June 8, 2015

Mr. Donald Shippelhoute, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
1220 N. Street
Sacramento, CA 95814

RE: June 3, 2015 Hearing: Post Hearing Brief

Mr. Donald Shippelhoute:

I, David Ahlem, on behalf of Hilmar Cheese Company, Inc. appreciate the opportunity to submit the following post-hearing brief to amplify portions of our testimony presented in Sacramento on June 3, 2015. As expressed at the hearing, Hilmar Cheese Company, Inc. does not support any increase in the 4b dry whey valuation and instead supports the Dairy Institute of California alternative proposal using liquid WPC-34. Hilmar Cheese Company, Inc. believes in a low regulated minimum price that allows the market to efficiently set high market-driven prices.

Higher cost of doing business in California

Our non-milk unit cost of production in California is higher than in Texas. Industrial electricity rates are over 100% higher and labor is over 20% higher. Other items we cannot share specifically, but are also more favorable in Texas, include plant development, waste water, and miscellaneous costs associated with permitting and regulation.

Federal Milk Marketing Orders and the establishment of market-driven milk prices:

In the June 3, 2015 hearing, there appeared to be some confusion about how milk is paid for under class in Federal Milk Marketing Orders. Below are some common ways milk can be paid for under class and a corresponding example.

Ways of paying below class in all federal orders:

1) Straight spot milk purchased from cooperatives or proprietary handlers (like a cheese plant)
    a. If the cooperative/handler selling the milk is pooled, they are still obligated to the minimum class price even if the milk is sold under class
    b. However, the cooperative can pass the loss onto producers in the region through re-blending down the milk price, absorb the loss and pass onto another regions, etc.
2) By contract between non-pool, pooled, and pooled handler

   a. These are often longer term contractual arrangements where milk is sold under class to another handler (non-pool plant-like cheese plant). Depending on whether the seller had that milk pooled determines whether they are obligated to minimums.
   b. Also, during spring flush or other times of surplus, it is common for milk handlers to charge 'slotting' allowances for certain companies milk trucks to unload first – usually tied to a discount.
3) Non-pool plant buys direct from producers below class
   a. Non-pool plants (such as cheese plants) can operate as pooling handlers and are the decision makers in what milk is pooled and not. Therefore, the handler/cheese plant has complete control over milk cost.

Furthermore, proprietary cheese plants and cooperatives can use combinations of these methods to pay producers below class. For example, a cheese plant may operate both as a non-pool and pool plant, allowing them to take advantage of some of the benefits of pool draws (PPD), while using the non-pool status to pay below Class III. If such a plant had 80% of its milk pooled and 20% not, it would have flexibility to pay a market-driven price below minimum regulated prices to their producers.

Example:

100,000 cwt of milk total

80,000 cwt pooled @ $20 Class III (mandatory pooled minimum price)

20,000 cwt not pooled at $10 (or any price the cheese plant sets)

Handler re-blends at (80,000 * $20) + (20,000 * $10) / total cwt = $18 per cwt for producers

PPD of $1 for 80,000 pooled = <u>$18.80 weighted net to all producers</u>

The above example also illustrates that one doesn't have to de-pool a significant amount of milk to impact the average price paid to producers. Even 5% to10% of milk de-pooled can have a significant impact on plant milk cost and producer pay prices!

Idaho milk prices versus California milk prices:

WUD testimony mentioned Idaho producers were being paid around Class III, therefore California cheese processors should be able to share that revenue in the pool. However, Idaho is really testament to free markets (Idaho has no MMO) and how investment in processing capacity increased competition for milk. Prior to the Chobani yogurt plant, Idaho had milk prices similar to California. In Glanbia's 2013 and 2014 half-year financial results, they mention the detrimental impact on their business performance due to milk procurement problems and higher milk prices following the Chobani yogurt plant. However, this is how markets are supposed to work. In addition, Idaho can offset some of the milk costs because of manufacturing cost advantage, as well as being able to realize higher cheese prices due lower transportation costs to market.

Raising 4b minimum prices hurts our high cheese yielding direct shippers and incentivizes them to ship to low value utilizations

Raising 4b minimum prices decreases the amount in premiums we can pay to our high quality, high cheese yielding, and high component dairies. This is because our premiums are generated by the extra value these dairies create over the minimum price, amounting to $120 million over the last several years. A much higher 4b price will instead re-distribute premium money into the milk pool, primarily to low component producers. We estimate our highest cheese yielding dairies, primarily Jersey herds, could lose $0.50 to $1.00 per cwt net if the producer group proposal is adopted. The end result will be an economic misallocation of resources since high component dairies will have little incentive to ship to a cheese plant versus, for example, a butter/nonfat dry milk plant. No additional value beyond the 4a price is created sending high component milk to such a plant. In the end, cheese makers will be forced to overpay for low cheese yielding milk, and underpay for high cheese yielding milk.

Setting the record straight

The testimony of others inappropriately characterized the nature of our supply base. In California, Hilmar Cheese Company, Inc. receives 82% of its milk from independent dairy producers (not owners). Since our inception, we have paid market-based premiums to all of our suppliers.

Additionally, on the average our non-owner milk supply has grown at identical rates as our owner supply in recent years. Over 80% of our contract volume increases have been given to non-owners the past several years.

New Mexico is a valid comparison to California

There was some criticism from a producer group for using New Mexico milk prices as a comparison to California. However, closer analysis suggests New Mexico should have advantages to California that result in higher milk prices. The Southwest FMMO which includes New Mexico, already has Class III by default, has a 35% Class I utilization (2014 rate, which is 2 to3 times California's), likely has processing costs comparable to Texas, is closer to eastern markets, however, producers there are still not being paid blend FMMO prices. The reason for this is that FMMOs allow milk to escape the system using the methods above, including milk contracted for under class and not pooling all milk. In the end, the mailbox milk price paid to dairy farmers in New Mexico is driven by supply and demand.

Impact of 4b higher whey valuation on whey markets

Markets for virtually all whey products are highly competitive and customers have options of who to buy from domestically and abroad. The last edition of the Daily Dairy Report commented, “U.S. whey product exports have faced increased competition from suppliers in Europe and Oceania and from an abundance of substitutes such as permeate.” In short, if a California supplier is faced with higher milk costs from the whey stream, there is virtually no ability to pass the cost on to customers and/or impact the market prices for end products.

Summary

On behalf of Hilmar Cheese Company, Inc., I urge the state to reject the petition from the producer groups. Their proposed increase in the regulated minimum 4b price will interfere with market forces, damage California cheese maker’s ability to compete, encourage more investment to move out of state, and delay real market oriented reform.

Thank you for the opportunity to submit a post hearing brief. We appreciate the consideration of the Hearing Panel.

Sincerely,

David Ahlem
Chief Operating Officer