seen ample evidence – some of which will be included in testimony at this hearing – that the discounted regulated prices in California have not attracted significant additional investment in processing capacity in the State. At the same time, news reports indicate that proprietary dairy processing companies are choosing to make investments in other areas of the country where the expected cost of a milk supply is higher than California. The logical reason is that the business climate – whether you're a dairy farmer or a dairy processor – is very hostile in California. The dairy producer side of our industry cannot afford to continue discounting our milk prices in some misguided attempt to overcome the red tape that exists in California and attract additional processing investment. That issue is larger than simply the milk price.

Reasonable Expectation that CDFA Will Follow the Law

Sellers of raw milk in California – whether that is an independent dairy farmer or a producer-owned cooperative – rely on a belief that the government will follow the law, and because of that, have established long-term contractual relationships for milk based on state-announced minimum prices. That is a reasonable position to take when looking at the California Food and Ag Code which states that:

- A goal of the regulations is to enable the dairy industry, with the aide of the state, to develop and maintain satisfactory marketing conditions…and bring about and maintain a reasonable amount of stability and prosperity in the production of market milk (Section 61805(d));
- CDFA shall establish prices that are in a reasonable and sound economic relationship with what comparable milk is worth around the country (paraphrase of Section 62062); and

- CDFA shall take into consideration that the reasonableness and economic soundness of market milk prices 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. And that in determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment (Section 62062(b)).

Dairies and their cooperatives rely on CDFA to follow the Food and Agricultural Code when they establish contracts to sell their milk to manufacturers. They rely on the fact that the prices must be competitive with what milk is worth in other parts of the country. They rely on the fact that CDFA must consider producers cost of production, including a reasonable return on investment and a cost of management, when establishing prices.

Why would sellers of raw milk in California agree to long-term contractual relationships fundamentally based on CDFA-announced minimum prices if they thought those prices would be systematically discounted below the national prices for milk sold to comparable manufacturing facilities? Why would sellers of raw milk agree to contracts that can't be reasonably expected over the long term to cover dairy producers' costs? It's simple; they wouldn't.

Managing Supply/Demand is Role Best Played by the Industry, not CDFA

In a March 28, 2012 letter written to California Dairies, Inc. with regard to this hearing, CDFA Marketing Services Director Masuhara wrote that, *"The Department has the responsibility and mandate to establish minimum prices that will encourage California's milk production to be marketed in an orderly fashion. The Class 4a and Class 4b prices must be set at a level that will "clear" the market or will facilitate the balancing of the supply and demand for milk."* (The full letter is attached to this testimony as Attachment C.) While this hearing structure does not allow for a dialogue with CDFA legal counsel, MPC would challenge the assertion that any such mandate exists. Where in the California Food and Agricultural Code is it stated that our manufactured class prices must be set at market-clearing prices? It is true that references in the Code list "orderly marketing" as something the Secretary must "consider" when establishing prices, no different than the requirement that CDFA "considers" producers cost of production and return on management/investment and the ability of the milk prices to cover those costs. But the only fundamental mandate that exists in the relevant sections of the Code is the mandate that the prices resulting from our classified pricing formulas be in a reasonable and sound economic relationship with the national value of manufactured milk products.

It's unrealistic to expect broad policies outlined by CDFA to be responsive enough to address supply/demand issues within the State. The ultimate responsibility for aligning our State's milk production with demand for that milk falls on the dairy producer sector, whether that's individual dairies that have contracts with their buyers, or producer-owned cooperatives. It's also worth noting that any financial cost that arises from a milk supply that exceeds local demand is borne directly by producers. The recent implementation of "base plans" by the state's major dairy cooperatives is clear evidence that the dairy producer sector of our industry is the only one that truly has the tools to affect regional supply/demand balance.

Basic Structure of the Class 4b Formula

A common theme in previous hearings on this issue has been that not all cheese manufacturers are created equal. Our State boasts a diverse collection of cheese manufacturers, from large-scale international companies to smaller-scale specialty manufacturers, and everything in between. These plants have all made individual business decisions about how to operate their plants.

The role of CDFA is to establish a minimum price for the milk these plants must purchase to run their operations. To accomplish this task, CDFA has established a Class 4b formula that is driven by the prices reported for commodity-grade cheddar cheese, being sold on the Chicago Mercantile Exchange in high-volume quantities (40,000 lb loads of Cheddar cheese blocks) and basic dried whey powder as reported by the U.S. Department of Agriculture. That's not to say that most of the cheese manufactured in California is cheddar cheese sold in high-volume quantities on the Chicago Mercantile Exchange. In fact, significantly more mozzarella cheese is being produced in California than cheddar cheese. But CDFA has chosen these basic commodity dairy products to serve as a surrogate for the purpose of establishing minimum prices for Class 4b milk.

Each individual manufacturing plant in California makes a business decision as to whether they can secure a milk supply at a price that allows them to process that milk into a product that can garner a profitable price in the marketplace. It's no different than the considerations that must be made by cheese manufacturers around the country – including those that operate in Federal Order areas that pay prices at/above Class III minimum prices.

The point is that the minimum price formulas established in California have not been designed to reflect the exact processes followed by each manufacturer, nor should they be. They are simply a tool used each month to establish a regulated minimum price for the various classes of milk sold to manufacturers, with the mandated standard that those prices must be in a reasonable and sound economic relationship with what prices are paid for comparable milk around the country.

Conclusion

In conclusion, for all the reasons stated above as well as the reasons outlined by previous/upcoming testimony given by fellow producer organizations/cooperatives, MPC is strongly supporting the identical petitions submitted by the Coalition and Western United Dairymen. That proposal is truly the only one being made today that will achieve the mandated standard of bringing our California Class 4b price into a reasonable and sound economic relationship with the national value of manufactured milk products. We strongly urge the Secretary to act quickly to implement this much needed change to our Class 4b formula.

Attachment A

ACTUAL DRY WHEY FACTOR VS. PROPOSED DRY WHEY FACTOR

CONVERSION: Each $0.01/cwt difference in the DWF represents ($0.01 / 8.8) difference per lb of SNF
SOURCE: Lbs. of 4b SNF from CDFA's monthly "Dairy Information Bulletin"

Month	DMN DW	Act. 4b DWF	Prop. 4b DWF	Difference	Lbs. of 4b SNF	$$ Impact	Act. Cl. 4b Price	Prop. Cl. 4b Price	FO Cl. III Price	Difference
Dec-07	$0.4406	$0.2500	$1.3699	$1.1199	139,705,000	$17,779,049	$18.58	$19.69	$20.60	($0.91)
Jan-08	$0.3780	$0.2500	$0.9800	$0.7300	138,053,000	$11,452,124	$16.91	$17.63	$19.32	($1.69)
Feb-08	$0.2588	$0.2500	$0.3144	$0.0644	131,027,000	$958,879	$17.54	$17.60	$17.03	$0.57
Mar-08	$0.2394	$0.2500	$0.2000	($0.0500)	134,968,000	($766,864)	$16.94	$16.89	$18.00	($1.11)
Apr-08	$0.2730	$0.2500	$0.4228	$0.1728	129,805,000	$2,548,898	$16.79	$16.96	$16.76	$0.20
May-08	$0.2813	$0.2500	$0.4786	$0.2286	130,811,000	$3,398,113	$18.66	$18.89	$18.18	$0.71
Jun-08	$0.2800	$0.2500	$0.4786	$0.2286	128,255,000	$3,331,715	$19.12	$19.35	$20.25	($0.90)
Jul-08	$0.2800	$0.2500	$0.4786	$0.2286	128,366,000	$3,334,599	$17.77	$18.00	$18.24	($0.24)
Aug-08	$0.2756	$0.2500	$0.4228	$0.1728	127,497,000	$2,503,577	$16.14	$16.31	$17.32	($1.01)
Sep-08	$0.2338	$0.2500	$0.2000	($0.0500)	125,227,000	($711,517)	$16.63	$16.58	$16.28	$0.30
Oct-08	$0.1860	$0.2500	$0.0000	($0.2500)	129,237,000	($3,671,506)	$16.63	$16.38	$17.06	($0.68)
Nov-08	$0.1663	$0.2500	$0.0000	($0.2500)	123,126,000	($3,497,898)	$15.14	$14.89	$15.51	($0.62)
Dec-08	$0.1588	$0.2500	$0.0000	($0.2500)	127,086,000	($3,610,398)	$13.95	$13.70	$15.28	($1.58)
Jan-09	$0.1495	$0.2500	$0.0000	($0.2500)	112,961,000	($3,209,119)	$9.02	$8.77	$10.78	($2.01)
Feb-09	$0.1519	$0.2500	$0.0000	($0.2500)	105,635,000	($3,000,994)	$10.11	$9.86	$9.31	$0.55
Mar-09	$0.1747	$0.2500	$0.0000	($0.2500)	117,906,000	($3,349,602)	$10.45	$10.20	$10.44	($0.24)
Apr-09	$0.2200	$0.2500	$0.1443	($0.1057)	115,161,000	($1,383,241)	$10.41	$10.31	$10.78	($0.47)
May-09	$0.2563	$0.2500	$0.3114	$0.0614	114,816,000	$801,103	$9.54	$9.60	$9.84	($0.24)
Jun-09	$0.2925	$0.2500	$0.5343	$0.2843	109,089,000	$3,524,318	$9.52	$9.80	$9.97	($0.17)
Jul-09	$0.3170	$0.2500	$0.6457	$0.3957	110,732,000	$4,979,165	$9.39	$9.78	$9.97	($0.19)
Aug-09	$0.3200	$0.2500	$0.7014	$0.4514	111,229,000	$5,705,542	$11.29	$11.74	$11.20	$0.54
Sep-09	$0.3200	$0.2500	$0.7014	$0.4514	109,678,000	$5,625,983	$11.40	$11.85	$12.11	($0.26)
Oct-09	$0.3350	$0.2500	$0.7571	$0.5071	112,753,000	$6,497,392	$12.69	$13.19	$12.82	$0.37
Nov-09	$0.3581	$0.2500	$0.8685	$0.6185	108,150,000	$7,601,224	$13.76	$14.37	$14.08	$0.29
Dec-09	$0.3860	$0.2500	$1.0357	$0.7857	111,183,000	$9,926,873	$15.04	$15.82	$14.98	$0.84
Jan-10	$0.4059	$0.2500	$1.1471	$0.8971	111,507,000	$11,367,378	$12.72	$13.61	$14.50	($0.89)
Feb-10	$0.4050	$0.2500	$1.1471	$0.8971	101,632,000	$10,360,689	$12.95	$13.84	$14.28	($0.44)
Mar-10	$0.4041	$0.2500	$1.1471	$0.8971	117,239,000	$11,951,717	$11.13	$12.02	$12.78	($0.76)
Apr-10	$0.4000	$0.2500	$1.1471	$0.8971	112,940,000	$11,513,463	$12.30	$13.19	$12.92	$0.27
May-10	$0.3972	$0.2500	$1.0914	$0.8414	116,912,000	$11,178,381	$12.40	$13.23	$13.38	($0.15)
Jun-10	$0.3915	$0.2500	$1.0914	$0.8414	115,441,000	$11,037,734	$12.23	$13.06	$13.62	($0.56)
Jul-10	$0.3859	$0.2500	$1.0357	$0.7857	121,059,000	$10,808,643	$13.37	$14.15	$13.74	$0.41
Aug-10	$0.3775	$0.2500	$0.9800	$0.7300	123,096,000	$10,211,373	$14.39	$15.11	$15.18	($0.07)
Sep-10	$0.3725	$0.2500	$0.9800	$0.7300	119,972,000	$9,952,223	$15.48	$16.20	$16.26	($0.06)
Oct-10	$0.3828	$0.2500	$1.0357	$0.7857	119,488,000	$10,668,377	$15.66	$16.44	$16.94	($0.50)
Nov-10	$0.3893	$0.2500	$1.0357	$0.7857	117,898,000	$10,526,416	$13.14	$13.92	$15.44	($1.52)
Dec-10	$0.3925	$0.2500	$1.0914	$0.8414	118,606,000	$11,340,351	$12.22	$13.05	$13.83	($0.78)
Jan-11	$0.4047	$0.2500	$1.1471	$0.8971	131,007,000	$13,355,270	$12.49	$13.38	$13.48	($0.10)

ACTUAL DRY WHEY FACTOR VS. PROPOSED DRY WHEY FACTOR

CONVERSION: Each $0.01/cwt difference in the DWF represents ($0.01 / 8.8) difference per lb of SNF
SOURCE: Lbs. of 4b SNF from CDFA's monthly "Dairy Information Bulletin"

Month	DMN DW	Act. 4b DWF	Prop. 4b DWF	Difference	Lbs. of 4b SNF	$$ Impact	Act. Cl. 4b Price	Prop. Cl. 4b Price	FO Cl. III Price	Difference
Feb-11	$0.4425	$0.2500	$1.3699	$1.1199	120,409,000	$15,323,414	$16.92	$18.03	$17.00	$1.03
Mar-11	$0.4831	$0.2500	$1.5928	$1.3428	133,396,000	$20,355,017	$16.76	$18.09	$19.40	($1.31)
Apr-11	$0.4859	$0.2500	$1.5928	$1.3428	131,651,000	$20,088,746	$14.34	$15.67	$16.87	($1.20)
May-11	$0.5031	$0.2500	$1.7042	$1.4542	138,855,000	$22,945,789	$14.74	$16.18	$16.52	($0.34)
Jun-11	$0.5355	$0.2500	$1.8713	$1.6213	130,293,000	$24,005,005	$18.79	$20.39	$19.11	$1.28
Jul-11	$0.5666	$0.2500	$2.0385	$1.7885	133,125,000	$27,056,143	$19.35	$21.12	$21.39	($0.27)
Aug-11	$0.5879	$0.2500	$2.1499	$1.8999	135,584,000	$29,272,277	$18.60	$20.48	$21.67	($1.19)
Sep-11	$0.6078	$0.6500	$2.2613	$1.6113	129,591,000	$23,728,407	$16.33	$17.92	$19.07	($1.15)
Oct-11	$0.6300	$0.6500	$2.4284	$1.7784	135,881,000	$27,460,315	$15.78	$17.54	$18.03	($0.49)
Nov-11	$0.6403	$0.6500	$2.4841	$1.8341	129,815,000	$27,056,101	$17.19	$19.00	$19.07	($0.07)
Dec-11	$0.6606	$0.6500	$2.5956	$1.9456	135,131,000	$29,876,236	$15.14	$17.06	$18.77	($1.71)
Jan-12	$0.6959	$0.6500	$2.7627	$2.1127	137,900,000	$33,106,969	$14.23	$16.32	$17.05	($0.73)
Feb-12	$0.6693	$0.6500	$2.5956	$1.9456	134,125,000	$29,653,818	$13.42	$15.34	$16.06	($0.72)
Mar-12	$0.5431	$0.5500	$1.9270	$1.3770	144,606,000	$22,627,553	$13.67	$15.03	$15.72	($0.69)
Apr-12	$0.5153	$0.5500	$1.7599	$1.2099	138,881,000	$19,094,559	$13.43	$14.63	$15.72	($1.09)
Since CA Class 4b formula was changed in December 2007						**$582,689,780**	**$14.39**	**$15.13**	**$15.55**	**($0.42)**
Since CA Class 4b formula was changed in September 2011						**$212,603,958**	**$14.90**	**$16.61**	**$17.44**	**($0.83)**

Attachment B

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

August 25, 2010

John Rossi
California Floor Price Committee
PO Box 332
Manteca, CA 95336

Dear Mr. Rossi:

This letter is in response to your petition received on August 13, 2010 requesting a public hearing to consider changes to Article III Section 300.0 (A), (D) and (E) of the Stabilization and Marketing Plans for Market Milk, as amended for Northern and Southern California.

The Department has reviewed your petition in accordance with Title 3, Section 2080.2 of the California Code of Regulations (3 CCR 2080.2). After careful consideration of the merits of the petition, the Department has decided not to call a hearing at this time. Establishing a floor price for a two year period would result in prices that are not in a reasonable and sound economic relationship with the national value of manufactured milk products, as required by Section 62062 of the Food and Agricultural code. Also, the petition requested a Compensatory Payment Program be instituted to require milk originating from outside of California be sold at specified price levels. The Department does not have any authority to implement a program of this type.

Sincerely,

Kevin Masuhara

Kevin Masuhara, Director
Division of Marketing Services

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State of California
Arnold Schwarzenegger, Governor

Attachment C

cdfa CALIFORNIA DEPARTMENT OF FOOD & AGRICULTURE
Karen Ross, Secretary

March 28, 2012

Dr. Eric M. Erba
Sr. VP Administrative Affairs
California Dairies, Inc.
2000 N. Plaza Drive
Visalia, CA 93291

Dear Dr. Erba:

On March 19, 2012, the Department received your letter dated March 14, 2012 requesting that the notice of the public hearing issued on March 16, 2012 be amended to expand the call of the hearing to include the Class 4a pricing formula in order to consider proposed changes to the f.o.b. price adjuster for butter and the butter and powder manufacturing cost allowances. You state that, as a standard practice, the Department has historically called hearings that consider proposed changes to both the Class 4a and Class 4b pricing formulas during a single hearing.

After carefully weighing the merits of your request, the Department has decided at this time to not expand the scope of the hearing to include the Class 4a pricing formula. The reason for not expanding the scope of the hearing is that the Department must consider your proposed changes in conjunction with the appropriate levels of the f.o.b. price adjuster for cheese and the cheese manufacturing cost allowance that are found in the Class 4b pricing formula. However, it is not currently appropriate to consider changes in these components of the Class 4b pricing formula within the public hearing process.

As you state in your letter, Class 4a and Class 4b are the manufacturing classes of milk that account for approximately 80% of the milk produced in California. The Department has the responsibility and mandate to establish minimum class prices that will encourage California's milk production to be marketed in an orderly fashion. The Class 4a and Class 4b prices must be set at a level that will "clear" the market or will facilitate the balancing of the supply and demand for milk. In order to balance the supply and demand of the state's milk production, both of these class pricing formulas need to be considered together when establishing pricing policy decisions.

As you are aware, during the Dairy Advisory Committee (DAC) Meeting held in October 2011 and two subsequent working group meetings comprised of DAC members held in November and December 2011, the long-term pricing issues of the f.o.b. price adjuster for cheese and the cheese

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manufacturing cost allowances were discussed in detail. Specifically, due to industry consolidation and data confidentiality issues of the Cheddar cheese sector in California, the Department will not be able to publish California Cheddar cheese pricing and production data or the cheese manufacturing cost study in its entirety. Since this information is necessary for the formulation of proposed changes to the f.o.b. adjuster for cheese and the cheese manufacturing cost allowance in the Class 4b pricing formula, DAC members began discussions to determine how to proceed in the future with pricing formula modifications in the face of data limitations. The process of determining how to handle these data limitations has not yet been finalized and will need to be finalized prior to being considered within the scope of a public hearing.

Because this issue facing the f.o.b. price adjuster for cheese and manufacturing cost allowance for cheese in the Class 4b pricing formula has not yet been resolved, it is not appropriate to consider changes to these factors within a public hearing. Additionally, since these Class 4b factors must be considered with corresponding Class 4a factors, such as the ones you propose to modify, it is not appropriate to consider Class 4a pricing formula modification at this time either.

Sincerely,

Kevin Masuhara

Kevin Masuhara
Director

TAB 8

PAUL
HASTINGS

date: May 31, 2012

to: Hearing Panel

from: Donna M. Melby
Paul Hastings LLP
Telephone Number: 1(213) 683-6098

subject: Testimony for Hearing on Class 4b Petition

file no.: 78977.00002

I. OPENING REMARKS

- Paul Hastings is privileged to represent the Coalition of dairy interests, which consists of dairy cooperatives and trade associations, including California Dairies, Inc.; the Dairy Farmers of America – Western Area Council; Land O' Lakes, Inc.; the Security Milk Producers Association; the Milk Producers Council; the California Dairy Campaign; and the Alliance of Western Milk Producers.

- This Coalition represents approximately 64% of the state's eligible milk producers and approximately 78% of the state's total milk production. [Graphic.] This is the first time that all of these groups have come together for a single purpose --- to seek a remedy to the fundamental inequity caused by the current Class 4b milk pricing formula.

- For that reason, on March 2, 2012, the Coalition submitted its Petition requesting that the Department replace the current Class 4b milk pricing formula with a formula that results in prices that bear a reasonable and sound economic relationship to the national value of manufactured milk products.

- The Petition --- including the proposed amendment of the Class 4b milk pricing formula --- is designed to address the under-valuation of milk produced by California's dairies.

- In addition, on March 2, 2012, Western United Dairymen submitted a similar Petition for review by this Panel. As you will hear today, the Coalition's argument will proceeds as follows.

- **First**, the law requires that the current Class 4b milk price bears a "reasonable and sound economic relationship with the national value of manufactured milk products." Cal. Food & Agric. Code § 62062. [Graphic.] The language of the Food & Agricultural Code is mandatory. In fact, the California legislature understood that the best way to achieve a reasonable amount of stability and prosperity in connection with the production of market milk was to ensure that the California pricing system would bear some reasonable and sound economic relationship with the national value of milk products. The Coalition simply seeks compliance with the Code.

- **Second**, we will offer testimony explaining the harm in the status quo; namely, that the current Class 4b milk pricing formula results in prices that under-value the milk produced by California's dairies, as well as instability and a lack of prosperity in the production of milk by producers, including the loss of millions of dollars in damage per day.
    - You will hear from representatives of the Coalition, including experts, members of trade associations, and some of California's dairy producers.

   - For example, you will hear testimony from Eric Erba, who is the Senior Vice President of Administrative Affairs for California Dairies, Inc. Dairy producers affiliated with CDI, as you may know, produce about 40% of the state's milk. In any event, Dr. Erba has a Ph.D. in Agricultural Economics from Cornell University (with a specialty in Dairy Market Policy). And, from 1997 to 2004, Dr. Erba served as a Senior Agricultural Economist for the Dairy Marketing Branch, during which time he performed quantitative analyses to assist the Secretary in the administration of the California Milk Marketing Program.

   - You also will hear from Rob Vandenheuvel, who is the General Manager of Milk Producers Council. Mr. Vandenheuvel was raised on a dairy farm in Chino, California, and his family continues to operate their dairy. Mr. Vandenheuvel is here to testify on behalf of the Coalition and MPC, the membership of which is comprised of dairies throughout Southern and Central California.

   - And, perhaps most importantly, members of the dairy producing community will testify before this Panel.

  - These witnesses will testify regarding, among other things, the economic hardship caused by the improper valuation of the milk produced by dairies. Specifically, they will tell you that, in large part, the improper valuation of milk can be traced to the "whey solids" factor and the failure of the Class 4b formula to reflect increases in the market price for whey.

  - The Coalition's witnesses also will testify that the under-valuation of milk produced by dairies has had a number of negative impacts on the Coalition families. These impacts include weaker equity positions in their dairy operations, mounting debt, tightening credit lines and defaults on existing lines of credit, and a shortfall in producer revenue of approximately $300 million in 2011 alone (with an equal gain in processor profits).

- **Third**, in view of these harms, the Coalition has proposed for the Department's consideration a practical, economically-viable amendment to the Class 4b milk pricing formula. The suggested language to amend the plan --- and a table --- has been attached to the Coalition's Petition. That said, there are a few notable features of the proposed amendment that should be highlighted here and about which the Coalition's witnesses will testify.

  - To begin, the Coalition has proposed that the Department's current "sliding scale" be replaced with a new "sliding scale" that results in a whey value that tracks the market direction followed by the Federal Milk Marketing Orders Class III whey value. Put simply, the Coalition urges that the FMMO Class III is the correct benchmark for Class 4b milk pricing, specifically with respect to the value of whey.

    - On this point, you will hear testimony from Dr. Erba, as well as Tom Wegner, and Elvin Hollon.

    - We already have introduced Dr. Erba. However, Mr. Wegner is the Director of Economics and Dairy Policy for Land O'Lakes, Inc., where he is responsible for, among other things, following the changes in federal and state milk marketing orders and regulations. Mr. Wegner has a Master's of Science degree in applied economics and agri-business management from the University of Wisconsin, Madison. Mr. Wegner has traveled from Minnesota to testify at today's hearing.

- In addition, Mr. Hollon is the Director of Fluid Marketing and Economic Analysis for the Dairy Farmers of America, and in that position, Mr. Hollon is familiar with milk pricing at the local and national levels. Mr. Hollon joins us today from Missouri.

- Next, the Coalition has proposed that the Department use a simple average of the Dairy Market News "West" price range for dry whey as part of the Class 4b milk pricing formula.

  - The Coalition understands that the Department prefers to use the Dairy Market News price range in lieu of the National Agricultural Statistics Service ("NASS") price range. Moreover, the proposal is based on a calculation of 95% of the FMMO Class III dry whey factor, which was a necessary adjustment to account for the trend that the Dairy Market News "West" price range has generally been slightly higher than the NASS price.

  - Again, you will hear from the Coalition's experts on this point.

- The last feature of the Coalition's proposed amendment to the Class 4b pricing formula pertains to the institution of a $0.00/hundredweight floor and a $4.00/hundredweight cap. With respect to this issue, too, you will hear testimony from the Coalition's economic experts.

- **Fourth**, we will conclude our presentation by addressing the arguments that have been set forth by cheese processors.

  - Dr. Erba, Mr. Hollon, Mr. Wegner, and Annie AcMoody will testify that cheese plants will not suffer undue harm if the Department adopts the Coalition's proposed amendment to the Class 4b milk pricing formula.

  - These witnesses will testify that, among other things, not all cheese plants manufacture whey, but those which have whey manufacturing capacity currently benefit from whey values that are far below market prices. In other words, many cheese plants have obtained windfall profits because of the under-valuation of milk produced by dairies.

  - In addition, many small and medium-sized cheese plants do not manufacture whey. Indeed, several of these plants often produce specialty cheeses (such as brie or gouda), and as such, they extract a premium for their cheeses in niche markets.

- **Finally**, the Coalition appreciates the opportunity to be heard in connection with its Petition. As a housekeeping matter, we also request the opportunity to file a post-hearing brief on behalf of the Coalition, and witnesses offered by the Coalition, with respect to matters addressed during this hearing.

II. LEGAL DISCUSSION

- As this Panel is aware, the Food and Agricultural Code authorizes the Department to regulate the price of milk sold in California pursuant to "Stabilization and Marketing Plans." Cal. Food & Agric. Code § 61801 et seq.

- Pursuant to its authority, the Department has implemented a "Stabilization and Marketing Plan" to establish prices for the various classes of milk. The Department determines a value for raw milk produced by dairy producers based on the end-uses of that milk. Cal. Food & Agric. Code § 62838.

- The overriding legislative intent of the statutory regime is to "[e]nable the dairy industry, with the assistance of the state, to develop and maintain satisfactory marketing conditions, **bring about and maintain a reasonable amount of stability and prosperity in the production of market milk**[.]" Cal. Food & Agric. Code § 61805(d) (emphasis added).

- As the Coalition has pointed out --- and as witnesses will testify during today's hearing --- the current Class 4b pricing system has created instability in the production of milk. Given this backdrop, the Coalition contends that while the Department has significant discretion in establishing milk prices for the various classes of milk, to comply with the law, the Department must set prices in accordance with certain criteria.

- Notably, the Code uses mandatory language --- for instance, it uses the word "shall" --- with respect to the application of certain criteria to the development of a minimum price.

    - First, the Code provides that, in connection with calculating a milk price, "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.**" Cal. Food & Agric. Code § 62062 (emphasis added).

    - The Code also provides that, in establishing milk prices, the Director **shall** take into consideration relevant economic factors, including the dairy producers' "cost of management" and whether the producers were capable of generating "a **reasonable return on necessary capital investment.**" Cal. Food & Agric. Code § 62062(a) (emphasis added).

- It is in these areas --- namely, whether the current Class 4b milk price bears a reasonable and sound economic relationship with the national value of manufactured milk products and whether dairy producers have been able to generate a reasonable return on their capital investment --- where the failure of the existing formula lies.

- Shortly, you will hear from witnesses who will testify that the current Class 4b price fails to bear a reasonable and sound economic relationship with the national value of milk products and that the pricing discrepancy has caused dairy producers to have weaker equity positions in their operations and, collectively, to lose nearly $300 million in 2011 alone.

- Suffice it to say that there is no reasonable basis to ignore the current trend and the Class 4b pricing discrepancy. In fact, the failure to reconcile the "whey solids" component of the Class 4b milk pricing formula with the national FMMO Class III pricing formula may be arbitrary and capricious, to the extent it would ignore the irreparable harm to the dairy producers as well as the Code's requirement that the Class 4b price shall bear some reasonable and sound economic relationship with the national value of manufactured milk producers.

- We understand that the Department has taken the position --- at least in a March 28, 2012 letter from Kevin Masuhara to CDI --- that its primary obligation is to establish a price that will "clear" the market or will facilitate the balancing of the supply and demand for milk. However, we have been unable to find the authority to support this proclaimed mandate. But, in any event, the Coalition contends that the express language of the Code, as provided a few moments ago, should govern the Department's review of the Class 4b milk pricing formula.

- At times, periods of over-supply should be accepted because of the need to fill plants in other parts of the year in which supply is not as high.

III. CONCLUSION

- The proposed amendment better tracks the FMMO Class III price, specifically with respect to adjustments in whey markets.

- We understand that the Department has 60 days upon which to act on the Petition pursuant to the Code. Given that this is a stressed time, the harm is accruing each day, and that the dairy producers already have waited for more than a year for an adjustment to the Class 4b milk pricing formula, the Coalition respectfully requests that the Department move quickly and diligently in its assessment of the proposed amendment.

- Any questions from the Hearing Officer or the Panel?

- The Coalition respectfully renews its request for filing a post-hearing brief, if necessary, in connection with the matters.

TAB 9

Testimony of Elvin Hollon representing Dairy Farmers of America, Inc.

In the Matter of: Amendments to the Stabilization and Marketing Plans for Market Milk for the Northern California and Southern California Marketing Areas

Regarding: Proposed changes to the whey valuation in the Class 4b pricing formula

May 31 – June 1, 2012

Mr. Hearing Officer and Members of the Hearing Panel:

Good morning, afternoon or perhaps evening. I am Elvin Hollon. I am Director of Fluid Marketing and Economic Analysis for Dairy Farmers of America, Inc. (DFA). On May 22, 2012, the DFA Western Area Council, whom I am representing, unanimously approved the position that I will be presenting today.

I want to thank the Department for calling this hearing and allowing me the opportunity to voice our concern about whey valuation in the California milk pricing system. We appear at the Hearing as a participant of what the Hearing notice has termed "the Coalition". Our testimony is in collaboration with "the Coalition". We offer testimony in support of Proposal 1 and we fully support the position and testimony of Donna Melby, representing the producer coalition. We also support the proposal made by Western United Dairymen.

Dairy Farmers of America, Inc. (DFA) is a Capper Volstead milk marketing Cooperative. We are a national cooperative of more than 15,000 member owners and represent approximately 320 farms that market milk in California. Our members produce approximately 20% of the state's milk supply. We market milk to 30 buyers in the state and operate two plants. Our facility at Hughson, California is primarily a Class 4a facility and our plant at Turlock, California is primarily a Class 4b facility. Several of our members operate dairies in California and in states where the Federal Milk Marketing Order system administers prices. Several of our customers operate plants in California and in regions of the country within the Federal Order system. As a cooperative with members, customers, and manufacturing plants operating within California and also throughout the country, DFA is well qualified to submit testimony and evidence to the Secretary on the matter of the appropriate contribution of whey value to the Class 4b price.

Our members support the regulated pricing system and clearly believe that the regulated system provides the best framework to support their farm operations, the customers to whom they market milk and the plants that they have invested in, own and operate.

The California Department of Food and Agriculture's (CDFA) state milk marketing Order system operates a regulated and transparent end product pricing formula system for establishing milk prices for the benefit of consumers, processors and dairy farmers. Milk buying decisions are the result of some type of end product formula calculation that compares the selling price with the revenue from the sale. A regulated system makes that process transparent, provides consistent terms of trade to all in the industry and generally provides for minimum prices to be paid for milk.

Both producers and processors must have faith that the system will establish and/or use reasonable market prices, make allowances and yield factors in the formulas. The hearing today focuses on the market price portion of the Class 4b end product pricing formula. DFA members believe that the current Class 4b formula does not value whey properly and in recent times has undervalued it significantly – thus undervaluing the 4b price and the ultimate milk price paid to them. The cap placed on the formula has proven to be inadequate in times of higher whey prices and is not reflective of national milk pricing conditions.

Analysis demonstrate in calendar year 2011 the difference between the existing formula and the one proposed by the Coalition, which we feel appropriately represents actual market conditions, resulted in a shortfall to producer revenue in California of approximately $300,000,000 and an equal gain to processor revenue. This is no small amount and has contributed to the lack of profitability and loss of producer equity which in turn has led to foreclosure, bankruptcy, and the ultimate loss of many family owned California dairies.

The current Class 4b pricing formula results in a price that significantly under values the milk produced by our members in California. The source of the under valuation is the method that the current 4b formula uses to value whey. Evidence of the largest inequity in the spread would be in January 2012 when the Federal Order monthly average whey price was $0.6875 per pound and the Western whey price was $0.6915 per pound. The Federal Order contribution to the Class III price was $2.8647 per hundredweight of milk ((.6875 - .1991) * 1.03 *5.9 *.965)) while in the 4b formula it was only $0.65 per hundredweight. Note that cheese manufacturers in much of the remaining U.S., paid dairy producers a value for whey in their regulated pricing formula, the Class III price, that would be reflective of the $300 million dollar value.

Producers who compare milk checks from their farm(s) in California to their farm(s) or others' farms located in Federal Order markets even while selling to the same company but one plant located in California and the other plant in a state covered by Federal Order regulation, do not conclude that the requirement that the California 4b price, bear a "reasonable and sound economic relationship with the national value of manufactured milk products" (Cal. Food & Agric. Code § 62062) has been met.

Our testimony relates primarily to the relationships between the CDFA 4b price and the Federal Order Class III price. We will demonstrate why the Class III price is the appropriate benchmark for comparison to the 4b price and to some operational issues within the Federal system focusing specifically on the practice of depooling. Additionally we will comment on dealing with temporary over supplies of milk, the small plant / whey processing situation and the recruitment of California's dairy farms by outside the state firms.

The Federal Order Class III is the appropriate benchmark for California 4b prices

While the Secretary is required to make sure that the Class 4b milk price bear a "reasonable and sound economic relationship with the national value of manufactured milk products" there is no list of appropriate market prices with which to compare firmly established in the statute. However, it seems reasonable and appropriate that the Federal Milk Marketing Order price for Class III milk be that benchmark for comparison.

It is well established that Federal Orders operate a nationwide coordinated system of prices. Prices are announced monthly for similar products and in both cases the product mix for each class is very much the same. The Class III milk price is only a minimum price and is the benchmark in the Orders for the basis of negotiated premiums.

Class III milk is defined in the Federal Order regulations at 7 C.F.R. PART 1000--GENERAL PROVISIONS OF FEDERAL MILK MARKETING ORDERS, Subpart F—Classification of Milk as:

> **§ 1000.40 Classes of utilization.**
>
> **Except as provided in § 1000.42, all skim milk and butterfat required to be reported pursuant to § ——.30 of each Federal milk order shall be classified as follows:**
>
> **...**
>
> **(c) Class III milk shall be all skim milk and butterfat:**
>
> **(1) Used to produce:**
>
> **(i) Cream cheese and other spreadable cheeses, and hard cheese of types that may be shredded, grated, or crumbled;**
>
> **(ii) Plastic cream, anhydrous milkfat, and butteroil; and (2) In shrinkage assigned pursuant to § 1000.43(b).**
>
> **...**

Class 4b milk is defined in the California State Order at California FOOD AND AGRICULTURAL CODE SECTION 61935 as:

> **...**
>
> **(b) Class 4b comprises all market milk, market skim milk, or market cream used in the manufacture of cheese other than cottage cheese.**
>
> **...**

The process for determining those prices, as is the practice in California, is the result of many public Hearings and extensive industry input. The Orders use a product price formula system, as is the practice in California that requires the use of market-determined benchmark commodity prices and hearing-determined make allowances and yield factors to establish prices. The Federal Order system administered milk prices for 65% of the nation's milk supply in 2011. That percentage has been reasonably consistent for many years. (**Table 1**) Within that system 38% of the milk supply was Class III in 2011 and again reasonably consistent over many years. Within the Order system the Upper Midwest Order accounts for 49.2% of the Order systems total Class III pounds. Between 2007 and 2011 the percentage has fluctuated between 46.1% and 51.4% and totaled 29.992 billion pounds for 2011. Likely Class III and 4b combined represent the largest classified use for milk in the country. **(Table 2)**

The National Agricultural Statistics Service's *Dairy Products Report*, published monthly, and recaps the production of manufactured dairy products. The Report publishes production pounds in total for the United States as well as for individual states where possible. **Table 3** recaps total cheese production for the US and for states available over the past five years.

Several observations can be made from this **Table 3**. First, cheese production is growing across the US as total production increased in each year. California is the second largest state in terms of total cheese production accounting for 21.5% of the nation's output over the five year period. Wisconsin is the largest cheese producing state with 25.2% of the national supply.

Categorizing each area's cheese output by regulatory oversight from CDFA, the Federal Order or as unregulated pricing geographies, the breakdown would be as follows: California/CDFA 21.5%; unregulated Utah and Idaho account for 8.8% of production; plants located in the Southwest Order 6.5%; plants located primarily in the Mideast Order 1.9%; primarily in the Northeast Order 12.6%; primarily in the Central Order 2.7%; primarily in the Upper Midwest Order 33.7%; plants located in all other states and primarily located within a Federal Order 12.6%. Additionally much if not most of the milk in Idaho and Utah is priced using terms and values that are driven by Federal Order pricing. DFA and the other cooperatives who market milk there compete with prices based on Class III values. The large privately owned cheese plants do also. One of those companies just recently converted their milk procurement pricing system from a privately calculated end product pricing formula that had been in place for more than 9 years directly to a Class III based price. Another large private company modified its end product pricing formula significantly. Our internal analysis of how its new formula would have worked, if in place since CY 2000, shows a greater than 95% correlation with the Class III price.

This would mean that conservatively 75% or more of the nation's cheese production has a base price that is or tracks closely with the Federal Order Class III price. There is no other milk price that would represent a better benchmark for the CDFA Class 4b price than the Federal Order Class III price.

Depooling in the Federal Order System

A frequent reason given for allowing the Class 4b price to significantly fall below the Class III price is that Federal Order plants are either non pool plants or are allowed at times to depool from the Order. Depooling is the term describing the action of removing milk from an Order's pricing pool and not paying in any value nor collecting any payments from the month's pooled returns. It occurs in the system for several reasons.

1) **Producer quality** - If a producer loses Grade A quality standards the milk is removed from the pool.

2) **Failure to meet Producer touch base standards** - All Orders require individual producer "performance standards" to be met. That is, a producer must indicate their ability to service the Grade A market by delivering some quantity of milk directly to an Order pool distributing plant (Generally a fluid processing plant.). In some cases the producer may deliver to a nearby manufacturing plant if that plant delivers a prescribed quantity of milk to pool distributing plants. This allows for performance to be demonstrated but not force uneconomic transportation costs. This performance standard is termed "touch-base" and if a producer does not meet the touch-base rules his milk would not be allowed to be pooled. Touch-base standards range from a single day to multiple days per month.

3) **Failure to meet Handler performance standards** - In addition to touch-base standards all Orders require handler level performance standards also. These standards require pooling entities (the "handler" of the milk) to deliver a percentage of its total milk supply to pool distributing plants. Over the course of a month a handler delivers milk to a plant for processing and "diverts" milk away from the plant to a balancing location when the milk is not needed for processing. The diversion percentage regulates the maximum amount of milk that can be delivered to a balancing location and still be pooled on the Order. In areas with a large supply of milk relative to distributing plant needs this percentage is large and in areas with a smaller supply of milk relative to distributing plant needs the percentage is small. A handler may not have enough shipments to pool distributing plants to qualify their entire milk supply. If this occurs, milk diverted to balancing locations in excess of the diversion percentage cannot be pooled.

4) **Reason of price** - There are times when milk is depooled for price reasons. That is, the class price charged for milk is higher than the blend price received from the pool. In this case the handler (seller) charges their buyer the class price but does not pool the sales price. For example if the Class III price is $15.00 and the Order blend price is $14.50 a handler

may choose to not pool milk delivered to a Class III buyer, charge the buyer the Class III price of $15.00 but not put the pounds or the dollars into the pool. In every case we have observed, the seller retains the higher value and does not share the added value with the milk buyer. Since the Orders only require Class I milk sales to be pooled, sales to Class II, Class III or Class IV may be depooled.

Reasons 1 and 2 account for a miniscule portion of milk pooled on the Order system. Reason 3 may account for more pounds but is only a fraction of a percent of the total milk pooled. Reason 4 represents the largest volume of depooled milk – but its volume was only 4.3% of CY 2011's total Federal Order pooled milk volume.

Calendar year 2011 statistics from the Agriculture Marketing Service (AMS) indicate 126.9 billion pounds of milk were pooled on Federal Orders. (**Table 4**) Of this total, AMS reported 5.4 billion pounds was not pooled (depooled) due to a disadvantageous price relationship. **Table 4** also indicated a large reduction in the pounds of depooled milk in the Orders since peaking out at 16.86% in 2004. Note also that this percentage is not broken out by Class. A significant portion of the depooled milk represents Class II and IV (comparable to CDFA 2, 3 and 4a) volume. **Table 5** compares, for example the relationships in Federal Order 30 in 2011. Order 30 with its very high Class III utilization and low Class I differential would be the most likely place to measure any impact from depooling because it is the location where the incidence would be most often economically feasible. The table presents the monthly announced blend price for Order 30 at the base zone and the months Class II, III and IV price. It indicates which months depooling of each class might occur. Depooling of Class II pounds would be economically beneficial in eight months, Class IV pounds five months and Class III pounds only one month. So in all likelihood more of the depooled pounds in Order 30, in 2011 represent's Class II and IV utilization than Class III. The competitive relationship between Class 4b and Federal Order Class II and IV is not the question in this Hearing.

When the Orders were reformed in 2000 the pooling provisions were liberalized. It was easier to add milk to many of the pools. The touch base and diversion limits were low relative to historical standards. For example a standard that allowed a single delivery "forever" unless milk was delivered to another Order's pool distributing plant coupled with a low diversion percentage allowed millions of pounds of California milk to be pooled on the Upper Midwest and Central Orders at the same time it was pooled in the California State Order for well over two years. In addition to it being much easier to add milk to the pools, it was much easier to depool milk. As price volatility increased the incidence of depooling increased. Both the ease of pooling milk on Orders and the increased occurrence of depooling created disorderly marketing conditions that even those who took advantage of the situation realized should be changed if the integrity of the Federal Order system was to be maintained.

Between 2000 and 2005, Hearings were held in the Pacific Northwest, Central, Upper Midwest and Mideast Orders to tighten performance standards and make it much more difficult to depool milk. By modifying the touch base rules, decreasing diversion percentages and in some cases more strictly defining what constituted a qualifying delivery the performance standards of these orders were tightened up and attaching milk to markets to collect monies but shipping only minimal volumes of milk to pool distributing plants was virtually eliminated. Equally important limitations were placed on pooling that greatly decreased depooling opportunities. In brief the volume of milk pooled in the current month is closely related to the volume pooled in a prior month, so removing volumes from the pool in the current month carries potential liabilities for future months as it may take several months to get ones entire volume back on the pool once removed. A calculation of financial benefit becomes a multi-month decision rather than a single month decision. One's ability to re-qualify milk for the pool plus one's ability to correctly forecast prices and price relationships and the pooling actions of others must be accurate if the decision to depool is ultimately successful. The combination of all these activities is difficult to accomplish successfully.

The language in Order 30 governing this practice is as follows:

7 CFR. PART 1030--MILK IN THE UPPER MIDWEST MARKETING AREA

...

§ 1030.13 Producer milk.

...

(f) The quantity of milk reported by a handler pursuant to either § 1030.30(a)(1) or § 1030.30(c)(1) for April through February may not exceed 125 percent, and March may not exceed 135 percent of the producer milk receipts pooled by the handler during the prior month. Milk diverted to non pool plants reported in excess of this limit shall be removed from the pool.

...

The language in Order 32 is similar but has the limit of 125% in any month and in Order 33 the limit is 115% in every month but March and is 120% then. The implications of the impact of depooling drawn from reading the dairy press from the middle part of the 2000 decade are simply not relevant to today's market landscape.

Price comparisons in months that milk is depooled

The exhibit from the Hearing Workshop detailing depooling for Order 30 demonstrates the success of these types of provision changes. The percentage of milk depooled there has declined markedly since peaking at 14.1% in 2007. Trends in the other Midwest Orders would show similar results. However, critics would say there continues to be depooling and thus the wide level of disparity between Class 4b and Class III is still warranted as depooling somehow gives the Federal Order handler / manufacturer a competitive advantage. That response is based on incomplete logic and incomplete facts. In Order 30, the single largest collective body of milk competing with California cheese plant operators, handlers continue to pay mailbox prices in excess of the Class III price – even in months when they depooled milk, hardly a competitive advantage. And despite paying a higher price for milk processors there, as shown by the extensive table of plant expansions in Land O'Lakes testimony, continue to invest and expand their asset base while the California processing sector appears to lag due to non-milk price issues.

Table 6 describes the calculation that reaches this conclusion. For each month in 2007 thru October 2011 the total pounds in the pool, the Class III pounds, the Class III price, the pounds of butterfat, protein and other solids, the test percentage of each component, and the price per pound of each component is listed for Order 30. The dollar value of the components over the standard test (3.5% for butterfat, 2.9915% for protein, 5.6935% for other solids) is calculated. The Mailbox Milk Price as published for Wisconsin by the Agriculture Marketing Service, the largest geographical portion reported within Order 30, was chosen to represent the comparison. The mailbox price was adjusted to the standard price by recognizing the value of the components that varied from the standard. One additional adjustment needs to be made – the producer price differential (PPD) needs to be subtracted from the mailbox price. The PPD generally represents the added value from the Class I and II sales in the Order. The remainder of the Mailbox price would then represent the value the paid to dairy producers at standard test and reduced by any premium valued derived from the operations of the Order. In every month but one the value is in excess of Class III – including the five months where milk was depooled. **Chart 1** depicts the values graphically. The minimum value over 58 observations is ($0.20) per hundredweight; the maximum $2.65; the average $0.90 and the median $0.56.

Additionally, there is no discernable pattern of different behavior surrounding the months in which milk was depooled. Reviewing the five price comparisons from the month prior to the month of depooling, and from the month of depooling to the month afterwards confirms that depooling did not add to the handler's ability to pay as a whole. In some month-to-month comparisons the value over Class III went up and in some months it went down. It seems clearer to conclude that the general level of pay over a multi-month period remained about the same regardless of the pooling status. This is logical as any firm's strategy to attract and maintain a milk supply must be a long-term plan and cannot be based on a single or few months of market conditions.

The Coalition proposal is designed to have a more equitable contribution from whey values to the Class 4b price. One of the standards the Secretary is to use when establishing a price, its relationship to surrounding market prices, can clearly be met by comparing the 4b price to the Federal Order Class III price. Here we have shown that the single largest collective competitor for manufacturing cheese, the Class III milk buyers in the Upper Midwest Federal Order pay well above the Class III price and consistently so. As noted in prior testimonies, we are not asking that the 4b price be equal to or exceed the Class III price but rather it return values closer to Class III to California dairy farm families – thus meeting the goal of the legislative intent.

Pool Plants versus Non Pool Plants in Federal Order's

There also seems to be some misunderstanding of the role that pool and non pool plants plan in the Federal Order process. A pool plant is one that meets the various but specific definitions of a plant. A pool plant may be a plant with high Class I or II usage (like a bottling plant with fluid milk production and/or cultured products and/or ice cream and cream products); or a plant that manufactures butter, milk powders, condensed milk products or cheese products. A pool plant may be cooperative owned or privately held. A special class of pool plants is a supply plant that serves the purpose of assembling and shipping milk to the market or providing balancing services to the market and frequently manufactures dairy products also. A non pool plant can do all of the above except produce Class I (fluid use) products. However the key point to realize is that milk delivered to a pool plant or to a non pool plant is included in the Orders' equalization pool by the seller (in Order terms – the Handler of the milk) so as to collect values from the Order pool. The Handler completes all the necessary reporting requirements to have the milk included in the Order blend price pool. They insure that all the rules are complied with. Unlike California where all milk is included in the pool unless it opts out on an annual basis, milk that participates in a Federal Order must meet performance requirements that are defined by each Order. The types of requirements are generally identical – all producers must deliver some quantity of milk to the market and that delivery then earns the right to associate milk with the pool. DFA, as a pooling handler, makes sure all of the milk of its members meets the requirements monthly, reports to the Market Administrator as required, submits and collects monies from the pool and pays its members. The billings to pool and non pool plants are not different due to pool status. We negotiate prices in the same manner. Negotiations may vary based on service level, component make-up seasonal variation or contractual performance. They may be on a spot or long run basis. Most if not all price negotiations have the appropriate Federal Order minimum price either directly or in component form as an initial minimum reference point.

Equally important is our settlement with the Federal Order pool is made on the basis of the appropriate Class price. That is when we remit / collect funds from the Blend price pool the Market Administrator determines our payment assuming we collected the minimum class price on the transaction. If a sale is made for more than the minimum price, the "over-class value" belongs to the seller and is not netted against the pool payment; if the sale is under class value the seller's ability to pay producers is reduced because the seller is not made whole by the Order for under class values. The pool's integrity at Class price minimum values is maintained. So the seller either collects the at least the minimum class value from the buyer or pools the milk and settles with the pool at the minimum class value.

Dealing with temporary over supplies of production

In several prior decisions it has been advanced that it is somehow the states responsibility to provide for prices that will clear the market and not allow for chronic levels of excess milk supplies. We do not think that this is the responsibility of the state. We do not find that language in the statute and perhaps of equal importance, we do not find evidence of action that would cause us to believe that the state is fulfilling that role.

In the California market, only producers bear the burden of dealing with excess supplies of milk. They both capitalize and operate facilities to deal with excess supplies, pay for the balancing of those supplies or institute plans to reduce milk production. There is no evidence that the last period of temporary over supply, roughly January 2008 – June 2008 with estimated milk production exceeding capacity in the months of February – May was solved by any action of CDFA. In fact, during that period, the change in whey factor contribution (the "25 cent cap" period) resulted in a positive contribution to producer revenue compared to the predecessor formula.

The rapid reduction in milk supplies was overwhelmingly the result of the institution of producer base plans by the major cooperative suppliers in the state, including DFA.

The current 2012 situation has been dealt with by the "restart" of cooperative base plans that resulted in milk production cutbacks. The DFA "restart" has served its purpose and the assessment on over base production has been eliminated effective June 1.

Additionally, seasonal fluctuations that result in short term over-supplies of milk are a usual occurrence in our industry because of the nature of milk production and the seasonality of demand. We need to recognize that some surplus balancing will always be a part of our industry and as such should be recognized by CDFA.

Small plants and whey processing

It has been noted that smaller plants are not able to recover the costs or generate revenue or profit streams from marketing whey. This is simply not true in our situation. The DFA Turlock CA cheese plant falls into the Group 7 category, two levels below the large plants category of table "The Pounds of Milk Processed into Cheese" published for the Hearing workshop. We manufacture Italian variety cheeses. We further process the liquid whey via a fines saver process, a separator process, a filtration system process and produce a pasteurized product for sale in condensed liquid form. We sell this product into several markets as food grade whey and the by-product as animal feed. At this time we do not manufacture any dry whey products. In 2011 our plant was profitable and the whey operations contributed 17.5% of the plants gross margin.

Relative to this argument, dairy farmer margins inevitably suffer because of the position granted to small cheese manufacturers. If this argument is valid, which we have concerns, it never the less must have some end in sight. Dairy farmers must have sustainable and viable businesses if the industry is to prosper; if there is no milk supply, there is no dairy industry. Small processors have had many years to adapt their business models to the realities of whey marketing. It seems unreasonable to restrain the income stream of dairy farmers unendingly to subsidize the processing capacity of a very small slice of the states cheese plant output.

In summary we have shown that Federal Order Class III is the appropriate price for the Secretary to use as a benchmark for the Class 4b price in meeting the standard of a price that bears a "reasonable and sound economic relationship with the national value of manufactured milk products". The Class III price is the minimum price standard for approximately 75% of the nations milk supply. As such the CDFA 4b price should value whey in its formula in a manner similar to that of Class III. We have demonstrated that the prospect of depooling milk in Federal Order manufacturing plants does not yield a competitive advantage to those plants and in the largest competitive sphere – Federal Order 30 plants consistently pay above the Class III price – even after adjusting the price to standard components and the producer price differential values. There was no discernable pattern of advantage or disadvantage from depooling when examining mailbox pay prices. We note that concerns over excessive surplus milk volumes should not an issue for this proceeding as only producers absorb the cost of dealing with that issue. There is no evidence that any action of the state has caused any corrective behavior in this regard. We have also noted that our own cheese plant, not among the largest plants in terms of capacity, is able to have a profitable whey marketing business. And we raise the question of how can the state perpetually justify the position that all dairy farmers should willingly subsidize small manufacturing plants forever.

Finally, we want to call to your attention an active and ongoing campaign to specifically recruit California dairy farm families to invest or even move their farms to the I-29 corridor in South Dakota. Members of what is termed the "I-29 team" are running billboards in California, placing ads in the dairy industry press, visiting farms and hosting farmers. While the tag line "No Base, No Quota Milk Your Cows in South Dakota" grabs your attention, it will certainly cause California dairy farmers to consider the alternatives.

The milk processing, procurement and feed companies involved in the recruitment include among others Agropur, Bel Brands, Davisco Foods and Valley Queen. Other partners include the state of South Dakota, and the lending firms Bank of the West and Farm Credit Services of America.

In a recent **Cheese Reporter** story Jon Davis of Davisco Foods was quoted as "We're collectively trying to organize a movement to recruit any dairy farmers who currently don't milk cows here."

Tim Czmowski of Agropur's Hull, Iowa facility specifically credited the state of South Dakota for its strong effort and desire to grow dairy. He went even further in noting, "The governor and his team have declared and identified the growth of dairy as the number one economic development opportunity," he said. "The governor and Secretary Bones wanted those 10-12 dairymen in Tulare to know the state of South Dakota is open for business. They wanted them to know South Dakota was ready to work with them in regard to permitting. That there is ample feed, ample water, and ample space to grow. The reaction I saw was really positive. They're pretty pro-business in South Dakota. And he (the governor) was stressing to those farmers that we want them to grow with us." (We are familiar with other similar efforts led by Secretaries of Agriculture in other states – but none quite as active as this one.)

These South Dakota plants are located in Federal Order markets – paying premiums for milk above the Class III price and paying values for whey that reflect what we are proposing rather than the current 4b price.

We hope both the Secretary and the Governor will see the importance of keeping dairy number one in California.

Again, I would like to thank you for the opportunity to testify today. I do request the opportunity to submit a post-hearing brief and I would be happy to answer any questions the panel may have.

Table 2

Comparison Federal Order Milk Production, Class III Pounds and Percentage Use, All Orders, 2007 - 2011

	Federal Order 1			Federal Order 5			Federal Order 6			Federal Order 7			Federal Order 30		
Year	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent
2007	23,039,863,949	5,638,874,243	24%	5,865,023,397	303,091,575	5%	3,206,499,471	174,882,766	5%	7,520,626,938	1,467,169,583	19%	26,489,881,523	20,081,235,603	75%
2008	23,895,032,867	5,323,116,943	22%	5,882,201,759	244,711,629	4%	3,130,160,081	97,489,271	3%	6,922,833,240	896,255,833	13%	28,040,611,738	21,418,716,872	76%
2009	23,497,425,683	5,531,160,011	24%	5,950,397,772	370,118,961	6%	3,027,183,639	49,741,573	2%	7,169,318,086	1,186,206,550	16%	32,183,931,575	25,746,958,811	80%
2010	24,334,721,891	5,951,694,667	24%	6,041,773,553	447,186,613	7%	2,901,728,440	73,118,799	3%	7,001,123,700	1,297,862,103	18%	33,803,149,208	28,304,253,510	84%
2011	24,358,273,875	6,097,133,361	25%	6,128,146,669	524,774,079	9%	2,919,070,100	79,503,905	3%	7,057,077,942	1,384,225,643	19%	32,766,255,532	26,991,910,493	82%
Grand Total	119,125,318,265	28,541,979,225	24%	29,867,543,150	1,889,882,857	6%	15,184,641,731	474,736,314	3%	35,670,979,906	6,231,719,712	17%	153,283,829,576	122,543,075,289	79%

	Federal Order 32			Federal Order 33			Federal Order 124			Federal Order 126			Federal Order 131			All Orders Total Milk Pooled	All Orders Class III	All Orders CIII	Federal Order 30 CIII Percent of All CIII
Year	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent	All Milk	Class III Pounds	CIII Percent				
2007	11,192,644,576	3,607,021,235	32%	16,267,739,204	5,700,774,106	35%	7,036,007,813	2,107,295,207	30%	9,990,320,756	3,468,809,088	31%	3,798,868,820	1,056,328,262	28%	114,407,476,447	43,605,481,668	38%	46.1%
2008	11,564,480,710	3,707,752,986	31%	15,707,154,391	4,775,420,458	30%	6,881,681,377	1,625,745,493	22%	9,687,446,649	2,394,254,986	21%	4,155,785,979	1,190,822,447	29%	115,867,388,791	41,674,286,918	36%	51.4%
2009	12,685,174,559	4,270,322,081	33%	16,595,746,586	5,386,595,310	32%	7,470,190,925	2,821,905,244	37%	10,808,789,521	4,007,875,336	35%	4,042,238,490	1,157,166,627	29%	123,430,396,836	50,528,050,504	41%	51.0%
2010	13,351,663,213	5,814,716,422	44%	16,021,616,543	5,880,770,218	37%	8,010,815,734	3,228,180,747	40%	11,210,369,525	5,042,111,911	45%	4,231,876,559	1,251,220,548	30%	126,908,838,366	57,291,115,538	45%	49.4%
2011	13,937,840,934	6,085,513,933	43%	15,938,483,727	5,858,569,179	37%	8,022,762,894	3,133,831,191	39%	11,260,109,042	4,486,667,586	39%	4,517,903,674	1,253,162,990	28%	126,905,924,389	55,895,292,360	44%	48.3%
Grand Total	62,731,803,992	23,485,326,657	37%	80,530,740,451	27,602,129,271	34%	37,421,458,743	12,916,957,882	34%	52,957,035,493	19,399,718,907	34%	20,746,673,522	5,908,700,874	29%	607,520,024,829	248,994,226,988	41%	49.2%

Source: http://apps.ams.usda.gov/USDAMIB/Main/Welcome.aspx Milk Marketing Order Statistics Public Database

Table 3

U.S. Total Cheese Production as Reported by the National Agricultural Statistics Service, by State, 2007 - 2011, Billion Pounds

State	2007	2008	2009	2010	2011	Total	Percent U.S. Total	California Percent	Unregulated but Class III	Remainder	Primary FO Southwest	Primary FO Mideast	Primary FO Northeast	Primary FO Central	Primary FO Upper Midwest	Primary FO Various
CALIFORNIA	2,287,248,000	2,113,236,000	2,057,375,000	2,197,462,000	2,245,051,000	10,900,372,000	21.5%	21.5%								
IDAHO	789,085,000	829,406,000	831,641,000	849,568,000	842,160,000	4,141,860,000	8.2%									
UTAH	104,114,000	108,485,000	106,504,000	-	-	319,103,000	0.6%		8.8%							
NEW MEXICO	602,324,000	602,890,000	609,283,000	725,516,000	743,683,000	3,283,696,000	6.5%				6.5%					
OHIO	194,466,000	182,147,000	199,148,000	207,733,000	201,577,000	985,071,000	1.9%					1.9%				
NEW JERSEY	-	30,455,000	32,371,000	-	-	62,826,000	0.1%									
NEW YORK	738,046,000	715,923,000	728,364,000	742,554,000	730,756,000	3,655,643,000	7.2%									
PENNSYLVANIA	393,877,000	402,058,000	402,709,000	418,576,000	411,894,000	2,029,114,000	4.0%									
VERMONT	155,562,000	149,267,000	125,734,000	111,765,000	122,007,000	664,335,000	1.3%						12.6%			
ILLINOIS	76,764,000	70,606,000	82,508,000	78,456,000	65,835,000	374,169,000	0.7%									
IOWA	147,241,000	167,450,000	219,913,000	240,628,000	241,293,000	1,016,525,000	2.0%							2.7%		
MINNESOTA	610,339,000	641,748,000	649,490,000	624,358,000	603,114,000	3,129,049,000	6.2%									
SOUTH DAKOTA	209,249,000	230,189,000	231,413,000	237,441,000	271,945,000	1,180,237,000	2.3%									
WISCONSIN	2,462,043,000	2,524,125,000	2,593,766,000	2,609,861,000	2,634,683,000	12,824,478,000	25.2%								33.7%	
OTHER STATES	1,006,427,000	1,144,843,000	1,203,980,000	1,392,023,000	1,483,032,000	6,230,305,000	12.3%									12.3%
Total	9,776,787,007	9,912,830,008	10,074,201,009	10,435,943,010	10,597,032,011	50,796,793,045	100.0%	21.5%	8.8%	69.8%						

Source: United States Department of Agriculture - National Agricultural Statistics Service

Table 1

Annual Milk Production United States and Federal Orders					
	Total Milk Federal Orders	U.S. Milk Production		Total Class III Milk Federal Orders	
Year	Pounds (000)	Pounds (000)	Percent of US	Pounds (000)	Percent of US
2000	116,624,970	167,392,550	70%	49,916,520	43%
2001	120,222,707	165,331,360	73%	53,124,264	44%
2002	125,546,228	170,062,380	74%	55,722,794	44%
2003	110,580,724	170,394,800	65%	39,360,411	36%
2004	103,047,684	170,933,600	60%	31,867,207	31%
2005	114,681,900	176,989,200	65%	41,020,619	36%
2006	120,618,281	181,797,800	66%	47,337,900	39%
2007	114,407,476	185,654,100	62%	43,605,482	38%
2008	115,867,389	189,982,300	61%	41,674,287	36%
2009	123,430,397	189,333,600	65%	50,528,051	41%
2010	126,908,838	192,847,300	66%	57,291,116	45%
2011	126,879,100	196,245,600	65%	47,813,862	38%

Source: United States Department of Agriculture - Agriculture Marketing Service

and National Agricultural Statistics Service - *Milk Production Report*

Table 4

Annual Milk Not Pooled			
All Federal Milk Marketing Orders			
Year	Pounds (000)	Pounds (000)	Percent
2000	3,632,165	116,624,970	3.11%
2001	3,432,394	120,222,707	2.86%
2002	2,850,258	125,546,228	2.27%
2003	14,900,120	110,580,724	13.47%
2004	17,376,578	103,047,684	16.86%
2005	6,555,427	114,681,900	5.72%
2006	2,543,829	120,618,281	2.11%
2007	8,560,217	114,407,476	7.48%
2008	8,921,904	115,867,389	7.70%
2009	4,362,148	123,430,397	3.53%
2010	2,779,206	126,908,838	2.19%
2011	5,401,742	126,879,100	4.26%

Source: United States Department of Agriculture - Agriculture Marketing Service

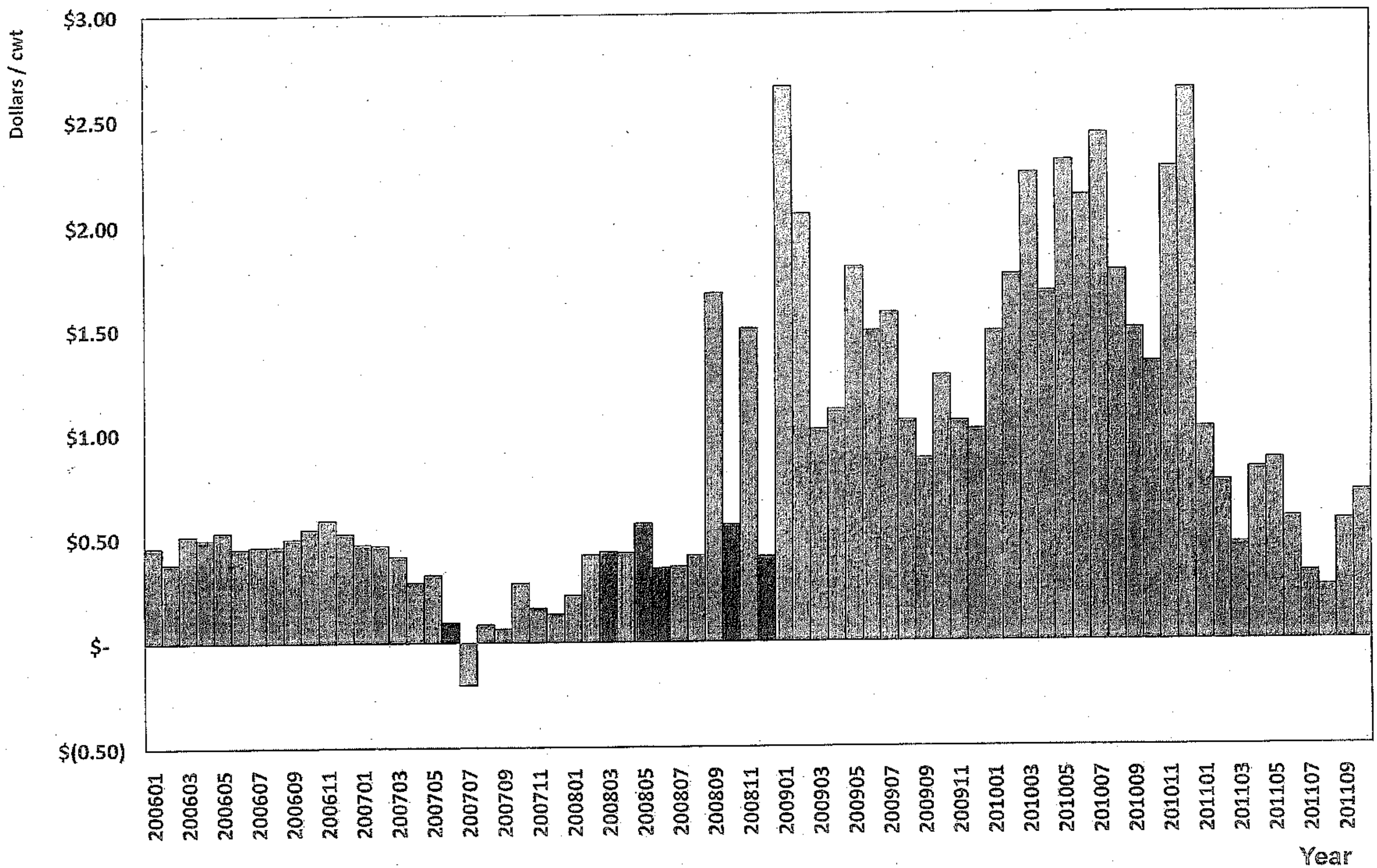
Table 5

2011 Comparison Federal Order 30 Class II, Class III, Class IV Price Compared to Announced Blend Price

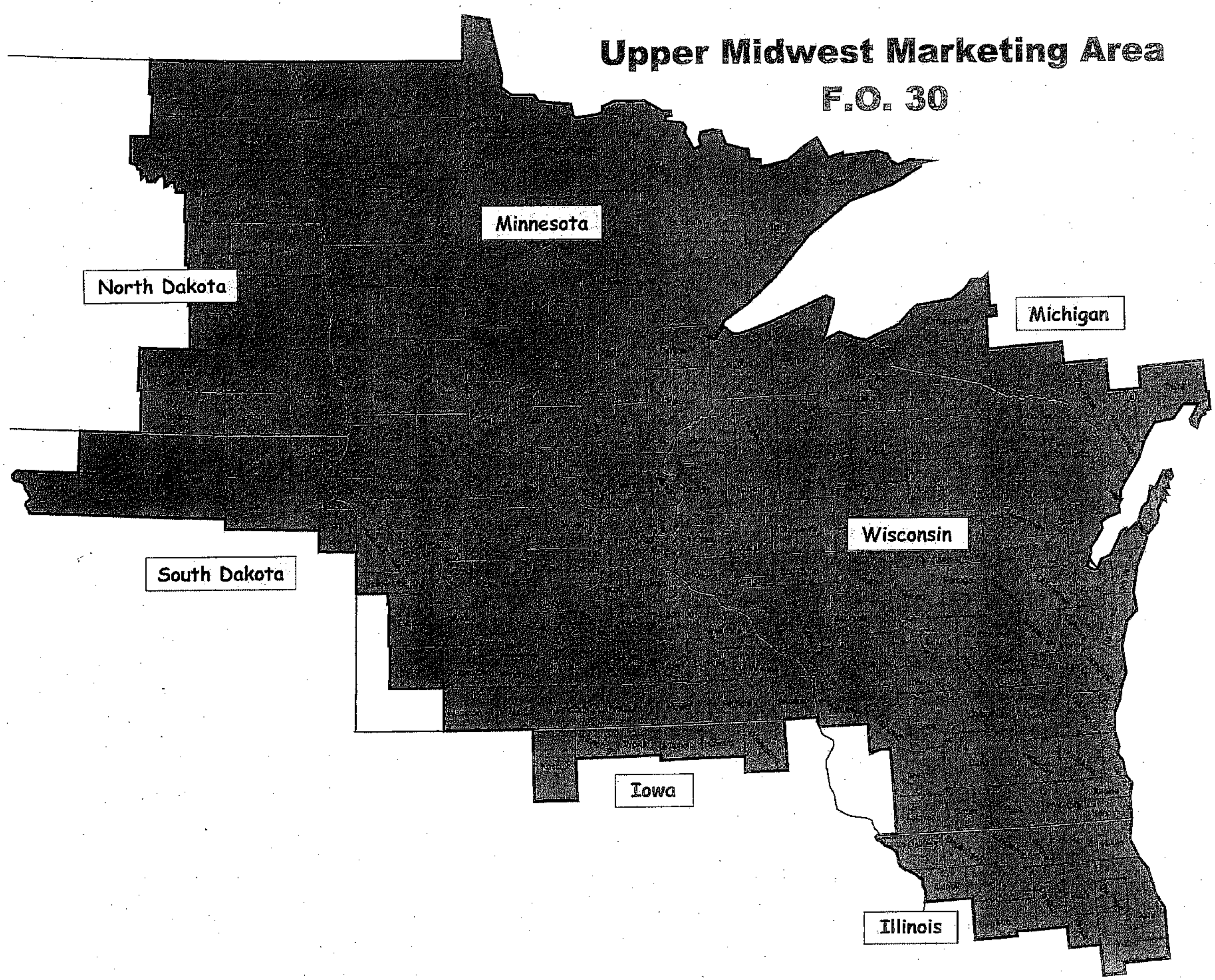
Month	Class II	Class III	Class IV	Blend Order 30	Blend Less CII	Blend Less CIII	Blend Less CIV
Jan	$ 16.79	$ 13.48	$ 16.42	$ 14.12	$ (2.67)	$ 0.64	$ (2.30)
Feb	$ 17.97	$ 17.00	$ 18.40	$ 17.23	$ (0.74)	$ 0.23	$ (1.17)
Mar	$ 18.83	$ 19.40	$ 19.41	$ 19.43	$ 0.60	$ 0.03	$ 0.02
Apr	$ 19.66	$ 16.87	$ 19.78	$ 17.51	$ (2.15)	$ 0.64	$ (2.27)
May	$ 20.63	$ 16.52	$ 20.29	$ 17.26	$ (3.37)	$ 0.74	$ (3.03)
Jun	$ 21.37	$ 19.11	$ 21.05	$ 19.58	$ (1.79)	$ 0.47	$ (1.47)
Jul	$ 21.29	$ 21.39	$ 20.33	$ 21.60	$ 0.31	$ 0.21	$ 1.27
Aug	$ 21.55	$ 21.67	$ 20.14	$ 21.92	$ 0.37	$ 0.25	$ 1.78
Sep	$ 20.55	$ 19.07	$ 19.53	$ 19.71	$ (0.84)	$ 0.64	$ 0.18
Oct	$ 19.41	$ 18.03	$ 18.41	$ 18.41	$ (1.00)	$ 0.38	$ -
Nov	$ 19.26	$ 19.07	$ 17.87	$ 19.15	$ (0.11)	$ 0.08	$ 1.28
Dec	$ 18.08	$ 18.77	$ 16.87	$ 18.71	$ 0.63	$ (0.06)	$ 1.84
	$ 19.62	$ 18.37	$ 19.04	$ 18.72	$ (0.90)	$ 0.35	$ (0.32)

Source: United States Department of Agriculture - Agriculture Marketing Service

Chart 1 Mailbox Milk Price @ Test Less PPD Less Class III Price
Federal Order 30 - 2006 - 2011

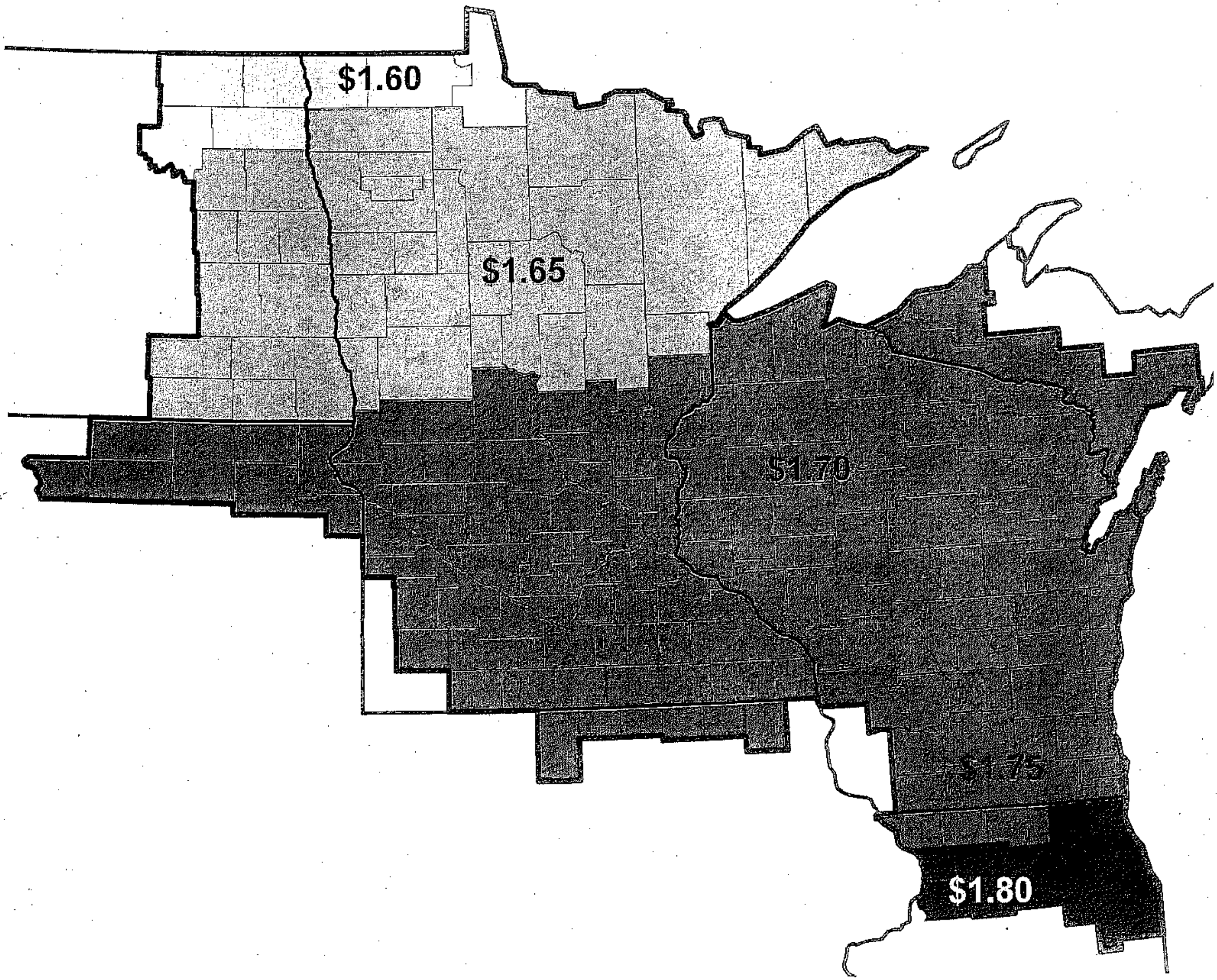


Upper Midwest Marketing Area
F.O. 30



Class I Price Surface -- Upper Midwest Order

(Dollar Amounts Represent Class I Differential)



TAB 10

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

Department of Food and Agriculture Auditorium
1220 N Street, Sacramento, CA

Testimony of
Thomas Wegner
On Behalf of Land O'Lakes, Inc.
May 31,2012

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, MN, 55164. My current title is Director of Economics and Dairy Policy. We thank the Department for calling this hearing to address issues of critical importance to the future of both our California dairy producer members and the entire California dairy industry.

Land O'Lakes (LOL) is a dairy cooperative with 3,000 dairy farmer member-owners. Land O'Lakes has a national membership base, whose members are pooled on the California State Program and five different Federal orders. Land O'Lakes members own and operate several cheese, butter-powder and value-added plants in the Upper Midwest, East and California. Currently, our 240 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 Factor of the Class 4b Formula
The current Class 4b formula contains a whey factorsliding scale that caps the contribution of whey at 65-cents per hundredweight regardless of whey's price in the Western whey markets. This sliding scaledrastically differsfrom the whey factor in calculating the Federal order ClassIII minimum price which is directly comparable to the California Class 4b minimum price. In calculating the FO Class III minimum price, the contribution of whey moves directly with the market price of whey with no artificial cap. Thus, whey's market price drives the contribution of whey in calculating the FO Class III minimum price.

For example, the federal order class III minimum price has averaged $17.44 per cwt. during the eight months since the Department adopted the current sliding scale whey factor. During the same eight months, the California class 4b price averaged $14.90 per cwt.; the federal order class III minimum price has exceeded the class 4b price by an average of $2.54 per cwt. from September 2011 thru April 2012. By contrast, over the same eight-month period just one year earlier, September 2010 thru April 2011, the difference between the federal order class III minimum price and the 4b price averaged $1.53 per cwt. As a result, the gap between the two minimum prices for milk used in cheese has become too large and is clearly unfair to California's dairy farmers.

Land O'Lakes' is a member of the aforementioned Coalition and we fully support the Coalition petition. Land O'Lakes also supports the Western United proposal which is identical to the Coalition proposal. The Coalition proposal would amend the current 4b formula by including an updated, market-basedwhey factor that wouldresult in Class 4b prices that meet the statutory requirement of a reasonable and sound economic relationship to the national value of manufactured milk products.

Updating the Whey Factor Will Directly Address Price Alignment
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.*"

In short, the class 4b price is out of alignment with the Federal order class III minimum price. The FO class III minimum price represents the national value of milk going into cheese and whey manufacturing which is directly comparable to the California Class 4b price. As a result of this gross misalignment in price, California producers are not being treated fairly 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 producer milk on federal orders. Adopting the Coalition's proposal will help to bring the class 4b price into better alignment with theFederal order class III minimum price and significantly reduce this price inequity.

Market Competition Ensures that Unregulated Cheese Plants in Federal Order Marketing Areas Pay the Federal Order Class III Minimum Price for Milk

Previous Departmenthearings have included testimony asserting thatunregulated cheese plants outside of California frequently buy milk below the Federal Order Class III minimum price. The testimony may have been referring to milk purchased by unregulated cheese plants in areas like Idaho that are not currently governed by a federal or state milk marketing order.

Since California is a regulated milk market it makes sense to compare California's regulated milk prices with the regulated milk prices in Federal milk marketing order areas. In addition, cheese plants in Federal order markets not only must compete with plants in unregulated areas, but must also compete with plants in the regulated market of California where class 4b prices have been significantly lower than the Federal order class III minimum price, particularly in recent years.

I'd like to focus my comments on sales of regulated producer milk to unregulated cheese plants in federal order markets in which the vast majority of milk in the market gets processed into cheese and whey products.While it is accurate that unregulated cheese plants are not required to pay the federal order class III minimum price, in practice these unregulated cheese plants enter into supply agreements that stipulate that the milk price paid will be at or above the federal order class III minimum price.

Land O'Lakes sells milk to cheese plants not regulated under federal orders and also buys milk from cooperatives and non-member producers for use in our own cheese plants located in the Upper Midwest. Land O'Lakes experience has been that the vast majority of milk sold to unregulated or non-pool cheese plants is contracted at prices at or above the federal order class III minimum price.

It only makes economic sense that the milk sold to unregulated cheese plants by cooperatives (who 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. Pricing this milk below the federal order class III minimum price would end up requiring the cooperative handler to make up the difference between the sale price and the federal order class III minimum price —the milk would be sold at a loss.

As previously noted, Land O'Lakes pools producers' milk on several Federal 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% of the 55.9 billion pounds of class III milk pooled in the entire federal order system during 2011. In the Upper Midwest Federal Order alone, the class III milk pounds averaged 82% of the total pounds pooled in this federal order in 2011.

Additionally, the price charged for milk sold to unregulated cheese plants has direct consequences on a cooperative's ability to pay a competitive price to their producers and thereby successfully retain their current producersand attract new ones. There is no value proposition in selling milk to unregulated cheese plants at a price below the federal order class III minimum pricewhen the cooperative handler, who sold the milk, must account to the federal order pool at the class III minimum prices. In sum, Land O'Lakes' customers that are unregulated cheese plants will typically buy milk at the current class III minimum price or higher. Selling below class III minimum prices would negatively impact the financial position of Land O'Lakes and weakenLand O'Lakes competitive position in the procurement of producer milk. Either of these actions doesn't make rational economic sense.

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 pool. Let me offer another perspective on how depooling impacts prices paid to producers.

There has been an assertion that processors who depool milk have an advantage over California processors. But the fact is that 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. By depooling, handlers forgo 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.

Unregulated cheese plants buying milk from a handler regulated under a Federal order handler must still pay the going market value for the milk whether it is pooled or depooled The going market value is at least the Federal order class III minimum price. As stated earlier, unregulated cheese plants typically enter into supply agreements that stipulate that the milk price paid will be at or above the class III minimum price.

The volume of depooled milk has decreased significantly in recent years, 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 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% 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.

Keep in mind that handlers can also choose to depool milk used in class II and IV products as well as milk used in class III products. This is especially important to note since the class IV minimum price has exceeded the class III minimum price in seventy-five percent of the months during the two-year period January 2010 thru December 2012. The higher priced class IV has provided an incentive for handlers of class IV milk to depool their class IV milk in eighteen of the twenty-four months.

Financial Conditions on California Dairy Farms Since Adoption of the Fixed Whey Factor
California's dairy farmers have gone through very trying financial times since December 2007 when the Department first implemented the 25-cent whey factor. To briefly recount, in 2008 income over feed dropped 32% from 2007 levels, and in 2009, margins over feed dropped to a catastrophically low level of $2.74 per cwt. representing a decrease of 73% 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 improved but we contend 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 encounter another period of catastrophically low margins like 2009. Margin projections for the remainder of 2012 do not look promising for California's dairy farmers.

Feed costs for California dairy farmers rose dramatically in 2011. Using data from the Department's Cost of Production Survey revealed that total feed costs rose to $11.11 per hundredweight in the final quarter of 2011, the highest feed cost during the five-year period 2007 thru 2011.

Total feed costs for California's dairy farms increased by $2.41 per hundredweight, an increase of twenty-eight percent in the twelve months from the final quarter of 2010 to the final quarter of 2011. Hay and grain mix prices drove this escalation in feed costs. Hay prices increased by $104 per ton, an increase of fifty-nine percent and grain mix prices rose $51 per ton, also an increase of fifty-nine percent over the same period. Accordingly, feed costs as a percentage of total milk production costs rose from 58.7% in Q4 2010 to 65.3% in Q4 2011.

Currently, margins have been squeezed to very low levels due in large part to the collapse of farm milk prices. The California overbase price dropped from $19.54 in July 2011 to $14.10 in April 2012 the lowest overbase price since December 2010. This precipitous dropof $5.44 in just nine months has resulted in negative margins on many California dairy farms. This price collapse also highlights another challenge facing California's dairy farms—price volatility.

Adding to the financial stress at the farm level is the fact that because of the structure of the 4b whey factor California dairy farmers have one less tool to utilize to protect themselves from the negative impacts of volatile milk prices. More specifically, the whey factor has severely hindered a California dairy farmer's ability to make effective use of the class III futures market to hedge their milk price. The variability of the basis between CA 4b and FO class III minimum price renders the class III futures ineffective in protecting the milk price for California dairy farmers.

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 minimum price differed by an average of $1.56 per cwt. from January thru 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 primarily due to the difference in whey value between the two regulated minimum prices.

In fact, 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 (Class 4b price – Federal Order Class III price) in February 2011 was -$0.08; in March 2011, the Class 4b basis had expanded to -$2.64; and, by December 2011 the basis ballooned to -$3.63. The gross difference between the class III futures price and the 4b cash price has widened and displayed a high level of volatility effectively preventing California dairy farmers from making use of class III futures as a hedging tool. UPDATE

Some CA producers have become so discouraged by thisvariable basis that it has driven them away from using any kind of milk price protection at a time when they need to develop and execute a risk management strategy now more than ever before due to the unprecedented level of milk price volatility.

Land O'Lakes' California producers significantly reduced their use of the Class III futures in 2011. Forty-two percent less producer milk has been hedged with class III futures in 2012 compared to 2011 volumes. This corresponds with the period of time when the basis to $3.63 in December 2011. In fact, since the June 2011 hearing, the 4b-Class III basis has averaged $2.38 per cwt. By contrast, Land O'Lakes' milk producers in the Upper Midwest region expanded their use of Class III by thirty percent in 2011 compared to 2010 volumes.

Furthermore, cheese processors who had made use of the class III futures before the misalignment of 4b and class III can easily avoid this basis risk by utilizing the Chicago Mercantile Exchange's cheese futures contract which tracks their end product prices much more closely than the class III futures. Since mid-2010, California's cheese processors can offset the basis risk by utilizing the cheese futures. By comparison, California's milk producers find themselves operating in a very volatile milk price environment with one less hedging tool to use to offset milk price risk.

On the feed side, cotton and corn continues to outbid hay acreage in California, reducing the hay supply and leading to higher hay prices. There are no established futures markets forhay. 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 dairy farmers lost significant equity in 2009 that has not been recovered, the availability of hedge lines to these farms has been severely limited.

Small CA Cheese Plants Have Had the Opportunity to Develop Their Whey BusinessSince 2007
All California cheese plants, large and small,benefited from the fixed whey factor adopted by the Department in 2007.From December 2007 through August2011, the 25-cent fixed factor has benefited cheese plants. By limiting the financial exposure to a maximum cost 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 provided a huge financial incentive and a golden opportunity for small cheese makers to develop a whey business.

The monthly Western dry whey price series used by the Department in the whey portion of the Class 4b formula has continued to show significant market strength since September 2011. Of the eight months from September 2011 thru April 2012, whey markets have traded at levels of 60 cents or greater seventy-five percent of the time.

This whey market strength stands in stark contrast to comments in the Hearing Panel Report regarding the public hearing held June 30 and July 1, 2011 in which the Panel stated "...it is more likely for dry whey commodity prices to fluctuate within the ranges of $0.20/lb – [to] $0.60/lb based on past experience..." Clearly, this has not been the case since September 2011. If the Department adopted the whey factor sliding scale with the intent of having the whey values in the Class 4b formula to be market-driven, the performance of the sliding scale has fallen far short of that intent as the whey value in the 4b formula has been artificially capped at 65-cents in most of those months.

Further, it's important to note that the current whey factor sliding scale caps the contribution of whey to the 4b price at 65 cents whenever the monthly average of the Western dry whey price equals or exceeds 60 cents per pound. Thus, thesustained price strength in the whey market has provided California cheese processors,both large and small, a financial benefit from marketing their whey. Even with the adoption of the whey factor sliding scale, California cheese processors have continued to have a generous market incentive to market their whey and develop their whey business

We are very curious to know how small cheese processors handle their whey and if they have explored ways to take advantage of the rising values in the whey market. We would be interested in hearing how small cheese processors manage to compete for milk supplies if they have no outlet for their whey.

Since 2007 Land O'Lakes has hadfirst-hand experience with the issue of a small cheese plant finding an outlet for whey processing. Initially 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. Currently, we continue to condense Orland's whey into whey protein concentrateand have established a new business 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.

After looking at the huge windfall that the large California cheese makers that process whey have been granted by the whey factor, it would be interesting to hear how their whey enterprises have performedsince December 2007 and to compare and contrast their Californiacheese plants' financial performanceto the financial performance oftheir cheese plants that they operate in federal order markets. It would be instructive to know how their whey enterprises have performed since the adoption of the whey factor sliding scale in September 2011. 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.

Industry's Role in Balancing California's Milk Supply

The market conditions of the past few months have led to a huge surge in milk production in California and the entire U.S. Land O'Lakes' California producers have experienced this increase in milk production as well due to the mild winter leading to ideal milk producing conditions on the dairies. Earlier this year, Land O'Lakes took proactive steps to manage our own milk supply in California to better balance milk supply and demand.

We are confident that we have the programs in place to continue to manage the milk supply in California and to do our part in matching milk supply with plant capacity and market demand. We understand that other cooperatives and one cheese processor have also taken steps to balance their own milk supply and demand.

The springof 2012 represents the second data point, along with the period in 2007-08 when cooperatives and one cheese processor took steps to balance the state milk supply, providing evidence that the California dairy industry has the tools/programs to manage milk supply with plant capacity and market demand.

Impact of Class 4b Price on Cheese Processing Capacity

Testimony presented at previous Department hearings has suggested that any actions that would raise the class 4b price would negatively impact or devastate future plant investments in California. The recent record of cheese plant investments inside and outside California strongly suggest that the class 4b price and, more generally, farm level milk prices may not be as critical a factor when processors consider investing in new or expanded plants as we may have been led to believe. I have assembled two tables that shed light on this issue.

Appendix Table 1 lists the publicly announced expansions or proposed new construction of cheese plants in states outside of California from December 2007 to present. Appendix Table 2 lists four year average of the USDA's AllMilk price for each of the ten states that have had plant expansions announced.

Recent history in California speaks for itself; since 2007, there has been one cheese plant expansion, Leprino's expansion of the Lemoore facility, and no new cheese plants constructed. During this four-year period 2008 thru 2011, California's all milk price averaged $15.39 per cwt. California's all milk price was lower than the all milk price in each of the ten states that have had new plant capacity announced.

Collectively, the ten states listed have had roughly 45.2 million pounds of daily raw milk receiving capacity announced over the same period. All ten states had a higher average all milk price than California over the four year period. Wisconsin alone has over seven million pounds of raw milk receiving capacity being planned to be added despite an all-milk price that averaged $1.74 per cwt. higher than California's.

Clearly, there are limits to what a low milk price can do to attract new cheese plant investment. The recent record of cheese plant investments seem to suggest that a low milk price does little to attract cheese plant investment. Perhaps the Department needs to consider other factors that may attract investment in cheese plants and take into consideration the financial sustainability of California's dairy farmers when hearing concerns about the level of the 4b price and its impact on future plant investments.

Position on Alternative Proposal
We oppose Farmdale's alternative proposal.

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

Appendix Table 1

Source: Industry periodicals and estimates made by Land O'Lakes

Appendix Table 2
All Milk prices in states that have added or will add dairy processing capacity in the period 2010 to 2014. All milk prices are a weighted average of the prices dairy processors pay for all Grade A and Grade B milk. The all milk price is calculated monthly by the National Agricultural Statistics Service (NASS) of the USDA.

Source: NASS, USDA

TAB 11

Testimony of the California Dairy Campaign (CDC)
Before the California Department of Food and Agriculture (CDFA)
May 31, 2012
Hearing to Consider Amendments to the Stabilization and Marketing Plans for Market Milk
Sacramento, California

Mr. Hearing Officer and Members of the Panel, my name is Lynne McBride. I currently serve as Executive Director of the California Dairy Campaign (CDC). CDC is a member organization of California Farmers Union (CFU) which represents more than 1400 farmer and rancher members statewide. CFU is a state chapter of the National Farmers Union (NFU) which represents 250,000 farmers and ranchers nationwide. The testimony I will present today is based on positions adopted by the CDC Board of Directors.

We support the petition put forward by the Coalition to incorporate a higher value for whey in the 4b pricing formula because it will pay producers a whey value that is based upon prevailing market demand. We support the identical proposal to change the whey factor in the 4b put forward by Western United Dairymen (WUD). We oppose the proposal put forward by Farmdale Creamery to decrease the whey factor in the 4b formula.

Already this year, in just two counties, Tulare and Kings, seventeen dairies have closed their doors. Despite the fact that dairy producer prices improved in 2011, forty eight dairies went out business that year which illustrates that even when producer prices improve, the toll of a price collapse like 2009 reverberates for years.

When a dairy closes, that dairy owner is not able to pay a number of vendors along the input supply chain and as a result, the consequences of the closure of one dairy have a dramatic impact on the local, regional and state economy. The consequences of the closure of more than 200 dairies statewide in just the last three years is taking a heavy toll on the local, regional and state economy in California and dramatically changing the social and cultural landscape of communities throughout the state.

Those dairy operations that remain in operation today continue to struggle to make up for the unprecedented loss of equity that all dairy producers suffered in 2009 and are once again facing financial crisis due to the fact that producer prices do not cover production costs. It is extremely difficult for dairy producers to secure credit as banks and other financial institutions continue to tighten credit and other requirements for all dairy operations.

According to CDFA data, feed costs increased by 28.8 percent from 2010 and 2011 and represented 63.9 percent of the total cost of production on California dairies. Feed costs in 2011 reaches record highs, but under our current system California dairy producers do not have the ability to pass on these higher costs. With feed and other input costs at record highs on dairy operations throughout the state, it is critical that dairy producers are paid are fair value for the milk they produce based upon the price received for milk in the market today. Whey represents a significant portion of that value and it is critical that the California 4b formula is modified as called for in the Coalition's petition.

The future for countless dairy operations around the state is far from certain and it is critical that CDFA consider the impact of today's petitions on producers who have already endured tremendous financial hardship over the last few years. Our dairy producer members continue to question whether dairy farming in California is feasible given the significant gap between dairy producer prices paid in our state compared with those paid in the federal milk marketing orders. The attrition of dairy operations throughout the state continues and it is critical that CDFA act quickly to increase the whey value in the 4b formula as a good first step towards remedying the already dire situation facing California dairy producers around the state.

Support for Coalition petition:

We testify in support of the petition put forward by the Coalition to increase the amount producers are paid for the value of whey. Adoption of the new "sliding scale" as called for in the petition will be an important step in the right direction towards making the 4b pricing formula more market oriented and more equitable.

Today, the price paid to California dairy producers for 4b milk is significantly below the price paid to dairy producers in the federal milk marketing orders. The significant difference in the amount that California dairy producers receive for 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 manufactured milk products. Adoption of the Coalition's proposal would increase the price paid to California dairy producers for 4b milk and put California prices in a more reasonable relationship with those in surrounding states the federal milk marketing orders.

On many occasions CDC has testified before CDFA calling for the California dairy pricing system to be more market oriented. The Coalition's proposal would establish a sliding scale whey value that tracks the market direction followed by the federal milk marketing order (FMMO) Class III whey value. The whey value factor included in the Coalition's petition, in part, achieves our long standing goal of making the California dairy pricing system more market oriented. The Coalition's petition incorporates a fair value for whey based on market conditions and will make the California dairy pricing of 4b milk more equitable for producers throughout the state.

Other proposals:

We support the petition put forward by Western United Dairymen because it is identical to petition put forward by the Coalition. We call upon CDFA to deny the Farmdale Creamery petitioı decrease the whey value to a fixed 25 cents per hundredweight. The petition greatly undervalues w given prevailing market conditions and would worsen the economic crisis dairy producers are fac caused by the fact that producer prices are significantly below production costs.

Conclusion:
We urge CDFA to adopt the Coaliton's petition to change the 4b pricing formula so that producers are paid a 4b price that is based on the value of whey in the market and so that the 4b formula is in a reasonable and sound economic relationship with the FMMO Class III price. Adoption of the Coalition's petition will be a good first step towards making the 4b dairy pricing formula more equitable for producers by including a whey factor that relates to prevailing market conditions.

The California Dairy Campaign (CDC) would like to thank the department for the opportunity to present our testimony today. We would also like to request the opportunity to submit a post-hearing brief. We look forward to working with CDFA to improve the outlook for dairy producers in this state now and for years to come.

TAB 12

I am Cornell Kasbergen, I own and operate a dairy with my wife, son and daughter in-law in Tulare, California. We have been in the dairy business for over 35 years. We also own a dairy in Wisconsin that we own in partnership with my brother and is being managed by our son-in law and daughter. We have owned the Wisconsin business for 13 years. I also served as a director on the Land O' Lakes board for almost 14 years. I am here today to testify on my behalf, not Land O Lakes.

There are 3 areas that I would like to cover.

1. First is the current relationship of California 4b pricing vs. Class III, the national price for milk used in cheese manufacture.
2. Second, the effect of the inequity of those pricing mechanisms on California dairies.
3. And Third, solutions to correct the inequities.

I have attached a monthly breakdown for milk pricing on our Wisconsin dairy, tab #1. The prices under actual gross dollars are taken from our milk statement and includes, the Producer Price Differential and premiums. I compared those Wisconsin prices to those that would have been received under the Californian 4b schedule. The difference is substantial and sobering.

Wisconsin prices are significantly higher than the California 4b. The average Wisconsin advantage for 2011 is $4.07, for the first 4 months of 2012 it is $4.33. Many have and will state that the Class 3 price is not being paid for milk in the Federal Orders. That is a correct statement, Class 3 milk in the Federal Orders is receiving a much higher price.

Herein lies the crux of the problem; California and Wisconsin are the number one and number two cheese producing states. Both pricing formulas have a basis in current market values, however, the California price received by dairymen is over $4.00/ cwt lower. That is 20% to 25% less income received by California dairy families.

Many of the companies that will testify today also operate in the Federal Orders, of which Wisconsin is one. These companies are paying the same higher price for milk in the Federal Orders. They come here today testify that they need the huge pricing advantage offered in California to continue to operate. The fact is that a cheese plant in California today has a significant advantage over any plant outside of California.

These national companies will tell you how difficult and costly it is to operate in California vs. the other states. The dairy families of California operate in the same environment. The Wisconsin dairy is very profitable as opposed to the dire situation in California for our dairies. The upper mid west continues to expand plant capacity. Competition for milk is fierce, and all this in an environment where input costs are 20% to 25% higher.

The milk market in Wisconsin is very dynamic; many cheese plants that do not process their whey operate very successfully. The market in Wisconsin is very competitive and by way of example, we could sell our milk to five different buyers.

The market price paid for milk in Wisconsin is the true market value for milk. I have heard the argument that the California price needs to reflect a clearing price. Where in the statute is that written? How does this comply with the statue, 62062, that states our price *"shall be in reasonable and sound economic relationship with the national value of manufactured milk products"*.

Yes, federal order plants can depool. The reality is that the impact at the producer level is minimal. In fact when comparing our Wisconsin milk price to a increase in Non-Pooled milk on tab #2 , in March 2011 and December 2011 it had little to no impact on our milk prices in Wisconsin. The ~~buyer~~ seller of the milk is covering the loss of income if the milk is discounted. If this cost were charged to the producer, they would probably leave that buyer of milk.

On tab #3 you can see the 22 year price chart on 4b prices. From 1990-2009 the difference between the 4b and Class 3 was $.55. From 2010-present it is $1.90 difference and it is getting further out of relationship as time goes on.

The CDFA has the responsibility to be the referee for the dairy industry. Until 2008 the department managed the states milk industry equitably. The game changer was ethanol and the cost of energy. Until 2008, we were the low cost producers of milk and we could survive and receive less for our milk than the rest of the country. Those days are gone.

The exit of dairy families is accelerating. Just last week I received flyers for 4 different dairy dispersal totaling 8,000 cows. The dairy families of California deserve better. The California pricing system is causing economic hell. Again in direct conflict with statute 318101-E. *"It's the policy of this state to promote, foster and encourage the intelligent production and orderly marketing , of commodities necessary to its citizens, including market milk, and to eliminate economic waste, destructive trade practices".*

Why do the administrators of the above statute not follow its mandate? CDFA must recognize the inequity in our 4b formula and give the dairy families a chance to continue to do business in California. It's time to level the playing field and the statute requires you to.

The argument will be made that the plants cannot process the milk if the price increases. The co-ops have and will continue to manage the volume of milk to best match the capacity. The responsibility of the CDFA is to give the dairy families a fair chance to compete economically. We cannot compete with producers that are receiving as much as $4.00 cwt more income than we are.

I support the Coalition and Western United petition. The dairy families should not receive less than the federal order Class III for our 4b milk, with no caps, or floors. This is the bench mark that this panel should consider. To take into consideration the all milk price is not equitable, since not all producers own a proportionate amount of Quota.

In my interaction with dairy families, I have seen the pain that is out there in our communities and much of it is because of the inaction by the CDFA. CDFA has been part of transferring over $500 million of producer money to the processors of this state.

We are going to hear that the plants will close down if they have to pay more money for the milk, however it's interesting to note that Leprino, Saputo, Hilmar as well as national cooperatives all have plants in the Federal Orders. They all pay more than the Class III for milk in those out of State plants and yet sit before you today and complain about California pay prices.

We are asking you to give the dairy families of California a fighting chance. You will know at the end of this hearing the pain that your inaction is causing. Your inaction has contributed to many dairy families losing their farms that have taken a lifetime to build. Yes, you have an unenviable position, but justice must prevail.

We, the dairy families have choices. If CDFA fails to correct the inequity between the 4b and the Class III, my first choice would be for California to join the Federal Order, which would dismantle the current bureaucracy and replace it with a federal system. That would level the playing field for processors and the dairy producers.

The best solution is for CDFA to act to rectify the obvious inequities.

I thank you for your time today, and hope that you make the right decisions for the sake of all California dairy families.

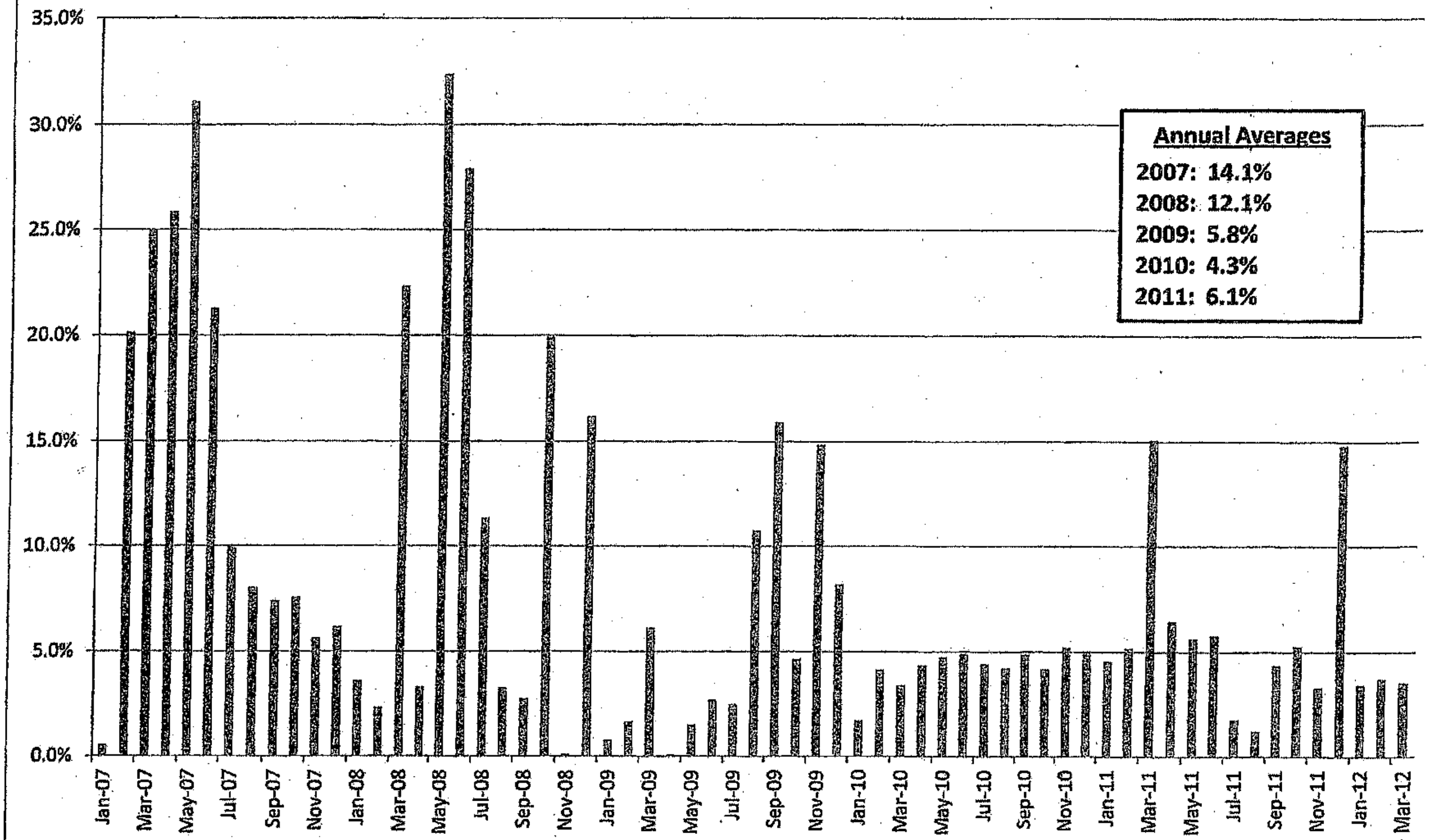
	4B	FO- Class3	Wis-CWT	4B $$$	Class3 $$$	Acutal Gross$$$	
January-11	$12.49	$13.48	38,157.00	$476,581	$512,606	$ 642,311	$ 16.83
February-11	$16.92	$17.00	35,139.80	$594,565	$595,627	$ 689,304	$ 19.62
March-11	$16.76	$19.40	40,603.00	$680,506	$785,948	$ 862,472	$ 21.24
April-11	$14.34	$16.87	40,783.00	$584,828	$686,259	$ 782,146	$ 19.18
May-11	$14.74	$16.52	41,665.00	$614,142	$686,556	$ 774,941	$ 18.60
June-11	$18.79	$19.11	39,044.40	$733,644	$744,388	$ 798,079	$ 20.44
July-11	$19.35	$21.39	41,091.20	$795,115	$877,191	$ 918,819	$ 22.36
August-11	$18.60	$21.67	41,633.20	$774,378	$900,441	$ 952,358	$ 22.87
September-11	$16.33	$19.07	40,821.80	$666,620	$776,722	$ 860,536	$ 21.08
October-11	$15.78	$18.03	41,296.00	$651,651	$742,817	$ 843,734	$ 20.43
November-11	$17.19	$19.07	40,393.40	$694,363	$768,552	$ 865,021	$ 21.41
December-11	$15.14	$18.77	42,985.20	$650,796	$805,082	$ 893,741	$ 20.79
Totals	$16.37	$18.37	483,613.00	$7,917,189	$8,882,190	$9,883,462	
		$ (2.00)		$ 16.37	$ 18.37	$ 20.44	
					$ (2.00)	$ (4.07)	
January-12	$ 14.23	$ 17.05	43,591.20	$ 620,303	$ 743,230	$ 837,998	$ 19.22
February-12	$ 13.42	$ 16.06	40,782.80	$ 547,305	$ 654,972	$ 733,477	$ 17.98
March-12	$ 13.67	$ 15.72	44,967.40	$ 614,704	$ 706,888	$ 787,147	$ 17.50
April-12	$ 13.43	$ 15.73	43,524.40	$ 584,533	$ 684,639	$ 757,135	$ 17.40
Totals	$ 13.69	$ 16.14	172,865.80	$ 2,366,845	$ 2,789,728	$ 3,115,757	
		$ (2.45)		$ 13.69	$ 16.14	$ 18.02	
					$ (2.45)	$ (4.33)	

#1

#2

Estimated Percentage of Non-Pooled Milk Upper Midwest FMMO

January 2007 - March 2012



Source: Upper Midwest Dairy News, FMMO No. 30 - www.fmma30.com

Non-pooled milk was previously pooled at one time on FMMO No. 30. Represents milk not pooled due to price or association with another FMMO.

#2

#3

Class 4b Price, 3.5 Percent Fat

$/CWT.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Class3	4b vs 3	
1990	12.66	11.01	10.82	11.51	11.86	12.26	12.40	12.40	11.86	10.33	9.32	9.32	11.31	12.21	$ (0.90)	
1991	9.29	9.29	9.30	9.31	9.53	10.05	10.55	11.16	11.47	11.55	11.25	10.84	10.30	11.06	$ (0.76)	
1992	10.48	10.00	9.88	10.75	11.40	11.57	11.69	11.79	11.48	11.11	10.81	10.32	10.94	11.88	$ (0.94)	
1993	10.03	9.88	10.12	11.50	11.87	11.28	10.61	10.38	11.34	11.48	11.48	11.26	10.94	11.80	$ (0.86)	
1994	11.08	11.12	11.66	11.89	10.75	10.16	10.70	10.89	11.17	11.33	10.86	10.31	10.99	12.00	$ (1.01)	
1995	10.38	10.86	11.01	10.36	10.25	10.82	10.82	11.21	11.88	12.21	12.31	12.26	11.20	11.83	$ (0.63)	
1996	11.95	11.79	11.87	12.31	13.07	13.14	13.65	14.51	15.13	14.11	11.41	10.67	12.80	13.39	$ (0.59)	
1997	10.77	11.30	11.45	10.65	9.79	9.90	10.37	11.84	12.11	12.18	12.33	12.55	11.27	12.05	$ (0.78)	
1998	12.50	12.52	11.98	11.12	10.44	13.14	14.36	14.87	15.40	16.37	16.81	17.14	13.89	14.20	$ (0.32)	
1999	14.34	11.29	11.52	11.48	10.68	11.91	13.96	16.90	15.06	11.66	9.88	9.67	12.36	12.43	$ (0.07)	
2000	9.58	9.28	9.34	9.27	9.17	9.98	10.64	10.57	11.32	9.01	8.71	9.39	9.69	9.74	$ (0.05)	
2001	9.22	10.05	11.34	12.12	14.16	14.82	14.96	15.26	15.55	12.30	10.60	10.97	12.61	13.10	$ (0.49)	
2002	11.42	10.40	10.20	10.59	10.23	9.59	8.90	9.69	9.93	10.42	8.97	9.43	9.98	10.42	$ (0.44)	
2003	9.58	9.36	8.84	9.21	9.28	9.50	12.59	14.03	14.14	14.21	12.50	11.61	11.24	11.42	$ (0.18)	
2004	11.10	11.74	15.57	19.88	19.34	16.35	12.76	14.01	14.03	13.60	15.14	14.99	14.88	15.39	$ (0.52)	
2005	14.38	13.93	13.87	14.34	13.39	13.62	14.01	12.99	14.23	13.72	12.69	13.25	13.70	14.05	$ (0.34)	
2006	12.56	11.14	10.49	10.43	10.48	10.65	10.28	10.80	11.87	11.40	12.32	12.37	11.23	11.89	$ (0.65)	
2007	12.47	13.20	14.13	15.20	18.05	21.18	20.54	19.41	19.34	17.65	19.75	18.58	17.46	18.04	$ (0.58)	
2008	16.91	17.54	16.94	16.79	18.66	19.12	17.77	16.14	16.63	16.63	15.14	13.95	16.85	17.44	$ (0.58)	
2009	9.02	10.11	10.45	10.41	9.54	9.52	9.39	11.29	11.40	12.69	13.76	15.04	11.05	11.36	$ (0.31)	$ (0.55)
2010	12.72	12.95	11.13	12.30	12.40	12.23	13.37	14.39	15.48	15.66	13.14	12.22	13.17	14.41	$ (1.24)	
2011	12.49	16.92	16.76	14.34	14.74	18.79	19.35	18.60	16.33	15.78	17.19	15.14	16.37	18.37	$ (2.00)	
2012	**14.23**	**13.42**	**13.67**	**13.43**									13.69	16.14	$ (2.45)	$ (1.90)

Source: CDFA - Dairy Marketing Branch

#3

TAB 13

Mr. Hearing Officer and members of the hearing panel:

My name is Michael Marsh. I am the Chief Executive Officer for Western United Dairymen. Joining me today is Annie AcMoody our Director of Economic Analysis. Our association is the largest dairy producer trade association in California, representing approximately 900 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 approved the position I will present here today at a special meeting on February 24th 2012.

We would like to thank Secretary Ross for the call of this hearing on our petition. We would also like to thank Governor Brown for his oft expressed support and recognition of California agriculture and dairy in particular as being a driver intrinsic to California's economic recovery. We appreciate the Governor's and the Secretary's attention and receptiveness to hearing our plea for relief.

Arriving at this position was a lengthy process that did not begin with this petition. With the fixed whey factor implemented on December 1, 2007, it was only a matter of time before prices would fall significantly out of alignment with federal order pricing. The issue became particularly apparent in 2011 as the value of dry whey started to rise. The producer community, concerned with the inequity, overwhelmingly supported some changes. Land O'Lakes submitted a petition on May 24, 2011.

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

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

After the Department's denial, the issue remained and producer discontent intensified. Our board discussed asking for reconsideration or immediately filing another petition. We held a number of meetings with the Secretary and her team sharing data and information which we hoped to be persuasive when we next asked for relief. We very much appreciate the open dialogue with the Secretary, the Undersecretary and her staff.

We stressed the imperative of resolving this issue sooner rather than later and impressed upon the Secretary that waiting until after cost studies were completed in September 2012 would not work. Our board was not going to give up on lost producer revenue and decided to petition again. Industrywide support on the producer side was evident. Lengthy discussions took place and each organization agreed on the requested changes that we are arguing in favor of today.

Relationship to 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 products" (Section 62062). According to CDFA analysis, with the current formula, the Class 4b price would have averaged $1.05 per hundredweight less than the federal order Class III price for the period April 2007 - March 2012. That difference is even more striking when looking at the last twelve months of data, where Federal Class III was an average $2.18 per hundredweight higher than 4b.

The deviation between Class III and 4b prices was caused by several factors. Notably, formula differences such as different price series (CME vs NASS), make allowances, yield and formula construct contribute to the divergence. But the whey value is what creates the most variance between the two class prices and this is a significant concern to the members of WUD. According to our analysis, since April 2007, 74% of the difference between Class 4b and Class III was attributable to the whey value.

More specifically, assuming current formulas had been in place since April 2007, the average difference between Class III and Class 4b would have been $1.05 per hundredweight. Of that amount, $0.27 per hundredweight would be due to formula differences other than the whey factor. The remaining $0.78 per hundredweight is due to the difference in whey value. With whey values that follow market movements in Class III and a sliding scale value in Class 4b capped at 65 cents per hundredweight, such a discrepancy was not unlikely to occur. As the price of whey fluctuates, so will the variance between the two classes if California retains a limited sliding scale. Clearly, the current scale 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 more closely tie our whey value to the end product pricing formula used in federal orders. As outlined in our petition, we propose the following whey value in Class 4b:

Average Western Monthly Dry Whey per lb			Whey Value per cwt
Less than $0.2000			$0.0000
$0.2000	to	$0.2099	$0.0329
$0.2100	to	$0.2199	$0.0886
$0.2200	to	$0.2299	$0.1443
$0.2300	to	$0.2399	$0.2000
$0.2400	to	$0.2499	$0.2557
$0.2500	to	$0.2599	$0.3114
$0.2600	to	$0.2699	$0.3671
$0.2700	to	$0.2799	$0.4228
$0.2800	to	$0.2899	$0.4786
$0.2900	to	$0.2999	$0.5343
$0.3000	to	$0.3099	$0.5900
$0.3100	to	$0.3199	$0.6457
$0.3200	to	$0.3299	$0.7014
$0.3300	to	$0.3399	$0.7571
$0.3400	to	$0.3499	$0.8128
$0.3500	to	$0.3599	$0.8685
$0.3600	to	$0.3699	$0.9242
$0.3700	to	$0.3799	$0.9800
$0.3800	to	$0.3899	$1.0357
$0.3900	to	$0.3999	$1.0914
$0.4000	to	$0.4099	$1.1471
$0.4100	to	$0.4199	$1.2028
$0.4200	to	$0.4299	$1.2585
$0.4300	to	$0.4399	$1.3142
$0.4400	to	$0.4499	$1.3699
$0.4500	to	$0.4599	$1.4256
$0.4600	to	$0.4699	$1.4814
$0.4700	to	$0.4799	$1.5371
$0.4800	to	$0.4899	$1.5928
$0.4900	to	$0.4999	$1.6485
$0.5000	to	$0.5099	$1.7042
$0.5100	to	$0.5199	$1.7599
$0.5200	to	$0.5299	$1.8156
$0.5300	to	$0.5399	$1.8713
$0.5400	to	$0.5499	$1.9270
$0.5500	to	$0.5599	$1.9828

Average Western Monthly Dry Whey per lb			Whey Value per cwt
$0.5600	to	$0.5699	$2.0385
$0.5700	to	$0.5799	$2.0942
$0.5800	to	$0.5899	$2.1499
$0.5900	to	$0.5999	$2.2056
$0.6000	to	$0.6099	$2.2613
$0.6100	to	$0.6199	$2.3170
$0.6200	to	$0.6299	$2.3727
$0.6300	to	$0.6399	$2.4284
$0.6400	to	$0.6499	$2.4841
$0.6500	to	$0.6599	$2.5399
$0.6600	to	$0.6699	$2.5956
$0.6700	to	$0.6799	$2.6513
$0.6800	to	$0.6899	$2.7070
$0.6900	to	$0.6999	$2.7627
$0.7000	to	$0.7099	$2.8184
$0.7100	to	$0.7199	$2.8741
$0.7200	to	$0.7299	$2.9298
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$0.7400	to	$0.7499	$3.0413
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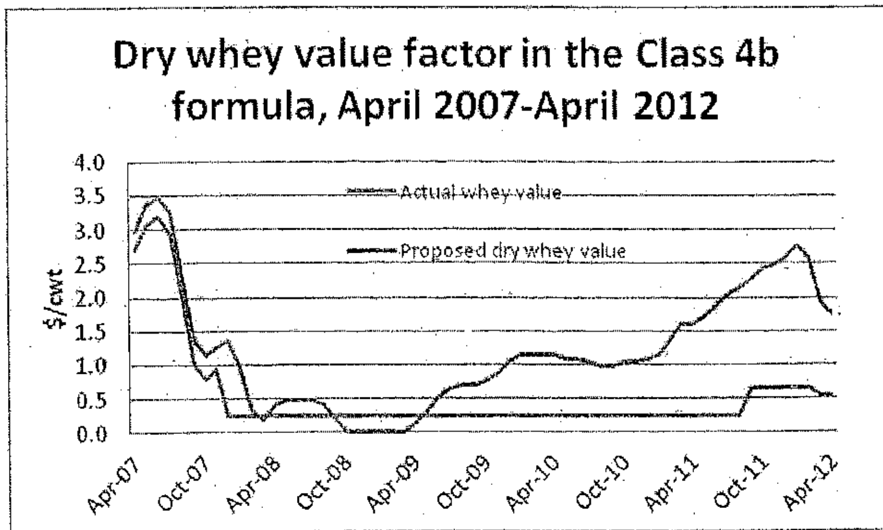
$0.7600	to	$0.7699	$3.1527
$0.7700	to	$0.7799	$3.2084
$0.7800	to	$0.7899	$3.2641
$0.7900	to	$0.7999	$3.3198
$0.8000	to	$0.8099	$3.3755
$0.8100	to	$0.8199	$3.4312
$0.8200	to	$0.8299	$3.4869
$0.8300	to	$0.8399	$3.5427
$0.8400	to	$0.8499	$3.5984
$0.8500	to	$0.8599	$3.6541
$0.8600	to	$0.8699	$3.7098
$0.8700	to	$0.8799	$3.7655
$0.8800	to	$0.8899	$3.8212
$0.8900	to	$0.8999	$3.8769
$0.9000	to	$0.9099	$3.9326
$0.9100	to	$0.9199	$3.9883
More than $0.9200			$4.0000

Figure 1 illustrates the impact of our proposal on the whey value.

Figure 1: Comparison of whey values



Source: USDA data and WUD calculations.

Since the current whey Class 4b formula was implemented in September 2011, revenues to producers from the whey value compared to our proposed whey value were $212 million lower.

The narrow range of the sliding scale used in the current formula is at the root of the problem. With a ceiling capping the whey value at 65 cents, there is tremendous potential for discrepancies between the Class 4b and Class III (as illustrated above). Similarly, a floor of 25 cents also creates the potential for discrepancies. The scale proposed in our petition removes the potential for these large discrepancies.

As the panel stated in 2005 before recommending the removal of price floors from the 4a and 4b formulae: "price floors create an artificial price within a market at a level that may be higher than the naturally occurring market price". The same is true of ceilings, creating an artificial price that may be lower than the naturally occurring market price. In this case, it has prevented producers from benefiting from that value.

The 2005 panel added: "federal milk order pricing formulas do not incorporate federal support purchase price as price floors. If the federal order pricing program is not revised on a comparable basis, then over the long term, the continued use of the federal support purchase price as price floors in California pricing formulas could place California manufacturing plants at a competitive disadvantage in commercial markets nationwide". Looking at the producer side of the equation then, if price ceilings are not used in federal order formulas and the pricing program is not revised on a comparable basis, then the continued use of a price ceiling in the California formula will and has placed California producers at a competitive disadvantage. Not only is a cap at 65 cents inequitable for producers in California, preventing them from getting a comparable share of the whey value like their counterparts in federal orders, it also exacerbates the issue of risk management (we will discuss this issue in more detail in a later section of our testimony).

In the past, it has been argued that a cap is necessary for small cheese processors who do not process whey. Whey has had a value for years. Many have found ways to make it profitable by investing in whey processing facilities – others dispose of it by selling it to dairymen so they can mix it into their feed ration for the cows. Many dairymen sell their hospital milk to calf raisers because it makes more sense than throwing it away. Cheese plants have had plenty of time to maximize opportunities to recover value or make whey products profitable, just like dairymen found value in hospital milk. Operation sizes have never been a focus in the milk pricing formulas in California – all dairy families get the same volatile price, regardless of the size of their operation. Cheese processors across the country have adapted to that reality, and have adapted well. And California dairy operations of all sizes have been facing dairy price volatility for years. Therefore, there is no place for a cap on the sliding scale on the grounds that some small cheese processors cannot afford whey price volatility.

As far as which data to use, we propose using *Dairy Market News* – 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 later). When comparing NASS and Dairy Market News dry whey data sets on a weekly basis (from April 2007 to prices for the week ending March 31, 2012, the difference amounts to less than a penny ($0.0059/lb)). *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.

Economic plight of the producers

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 dairy have increased significantly. This was the case at the hearing last summer and remains ever more so the case today.

As everyone well remembers, producer milk prices fell significantly through most of 2009, posting an overbase price of only $9.60 per hundredweight in July 2009 compared to $17.35 per hundredweight the prior July. 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-$13 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 overbase price reached $14.84 per hundredweight. The overbase price made it all the way to $15.94 per hundredweight in October. With the statewide average cost of production of $15.13 per hundredweight for the third quarter of 2010, some producers were likely experiencing positive margins again but the equity hole dug by the economic duration will take years of prosperity to fill.

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 2008-2010. Revenues per cow in 2010 did not come close to the losses per cow incurred in 2008 - 2009. 2011 was an improvement but 2012 has proved to be financially challenging for a lot of dairymen. After all the aforementioned losses, another downturn may prove unbearable for some.

A comparison of California overbase prices 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 cost of production and overbase price in 2009 is striking evidence of the catastrophe that occurred for California dairy families (see Table 1). The difference in 2011 is evidence that it will take time to recover those losses.

Table 1: California Dairy Production Margin

(per hundredweight)	CA statewide cost of production	CA overbase price	Margin
2001	12.24	13.11	**0.87**
2002	12.61	10.24	**-2.37**
2003	12.44	10.70	**-1.74**
2004	12.75	13.89	**1.14**
2005	13.43	13.17	**-0.26**
2006	14.18	10.87	**-3.31**
2007	15.77	17.27	**1.50**
2008	18.53	16.02	**-2.51**
2009	16.86	10.81	**-6.05**
2010	15.23	13.92	**-1.31**
2011	17.45	17.53	**0.08**

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% of the total cost of production in 2003 to 60% of total costs by the third quarter of 2008. Feed costs dropped to an average of 56.5% 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.

In 2011, estimates from USDA reported the corn ending stocks-to-use ratio at its lowest level since 1995/96. This outlook has led to dramatic increases in feed prices, further eroding already tight margins. CDFA data indicates that feed costs reached an all time high of 61% of total cost of production for the first quarter of 2011. The issue remained throughout the year as feed costs represented an ever increasing share of total cost of production (63.9%, 64.7% and 65.3% for the second, third and fourth quarter respectively). While 2012 cost of production data is not yet available, the significant declines in overbase prices combined with fairly steady feed prices will likely show ever more deteriorating margins for California dairy families. With current feed prices and a projected overbase under $14 per hundredweight in May, the financial picture for producers is somber.

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. In addition to the inequality the whey value in Class 4b is causing, compounding the issue of already low milk prices, we reviewed the cost of production information because the Department must take it into account:"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." (Section 60262 of the Food and Ag Code).

While it may be tempting for the panel to interpret the current milk production trends in the state as a sign that producers are doing ok, we strongly disagree. Milk production patterns respond to a variety of factors. Notably this spring, weather has been fantastic for cow comfort and production increased significantly, without producers necessarily making production decisions to increase volume. As outlined above, producers are still recovering from the losses incurred a few years ago – with decent prices in late 2011 and milk per cow at good levels, dairymen were in recovery mode and incentives to reduce cow numbers would have been limited. Still, in 2012 good beef prices combined with the current high feed costs have pushed many to trim their herds. When this happens, dairymen get rid of lower end cows, keeping the higher producing ones, thus increasing their herd's milk per cow average. The resulting increased milk per cow is clearly not due to higher milk prices.

While production is increasing and plant capacity has been mentioned as an issue in the past, base programs have been put in place in the state to take care of that issue. Keeping a lower milk price in our state would only contribute to the financial plight of dairy producers, not to bring supply more in line with capacity. Producers are the ones bearing the cost of a lack of capacity and they can respond to it by either building capacity or reducing production via their plant's supply management programs. The current whey issue is one of fairness with prices observed in the rest of the country, not one pertaining to plant capacity.

Risk management

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

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

The futures contract most commonly used by California dairymen is tied to 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 more effectively. As illustrated earlier, the spread between Class III and our milk price has gotten much larger due to higher whey values being reflected in 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, ironically 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 March. Three years ago, the whey value in Federal Orders generated $0.44 less than in California. Last year, it generated $1.27 more. And this year, it generates $1.86 more than the current sliding scale. Looking back at historical relationships between prices received at the dairy and Class III (which is how one can determine the basis) is certainly not a good predictor of basis because of this disparity.

If the crisis is fresh in dairyman's mind, it's not very far from lenders' minds either. At the Dairy Advisory Committee industry meeting hosted by the Secretary on March 30, 2012, dairy producers sitting on lending institutions' boards made clear that dairy loans were increasingly undesirable, making it harder for dairymen to get funding when needed. Risk management tools could be very useful for dairymen to show strong business plans to their bankers, reassuring them of less volatile margins. Lending standards have tightened and banks like to know where their borrower's bottom line will be. At a dairy financing conference in Visalia on February 22, 2011, speakers stressed that "borrowers will need to have a prudent business strategy and a 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.

Even processors recognize the importance of those tools and want producers to be able to use them effectively. Adjusting the whey factor to allow fluctuation with market 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 anymore. It is widely recognized that the whey stream has generated considerable revenues for the cheese processing industry. Various sources continually point to the increasing use of high-value whey products, domestically and abroad. According to the latest U.S. Dairy Export Council (USDEC) data, the U.S exported 46% of the dry sweet whey it produced in March 2012. USDEC adds that whey exports improved in March and "China remains the major customer, with first quarter purchases up 5% vs the prior year. In addition, exports to Mexico were up 43%". While specific California trade data is not available, with its proximity to Asia and its major shipping ports as well as our shared border with Mexico, California is well positioned to participate in those 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 this 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.(DMI) has led to an entire new industry developed around whey protein-enhanced foods and beverages, because of their many benefits". DMI is funded through dairy checkoff 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.

While products have been developed, the most important part of the whey story is perhaps the tremendous growth potential that remains. Mark Beck, senior vice-president at USDEC, said in a *Cheese Market News* column (December 9, 2011) that "2011 might best be remembered as the year that whey protein crossed over from an ingredient on the rise to a full-fledged, long-term global growth proposition. Trends and events of the past 12 months point to a new level of recognition of the benefits of whey products from suppliers, food and beverage manufacturers and consumers alike and, with it, a corresponding rise in demand even in the face of price hikes". If demand will expand, producers need a fair share of the value.

Mr. Beck adds that facilities around the world are going online, aiming at high-protein applications. They are "being built not to serve some theoretical projected rise in whey protein demand. The demand is already there. Markets are short now. The world needs supply and needs it fast. [...] Sources indicate a number of U.S. suppliers are nonetheless contemplating new whey projects and could soon pull the trigger – and none too soon. It is critical that the United States builds on its market leadership and that U.S. efforts include a stronger position in higher end whey fractions". Producers in federal orders will benefit from higher whey value with the current Class III formula – it is only fair that producers in California also get a share of this growing market.

Furthermore, the Panel has in the past been concerned about being proactive rather than reactive. In light of this potential growth, it should be an important focus. 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". With the current demand projections, the current valuation of whey in the Class 4b formula will fall short of the value generated in the Class III. The issue is likely to get larger, not smaller.

One difference between California and federal orders that we cannot fail to discuss is the fact that processors in federal orders have to abide by different pooling rules. We are cognizant of this situation. As described in a FAPRI/University of Wisconsin Policy Briefing Paper on Federal Milk Marketing Order – Pooling[1], "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 being amended to make it more difficult for plants to depool".

While there are some differences between the two systems, it is recognized that depooled volumes are minimal – data presented at the workshop highlighted depooled volumes in the Upper Midwest order representing 6.1% of milk production receipts in 2011, all classes combined. Some of that milk could have been pooled in other orders. Nationally, only 4.3% of the milk in federal orders, all classes combined, was depooled due to price. In 2010, that number was even smaller at about 2.2%[2]. Cooperatives operating both in California and federal orders have knowledge of the differences and can attest that plants in federal orders, despite the different pooling rules, still pay the minimum Class III price. Thus, the idea that plants in

[1] The paper is dated April 2010 and can be found at http://future.aae.wisc.edu/briefing_12.html.

[2] Federal Milk Order Marketing and Utilization Summary, Annual 2011. Found at http://www.ams.usda.gov/AMSv1.0/getfile?dDocName=STELPRDC5096974

federal orders can escape the minimum price easily cannot be justification for a lower whey value in California.

In addition, the option to depool may not be the same in California, but there are options for plants to pay less than the minimum price in the state. When a producer elects to go Grade B, no minimum price applies to that producer. Plants, whether they are pooled or not, can agree on whichever price they want with the producer. In 2011, Grade B represented approximately 1.7% of total milk production in the state. In 2010, that percentage was around 5.3%. The picture in California is not as different from federal orders as some processors would like us to believe.

Other proposals

We oppose the alternative proposal submitted by Farmdale. Reverting to a fixed whey factor would put California producers at a bigger disadvantage with federal orders than they are with the current sliding scale. It would also further deteriorate the relationship between Class 4b and Class III. This was clearly illustrated in CDFA's analysis presented at the pre-hearing workshop: over the last five-years, it would have resulted in a Class 4b price $0.18/cwt lower than the current, insufficient, Class 4b formula. The difference with federal order Class III would have gone from$1.05/cwt with the current formula to $1.23/cwt with their proposal. Farmdale's proposal would put California producers in a worse place than with the current formula so we are obviously adamantly opposed to such a scenario.

We support the coalition's petition and position as we share the same concerns and objectives.

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. We would be pleased to answer any questions you may have and request the option to file a post-hearing brief.

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TESTIMONY

California Department of Food & Agriculture
Hearing on California Stabilization and Marketing Plans for Market Milk
Sacramento, California
May 31, 2012

Western United Dairymen

Presented by

Michael Marsh, CPA
Chief Executive Officer

Annie AcMoody
Director of Economic Analysis

Mr. Hearing Officer and members of the hearing panel:

My name is Michael Marsh. I am the Chief Executive Officer for Western United Dairymen. Joining me today is Annie AcMoody our Director of Economic Analysis. Our association is the largest dairy producer trade association in California, representing approximately 900 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 approved the position I will present here today at a special meeting on February 24th 2012.

We would like to thank Secretary Ross for the call of this hearing on our petition. We would also like to thank Governor Brown for his oft expressed support and recognition of California agriculture and dairy in particular as being a driver intrinsic to California's economic recovery. We appreciate the Governor's and the Secretary's attention and receptiveness to hearing our plea for relief.

Arriving at this position was a lengthy process that did not begin with this petition. With the fixed whey factor implemented on December 1, 2007, it was only a matter of time before prices would fall significantly out of alignment with federal order pricing. The issue became particularly apparent in 2011 as the value of dry whey started to rise. The producer community, concerned with the inequity, overwhelmingly supported some changes. Land O'Lakes submitted a petition on May 24, 2011.

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

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

After the Department's denial, the issue remained and producer discontent intensified. Our board discussed asking for reconsideration or immediately filing another petition. We held a number of meetings with the Secretary and her team sharing data and information which we hoped to be persuasive when we next asked for relief. We very much appreciate the open dialogue with the Secretary, the Undersecretary and her staff.

We stressed the imperative of resolving this issue sooner rather than later and impressed upon the Secretary that waiting until after cost studies were completed in September 2012 would not work. Our board was not going to give up on lost producer revenue and decided to petition again. Industrywide support on the producer side was evident. Lengthy discussions took place and each organization agreed on the requested changes that we are arguing in favor of today.

Relationship to 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 products" (Section 62062). According to CDFA analysis, with the current formula, the Class 4b price would have averaged $1.05 per hundredweight less than the federal order Class III price for the period April 2007 - March 2012. That difference is even more striking when looking at the last twelve months of data, where Federal Class III was an average $2.18 per hundredweight higher than 4b.

The deviation between Class III and 4b prices was caused by several factors. Notably, formula differences such as different price series (CME vs NASS), make allowances, yield and formula construct contribute to the divergence. But the whey value is what creates the most variance between the two class prices and this is a significant concern to the members of WUD. According to our analysis, since April 2007, 74% of the difference between Class 4b and Class III was attributable to the whey value.

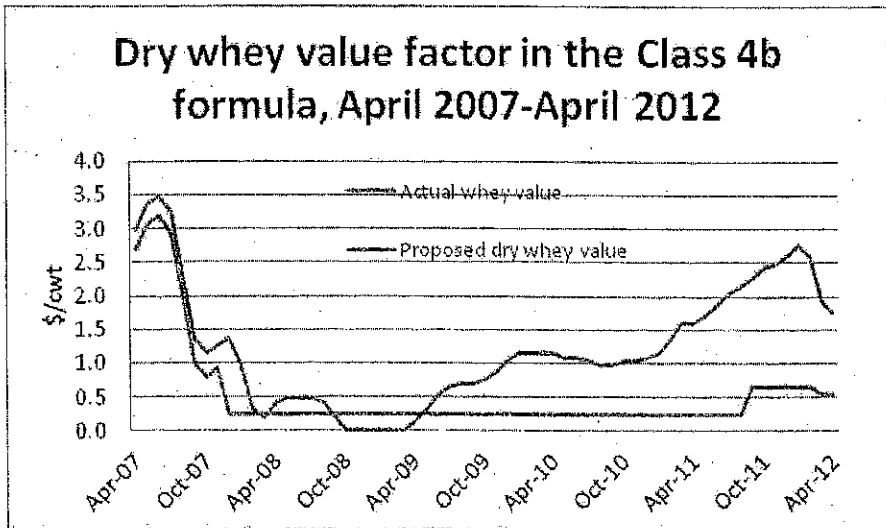
More specifically, assuming current formulas had been in place since April 2007, the average difference between Class III and Class 4b would have been $1.05 per hundredweight. Of that amount, $0.27 per hundredweight would be due to formula differences other than the whey factor. The remaining $0.78 per hundredweight is due to the difference in whey value. With whey values that follow market movements in Class III and a sliding scale value in Class 4b capped at 65 cents per hundredweight, such a discrepancy was not unlikely to occur. As the price of whey fluctuates, so will the variance between the two classes if California retains a limited sliding scale. Clearly, the current scale 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 more closely tie our whey value to the end product pricing formula used in federal orders. As outlined in our petition, we propose the following whey value in Class 4b:

Average Western Monthly Dry Whey per lb			Whey Value per cwt	Average Western Monthly Dry Whey per lb			Whey Value per cwt
Less than $0.2000			$0.0000	$0.5600	to	$0.5699	$2.0385
$0.2000	to	$0.2099	$0.0329	$0.5700	to	$0.5799	$2.0942
$0.2100	to	$0.2199	$0.0886	$0.5800	to	$0.5899	$2.1499
$0.2200	to	$0.2299	$0.1443	$0.5900	to	$0.5999	$2.2056
$0.2300	to	$0.2399	$0.2000	$0.6000	to	$0.6099	$2.2613
$0.2400	to	$0.2499	$0.2557	$0.6100	to	$0.6199	$2.3170
$0.2500	to	$0.2599	$0.3114	$0.6200	to	$0.6299	$2.3727
$0.2600	to	$0.2699	$0.3671	$0.6300	to	$0.6399	$2.4284
$0.2700	to	$0.2799	$0.4228	$0.6400	to	$0.6499	$2.4841
$0.2800	to	$0.2899	$0.4786	$0.6500	to	$0.6599	$2.5399
$0.2900	to	$0.2999	$0.5343	$0.6600	to	$0.6699	$2.5956
$0.3000	to	$0.3099	$0.5900	$0.6700	to	$0.6799	$2.6513
$0.3100	to	$0.3199	$0.6457	$0.6800	to	$0.6899	$2.7070
$0.3200	to	$0.3299	$0.7014	$0.6900	to	$0.6999	$2.7627
$0.3300	to	$0.3399	$0.7571	$0.7000	to	$0.7099	$2.8184
$0.3400	to	$0.3499	$0.8128	$0.7100	to	$0.7199	$2.8741
$0.3500	to	$0.3599	$0.8685	$0.7200	to	$0.7299	$2.9298
$0.3600	to	$0.3699	$0.9242	$0.7300	to	$0.7399	$2.9855
$0.3700	to	$0.3799	$0.9800	$0.7400	to	$0.7499	$3.0413
$0.3800	to	$0.3899	$1.0357	$0.7500	to	$0.7599	$3.0970
$0.3900	to	$0.3999	$1.0914	$0.7600	to	$0.7699	$3.1527
$0.4000	to	$0.4099	$1.1471	$0.7700	to	$0.7799	$3.2084
$0.4100	to	$0.4199	$1.2028	$0.7800	to	$0.7899	$3.2641
$0.4200	to	$0.4299	$1.2585	$0.7900	to	$0.7999	$3.3198
$0.4300	to	$0.4399	$1.3142	$0.8000	to	$0.8099	$3.3755
$0.4400	to	$0.4499	$1.3699	$0.8100	to	$0.8199	$3.4312
$0.4500	to	$0.4599	$1.4256	$0.8200	to	$0.8299	$3.4869
$0.4600	to	$0.4699	$1.4814	$0.8300	to	$0.8399	$3.5427
$0.4700	to	$0.4799	$1.5371	$0.8400	to	$0.8499	$3.5984
$0.4800	to	$0.4899	$1.5928	$0.8500	to	$0.8599	$3.6541
$0.4900	to	$0.4999	$1.6485	$0.8600	to	$0.8699	$3.7098
$0.5000	to	$0.5099	$1.7042	$0.8700	to	$0.8799	$3.7655
$0.5100	to	$0.5199	$1.7599	$0.8800	to	$0.8899	$3.8212
$0.5200	to	$0.5299	$1.8156	$0.8900	to	$0.8999	$3.8769
$0.5300	to	$0.5399	$1.8713	$0.9000	to	$0.9099	$3.9326
$0.5400	to	$0.5499	$1.9270	$0.9100	to	$0.9199	$3.9883
$0.5500	to	$0.5599	$1.9828	More than $0.9200			$4.0000

Figure 1 illustrates the impact of our proposal on the whey value.

Figure 1: Comparison of whey values



Source: USDA data and WUD calculations.

Since the current whey Class 4b formula was implemented in September 2011, revenues to producers from the whey value compared to our proposed whey value were $212 million lower.

The narrow range of the sliding scale used in the current formula is at the root of the problem. With a ceiling capping the whey value at 65 cents, there is tremendous potential for discrepancies between the Class 4b and Class III (as illustrated above). Similarly, a floor of 25 cents also creates the potential for discrepancies. The scale proposed in our petition removes the potential for these large discrepancies.

As the panel stated in 2005 before recommending the removal of price floors from the 4a and 4b formulae: "price floors create an artificial price within a market at a level that may be higher than the naturally occurring market price". The same is true of ceilings, creating an artificial price that may be lower than the naturally occurring market price. In this case, it has prevented producers from benefiting from that value.

The 2005 panel added: "federal milk order pricing formulas do not incorporate federal support purchase price as price floors. If the federal order pricing program is not revised on a comparable basis, then over the long term, the continued use of the federal support purchase price as price floors in California pricing formulas could place California manufacturing plants at a competitive disadvantage in commercial markets nationwide". Looking at the producer side of the equation then, if price ceilings are not used in federal order formulas and the pricing program is not revised on a comparable basis, then the continued use of a price ceiling in the California formula will and has placed California producers at a competitive disadvantage. Not only is a cap at 65 cents inequitable for producers in California, preventing them from getting a comparable share of the whey value like their counterparts in federal orders, it also exacerbates the issue of risk management (we will discuss this issue in more detail in a later section of our testimony).

In the past, it has been argued that a cap is necessary for small cheese processors who do not process whey. Whey has had a value for years. Many have found ways to make it profitable by investing in whey processing facilities – others dispose of it by selling it to dairymen so they can mix it into their feed ration for the cows. Many dairymen sell their hospital milk to calf raisers because it makes more sense than throwing it away. Cheese plants have had plenty of time to maximize opportunities to recover value or make whey products profitable, just like dairymen found value in hospital milk. Operation sizes have never been a focus in the milk pricing formulas in California – all dairy families get the same volatile price, regardless of the size of their operation. Cheese processors across the country have adapted to that reality, and have adapted well. And California dairy operations of all sizes have been facing dairy price volatility for years. Therefore, there is no place for a cap on the sliding scale on the grounds that some small cheese processors cannot afford whey price volatility.

As far as which data to use, we propose using *Dairy Market News* – 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 later). When comparing NASS and Dairy Market News dry whey data sets on a weekly basis (from April 2007 to prices for the week ending March 31, 2012, the difference amounts to less than a penny ($0.0059/lb)). *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.

Economic plight of the producers

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 dairy have increased significantly. This was the case at the hearing last summer and remains ever more so the case today.

As everyone well remembers, producer milk prices fell significantly through most of 2009, posting an overbase price of only $9.60 per hundredweight in July 2009 compared to $17.35 per hundredweight the prior July. 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-$13 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 overbase price reached $14.84 per hundredweight. The overbase price made it all the way to $15.94 per hundredweight in October. With the statewide average cost of production of $15.13 per hundredweight for the third quarter of 2010, some producers were likely experiencing positive margins again but the equity hole dug by the economic duration will take years of prosperity to fill.

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 2008-2010. Revenues per cow in 2010 did not come close to the losses per cow incurred in 2008 - 2009. 2011 was an improvement but 2012 has proved to be financially challenging for a lot of dairymen. After all the aforementioned losses, another downturn may prove unbearable for some.

A comparison of California overbase prices 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 cost of production and overbase price in 2009 is striking evidence of the catastrophe that occurred for California dairy families (see Table 1). The difference in 2011 is evidence that it will take time to recover those losses.

Table 1: California Dairy Production Margin

(per hundredweight)	CA statewide cost of production	CA overbase price	Margin
2001	12.24	13.11	**0.87**
2002	12.61	10.24	**-2.37**
2003	12.44	10.70	**-1.74**
2004	12.75	13.89	**1.14**
2005	13.43	13.17	**-0.26**
2006	14.18	10.87	**-3.31**
2007	15.77	17.27	**1.50**
2008	18.53	16.02	**-2.51**
2009	16.86	10.81	**-6.05**
2010	15.23	13.92	**-1.31**
2011	17.45	17.53	**0.08**

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% of the total cost of production in 2003 to 60% of total costs by the third quarter of 2008. Feed costs dropped to an average of 56.5% 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.

In 2011, estimates from USDA reported the corn ending stocks-to-use ratio at its lowest level since 1995/96. This outlook has led to dramatic increases in feed prices, further eroding already tight margins. CDFA data indicates that feed costs reached an all time high of 61% of total cost of production for the first quarter of 2011. The issue remained throughout the year as feed costs represented an ever increasing share of total cost of production (63.9%, 64.7% and 65.3% for the second, third and fourth quarter respectively). While 2012 cost of production data is not yet available, the significant declines in overbase prices combined with fairly steady feed prices will likely show ever more deteriorating margins for California dairy families. With current feed prices and a projected overbase under $14 per hundredweight in May, the financial picture for producers is somber.

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. In addition to the inequality the whey value in Class 4b is causing, compounding the issue of already low milk prices, we reviewed the cost of production information because the Department must take it into account:"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." (Section 60262 of the Food and Ag Code).

While it may be tempting for the panel to interpret the current milk production trends in the state as a sign that producers are doing ok, we strongly disagree. Milk production patterns respond to a variety of factors. Notably this spring, weather has been fantastic for cow comfort and production increased significantly, without producers necessarily making production decisions to increase volume. As outlined above, producers are still recovering from the losses incurred a few years ago – with decent prices in late 2011 and milk per cow at good levels, dairymen were in recovery mode and incentives to reduce cow numbers would have been limited. Still, in 2012 good beef prices combined with the current high feed costs have pushed many to trim their herds. When this happens, dairymen get rid of lower end cows, keeping the higher producing ones, thus increasing their herd's milk per cow average. The resulting increased milk per cow is clearly not due to higher milk prices.

While production is increasing and plant capacity has been mentioned as an issue in the past, base programs have been put in place in the state to take care of that issue. Keeping a lower milk price in our state would only contribute to the financial plight of dairy producers, not to bring supply more in line with capacity. Producers are the ones bearing the cost of a lack of capacity and they can respond to it by either building capacity or reducing production via their plant's supply management programs. The current whey issue is one of fairness with prices observed in the rest of the country, not one pertaining to plant capacity.

Risk management

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

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

The futures contract most commonly used by California dairymen is tied to 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 more effectively. As illustrated earlier, the spread between Class III and our milk price has gotten much larger due to higher whey values being reflected in 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, ironically 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 March. Three years ago, the whey value in Federal Orders generated $0.44 less than in California. Last year, it generated $1.27 more. And this year, it generates $1.86 more than the current sliding scale. Looking back at historical relationships between prices received at the dairy and Class III (which is how one can determine the basis) is certainly not a good predictor of basis because of this disparity.

If the crisis is fresh in dairyman's mind, it's not very far from lenders' minds either. At the Dairy Advisory Committee industry meeting hosted by the Secretary on March 30, 2012, dairy producers sitting on lending institutions' boards made clear that dairy loans were increasingly undesirable, making it harder for dairymen to get funding when needed. Risk management tools could be very useful for dairymen to show strong business plans to their bankers, reassuring them of less volatile margins. Lending standards have tightened and banks like to know where their borrower's bottom line will be. At a dairy financing conference in Visalia on February 22, 2011, speakers stressed that "borrowers will need to have a prudent business strategy and a 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.

Even processors recognize the importance of those tools and want producers to be able to use them effectively. Adjusting the whey factor to allow fluctuation with market 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 anymore. It is widely recognized that the whey stream has generated considerable revenues for the cheese processing industry. Various sources continually point to the increasing use of high-value whey products, domestically and abroad. According to the latest U.S. Dairy Export Council (USDEC) data, the U.S exported 46% of the dry sweet whey it produced in March 2012. USDEC adds that whey exports improved in March and "China remains the major customer, with first quarter purchases up 5% vs the prior year. In addition, exports to Mexico were up 43%". While specific California trade data is not available, with its proximity to Asia and its major shipping ports as well as our shared border with Mexico, California is well positioned to participate in those 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 this 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.(DMI) has led to an entire new industry developed around whey protein-enhanced foods and beverages, because of their many benefits". DMI is funded through dairy checkoff 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.

While products have been developed, the most important part of the whey story is perhaps the tremendous growth potential that remains. Mark Beck, senior vice-president at USDEC, said in a *Cheese Market News* column (December 9, 2011) that "2011 might best be remembered as the year that whey protein crossed over from an ingredient on the rise to a full-fledged, long-term global growth proposition. Trends and events of the past 12 months point to a new level of recognition of the benefits of whey products from suppliers, food and beverage manufacturers and consumers alike and, with it, a corresponding rise in demand even in the face of price hikes". If demand will expand, producers need a fair share of the value.

Mr. Beck adds that facilities around the world are going online, aiming at high-protein applications. They are "being built not to serve some theoretical projected rise in whey protein demand. The demand is already there. Markets are short now. The world needs supply and needs it fast. [...] Sources indicate a number of U.S. suppliers are nonetheless contemplating