June 8, 2015

Hearing Panel
Dairy Marketing Branch
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814

RE: June 3, 2015 Consolidated Stabilization Plan Hearing on Class 4b Whey Valuation -- Post Hearing Brief

Mr. Hearing Officer and Members of the Panel:

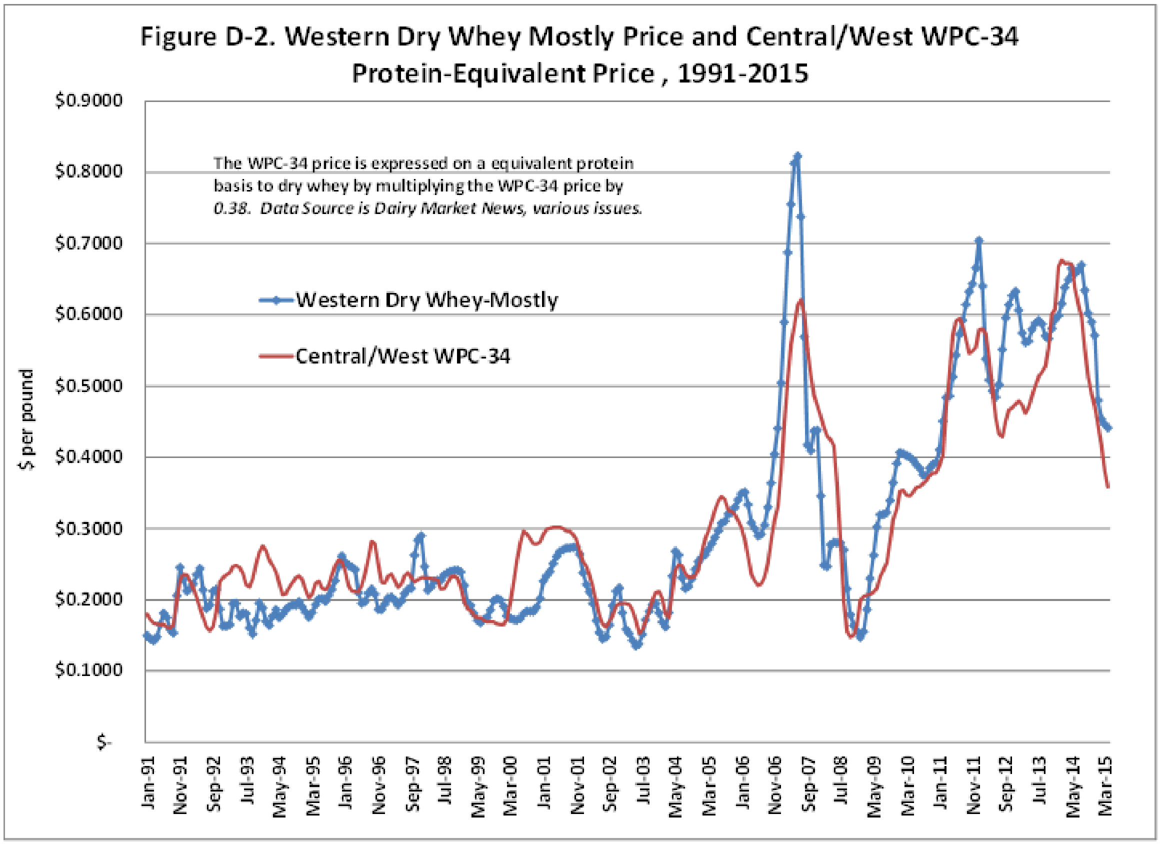
Dairy Institute appreciates the opportunity to submit the following post-hearing brief to respond to hearing panel questions and to amplify portions of our testimony presented in Sacramento on June 3, 2015. The paragraphs that follow build on the propositions that we put forth in our testimony.

Impact of Dairy Institute's Whey Scale Change on Markets for Whey Products.

In response to a question from the Panel regarding the impact of our proposed whey scale change on whey markets, I believe that any impact of our proposal on whey prices and whey market dynamics will be negligible. Whey product prices are heavily influenced by global supply and demand conditions because the U.S. exports such a significant portion of its finished whey products. The importance of the proposal that Dairy Institute put forward at the hearing is that it bases the contribution of whey to the Class 4b milk price on products that are actually made by the California cheese plants the process whey. While the existing dry whey price scale may have a history it is largely ad hoc and does not relate well to the price of whey products made in California.

Similarly, the producer proposal, based as it is on the Federal Order other solids end-product formula, might have a history and the Federal Orders may have some experience with it, but such experience and history is of little value if it does not represent the whey products produced in California. What is clear from testimony at the hearing is that very few cheese plants have whey revenue that is in direct proportion to the dry whey price. What is also true is that the correlation between dry whey has become weaker over time.

While the 10-year correlation coefficient between the AMS Western Mostly Dry Whey price and the Central and West Mostly 34% WPC price was 0.88 during the period of April 2005 to March 2015. The correlation coefficient for the most recent three year period (ending March 2015) was only 0.66. However, even if the dry whey price series were to track the movements of WPC-34 with a high degree of accuracy, its use could vastly overstate the whey revenues earned by plants making WPC or liquid whey. The following graph from Appendix D of our testimony shows the over-valuation inherent in the dry whey price as compared to WPC-34. Although the two series may seem reasonably correlated, the equivalent value from dry whey overstates the revenue from attainable by making WPC-34 in most months since early 2009.



The notion that adopting a formula that more closely reflects cheese plants' whey revenues should be rejected simply because the industry has more experience with a price series and associated costs that relate to a product that we know fails to accurately reflect the products made by California cheese plants strikes me as an odd one. While, we have less of a history of data on costs of making liquid WPC, it would be an improvement, and more in keeping with the spirit and underlying meaning of Food and Ag. Code Section 62062 if we were to use available industry information to construct a formula based on a product that is far more relevant (WPC-34) to the California industry than is dry whey.

Arguing that dry whey prices and costs should continue to be used merely because we have more experience and history with them, seems to be an argument that would forestall any change or improvements to the formula based on new information. It also ignores FMMO history in adoption of the dry whey-based other solids formula and CDFA adoption of its dry whey factor in 2003, when a make allowance for dry whey was adopted with little actual data about the cost of drying whey. If WPC-34 is a more representative price than dry whey for the values received by California cheesemakers for the whey products they make, it should be adopted in place of the existing dry whey-based sliding scale.

Application of Federal Milk Marketing Order Regulated Prices with Respect to De-pooled Milk and Pooled Milk Diverted to Nonpool Plants.

We noted in our testimony that California Class 4b and Federal Class III price comparisons were invalid owing to the differences in how the two system apply these minimum prices. Such differences in the applicability of minimum pricing between California and Federal Milk Marketing Orders (FMMOs) necessitate that that California regulated prices be true minimum prices, while the same requirement, while desirable from a policy perspective, has perhaps less dire consequences under Federal regulations even if it is not met.

In FMMOs, milk that is not pooled is not subject to minimum pricing under the order. Options exist to remove previously pooled milk from regulated prices if it is needed to clear the market or if there is an opportunity to procure milk more cheaply (or to share higher revenues with the plant's milk suppliers rather than with all the producers in the market). Handlers (cooperative or proprietary) are the ones that make the choice about whether or not to depool milk. The price at which the manufacturing plant buys depooled milk from its supplier(s) will be determined by the purchasing plant's contractual arrangements with its supplier, and the supply and demand conditions in the market. In some cases, where milk supplies are tight, depooled milk might be sold at prices that exceed order Class prices. In regions where milk supplies are long, the price might be below order Class prices. Spot milk purchases, especially, are subject to market conditions (rather than contractual ones), and have been selling below Federal class prices in several areas of the country this spring. So in the Federal orders, cheese plants have the ability to pay below order class prices for the milk they receive if market conditions allow for it.

Handlers that operate nonpool plants likewise are not required to pay their suppliers minimum regulated prices for the milk they buy, either as depooled milk or as diverted pool milk. It might be that this milk is pooled by the cooperative handler that supplies a nonpool cheese plant, but the handler diverts the milk to a nonpool cheese plant, which is not obligated to pay the minimum class price to the handler. However, the handler diverting the milk is required to account to the pool at order prices. This feature of Federal orders might help explain producers' statements that their farms in Federal order regions outside California are paid the Class III price, even when cheese plants in those regions are buying milk at less than the Class III price.

The key here is that if prices are set too high under FMMO regulation, these options to pay less than the order minimum create an "escape valve" that allows plants the margin they need to operate, and provides an avenue for milk to clear the market when it exceeds demand at order prices. In California, all Grade A milk must be paid the established state minimum price regardless of its pool status. If the price is set too high, plants will be put out of business because their margins will be insufficient to cover their elevated raw product cost. Also, whenever milk supply exceeds demand at the state-regulated price, milk must move out of state to find processing homes, instead of being able to clear locally. When this distressed milk ends up in cheese plants in other states at prices lower than those plants would ordinarily obtain their milk, the competitive position of

California cheesemakers is put at risk. For this reason, California's regulated prices for manufactured milk MUST be set at levels that clear the market to ensure orderly marketing. Moreover, if regulated prices in the state are insufficient to bring forth an adequate supply of milk for all purposes, plants will pay whatever is necessary (to the extent they are able) to ensure adequate milk supplies.

We want to caution those who believe the cooperatives' "caps" on the milk supply through their base programs and excess marketing penalties provide an opportunity to increase regulated prices. The base plans and over-base penalties, while commendable as a mechanism to deal with the emergency conditions, are not a viable long-term or solution to the state's need to attract additional plants or to improve the competitiveness of the state's dairy industry. Using the base plans temporary effectiveness as an excuse to push regulated prices higher will not further the state's progress toward increasing competition for producer milk, boosting innovation and efficiency in the production and processing sector, or establishing the state as a formidable competitor in the global marketplace. It will lead only to industry stagnation.

Testimony Corrections.

Sources for some of the graphs in our testimony were inadvertently omitted. They are listed below.

Figure B6: Source: USDA Milk Production Estimates by State. http://www.ers.usda.gov/datafiles/Milk_Cost_of_Production_Estimates/Milk_CostofProduction_Estimates2010_Base/Annual/MilkStates2010%20base.xls

Figure B7: Source: USDA Milk Production Report, February Issue, various years.

Figure C-2: Source: USDE, AMS, Central Milk Marketing Order, Marketing Service Bulletin, *February 2015 issue.*

Table D-1: Source: CDFA, Background Material for the Class 4b Hearing – June 3, 2015.

Thank you for the opportunity to file this post-hearing brief.

Sincerely,

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