April 18, 2016

Hearing Panel
Dairy Marketing Branch
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814
Via email: dairy@cdfa.ca.gov
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Re: March 11-12, 2016, consolidated hearing on Class 4b milk price formula

Hilmar Cheese Company (HCC) submits this post-hearing brief to respond to questions by the hearing panel to HCC and other parties, and to amplify portions of our testimony. We hope that our testimony and this brief will assist the Secretary in preparation of the statement of factual and legal basis for the agency decision following this hearing, consistent with California Government Code §§ 11425.50 and 11425.10(a)(6).

Comments and clarification on economic policy and constitutional requirements of return on investment in milk product price formulas and other forms of price control.

As stated in our testimony, CDFA has historically priced Class 4a and 4b milk in a manner that allows a modest return on investment in the margin between product price received by the manufacturer and milk price that must be paid by the manufacturer. This has been done as a matter of rational economic policy, and in compliance with specific factors of product prices, product yields, and manufacturing costs that CDFA is required to consider. Food & Agric. Code § 62076(c). In *Golden Cheese Co. v. Voss*, 230 Cal. App. 3d 547, 564-66 (1991), the court expressly approved a new Class 4b cheese product price formula with a make allowance near the average cost to cover "reasonably efficient plants," but not less efficient plants.

USDA, for Class III and IV product price formulas, has similarly expressed the view that such prices should "not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit." 64 Fed. Reg. 16026,

16094 - 95 (April 2, 1999). In 2002-03, this policy was tested in California and in FMMO markets by proposals to reduce product make allowances to increase milk prices when milk production costs were increasing. USDA rejected this notion, and CDFA adopted USDA's following analysis:

> Make allowances that decline as a result of increasing production costs would squeeze plant margins, and manufacturers will have to choose between not receiving milk, refusing to receive pooled milk, or paying less than the order prices to cooperative associations for milk used in manufactured products. None of these outcomes would be in the interests of dairy farmers, processors, or consumers.

CDFA Hearing Panel Report on Class 2, 3, 4a and 4b pricing formulas, based on public hearing of January 29 – 30, 2003, Panel Report at 32, quoting USDA final decision of November 7, 2002.

But in 2015-16, the return on investment policies of CDFA and USDA have been challenged by concurrent state and federal cheese manufacturing milk price proposals which are at best indifferent to manufacturing plant margins or by design seek to squeeze plant margins by imputing product revenue to California plants which is not received by the plants for their products.

Because of this proposed departure from federal and state regulatory norms, HCC worked with a team of experts on comprehensive review of price control law and constitutional limitations. The product of this effort was included in our USDA FMMO post hearing brief filed in late March. Our testimony at the April 11 CDFA hearing just sparingly summarized that review.

HCC had hoped to informally discuss these issues with CDFA officials prior to the next "whey factor" hearing, as is customary practice, but the Notice of Hearing and the Government Code §11430.10 prohibition against *ex parte* communications on the merits precluded that option. We hope these comments, prepared with the assistance of HCC's team of experts, resolve Hearing Panel questions.

The legal foundation for state (and federal) milk price controls was established over 80 years ago by the Supreme Court in *Nebbia v New York*, 291 U.S. 502 (1934). California's Supreme Court relied on the authority of *Nebbia* when it found that the state Milk Stabilization Act was constitutional. *Jersey Maid Milk Products Co. v. Brock*, 13 Cal. 2d 620, 637 (1939). *Nebbia* also opened the door to a wide variety of government price controls other than traditional utility ratemaking. As explained by the California Supreme Court in a rent control case: "The time when extraordinarily exigent circumstances were required to justify price control outside the traditional public utility areas passed on the day that Nebbia v New York... was decided." *Birkenfeld v. City of Berkeley*, 17 Cal.3d 129, 157 (1976)

Price controls in a variety of market regulation settings, not just rate making for utilities or transportation providers, are referenced on pages 33-36 of our USDA brief. What all of these have in common is affirmation of a constitutional standard of reasonable return on investment to reasonably efficient regulated entities when

the government undertakes market regulation of the margin between prices received and costs incurred. What almost all have in common is reliance on *Nebbia* as a source of the constitutional standard. As the California Supreme Court explained in Calfarm Ins. Co. v. Deukmejian, 48 Cal.3d 805, 816 (1989) an insurance price control case,

> The constitutional test for the validity of state price controls was established in *Nebbia v. New York* (1934) 291 U.S. 502, 539 [78 L.Ed. 940, 958, 54 S.Ct. 505, 89 A.L.R. 1469]: "Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty." The United States Supreme Court reaffirmed this test in *Pennell v.City of San Jose* (1988) 485 U.S. 1, 13 [99 L.Ed.2d 1, 14, 108 S.Ct. 849, 857]. We followed it in *Birkenfeld v. City of Berkeley (*1976) 17 Cal.3d 129 [130 Cal. Rptr. 465, 550 P.2d 1001] , a rent control case, and went on to explain that "[t]he provisions are within the police power if they are reasonably calculated to eliminate excessive rents and at the same time provide landlords with a just and reasonable return on their property." (P. 165.)
>
> The state and federal Constitutions are concerned not so much with the way in which the initial rates are set as with whether the rates as finally set are confiscatory. "[I]t is the result reached not the method employed which is controlling." [citation omitted].

In *Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal. 4th 761, 771-72 (1997), the California Supreme Court reconfirmed that state and federal due process requirements "prevents government from enacting legislation that is 'arbitrary' or 'discriminatory' or lacks 'a reasonable relation to a proper legislative purpose" (quoting *Nebbia*), and that a law which provides "investors a 'fair return'" meets this standard.

It is true that price control which regulates a market need not assure a return on investment to all entities, whether efficient or inefficient. The leading case is *Permian Basin Area Rate Cases*, 390 US 747, 769-70 (1968), which involved a single maximum price for a class of regulated natural gas producers in the Permian Basin production area, and discussed on pp. 33-36 of our USDA brief. A thorough discussion on market regulation versus utility regulation in a price control context is contained in a federal court decision on gasoline wholesale prices, *Texaco Puerto Rico, Inc. v. Ocasio Rodriguez,* 749 F. Supp. 348, 358-360 (D. Puerto Rico 1990). The rule of law explained in *Permian Basin* and *Texaco Puerto Rico*, which is consistent with the result in the California court's *Golden Cheese* decision on Class 4b pricing, should apply in this CDFA Class 4b proceeding, as it should apply to a future USDA decision on possible FMMO pricing for California. CDFA has done it right for a quarter century. The agency should stay on the established course and avoid

imputing product revenue that does not come to cheese plants, thereby squeezing the margin between product price and cost below any return on investment.

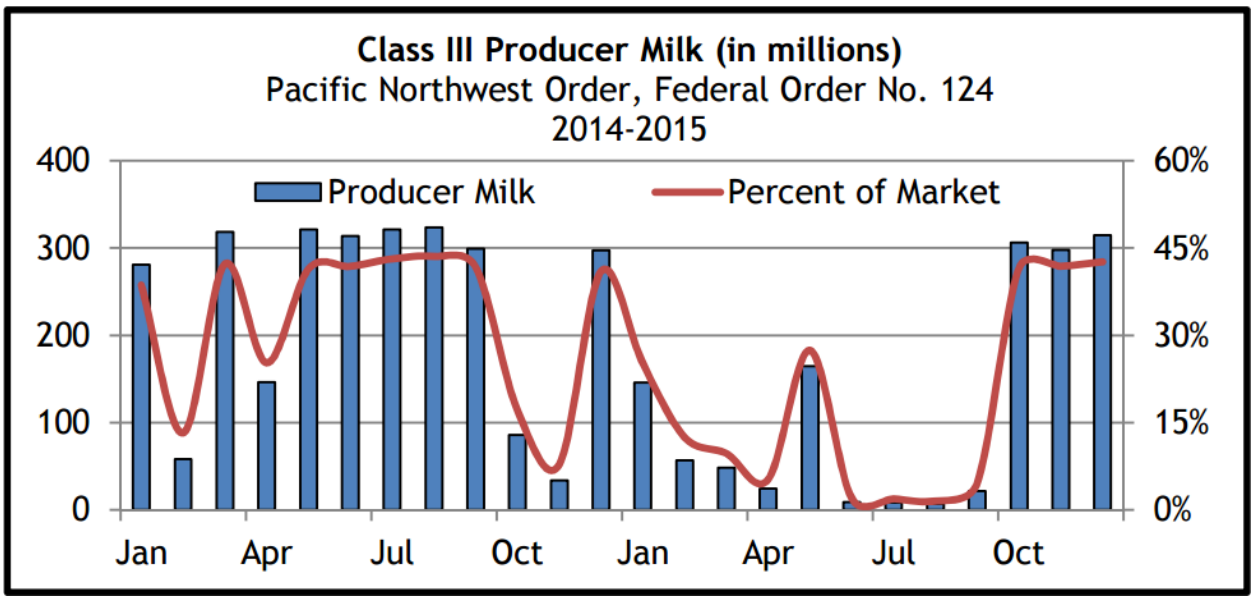
The assertion by a cooperative witness that milk price is not a major factor in plant investment decisions is false

Although a robust milk supply is an important factor in plant investment decisions, the ability to operate that plant profitably is the ultimate investment factor. The price of milk in combination with the cost of processing and location value of products are the critical factors. A large supply of milk at a price that is too high for profitable investment is simply a disconnection between supply and demand. California has experienced this disconnection in the past. For a plant to have a positive cash flow, product value must be greater than milk costs plus manufacturing and finance costs. Milk is by far the largest of the costs. Plant margins are measured in pennies or fractions of pennies per lb. of product, as reflected in the ROI built into regulated make allowances. Therefore, even small changes in minimum milk costs can tip the scales from having a reasonable return to an inadequate or negative return on investment. The idea that investment in dairy product manufacturing takes place with little regard to milk costs is completely fallacious. All of HCC's manufacturing investment decisions have heavily factored in the milk price versus the expected business costs and revenue.

Regarding Mailbox price comparisons, FMMO 124 is not appropriate comparison to California, contrary to claims by a cooperative witness

The ability of Darigold and Tillamook, operating primarily in FMMO 124, to survive under federal Class III and IV minimum prices is enhanced by their ability opt out of regulation, or depool milk (Figure 1), when there is an opportunity to enhance income or recover past regulated price losses. Darigold has historically depooled to help recover losses from their Class III and IV plants under FMMO price formulas. FMMO 124 allows depooling and re-pooling without monthly volume restrictions. California plants do not have the same ability to opt-out of state-regulated minimum Class 4a and 4b milk prices.

Figure 1: Substantial volumes of Class III milk in FMMO 124 continue to depool



Source: http://www.fmmaseattle.com/statistics/stats/stats15%20124.pdf pg. 7

In 2004 a witness for the Northwest Dairy Association (the cooperative which owns Darigold) testified that their depooling helped offset regulatory losses. This was summarized in the Federal Register Final Decision on September 13, 2006 [71 Fed. Reg. 54136, 54140 (September 13, 2006) (Final Decision, Upper Midwest Marketing Order)].

> "The witness explained that NDA engages in the practice of de-pooling in other Federal orders as a way to recover costs in their manufacturing of butter and cheese because the Class III and IV make allowances do not adequately reflect such costs. The NDA witness was of the opinion that the practice of depooling should be addressed at a national hearing that would also consider other issues such as the make allowances used in the Class III and IV price formulas."[1]

Additionally, as cooperatives, Dairigold and Tillamook are able to reblend losses to member producers (Darigold assessed members $1.25 per cwt from January – March 2015). These cooperative manufacturing plants also benefit from heavy use of the nationally funded Cooperative Working Together (CWT) program to subsidize exports which California proprietary cheese plants cannot use. Mailbox prices are

[1] http://www.dairyprogramhearing.com/getfile74527452.pdf?dDocName=STELPRDC5057322

further enhanced in FMMO 124 because Class I utilization averages about 25% in months when most milk is pooled (nearly double California's Class I utilization).

FMMO 30 competitive milk pricing is not appropriate for mailbox price comparison with California, contrary to claims of the DFA witness.

While both California and the Upper Midwest have a large percentage of milk going into manufacturing uses, the price received for dairy products is not comparable. Figure 2 compares the last available cheddar cheese price data from USDA and CDFA audited cheddar cheese prices which show a substantial product value difference that has increased in spread over the years. This is caused by the proximity of Wisconsin and Minnesota to cheese demand markets, and the large surplus of dairy products in the Western US that must clear the market and incur transportation costs to eastern demand centers (Figure 4 and 5).

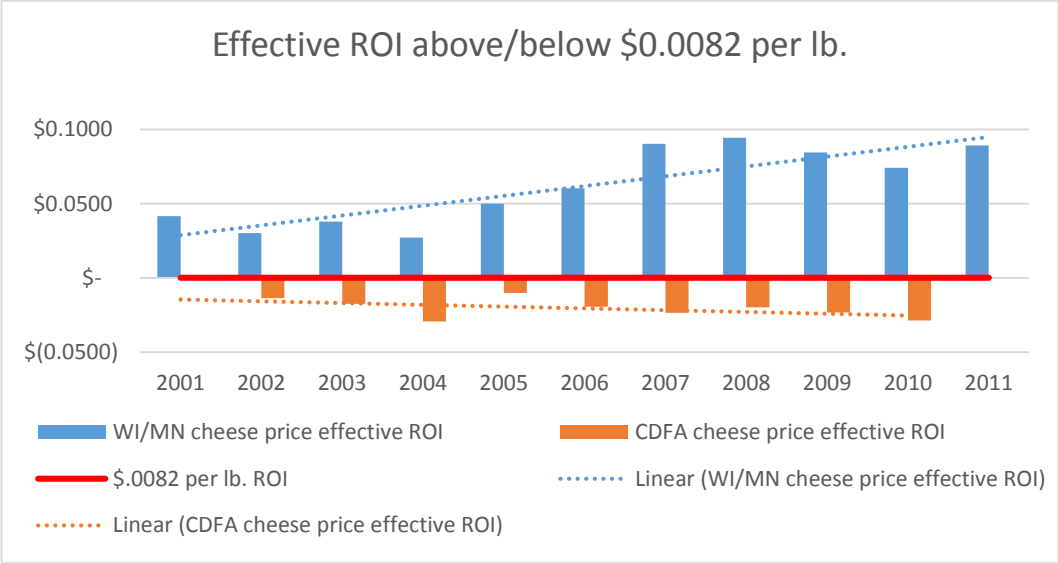
Figure 2: USDA NDPSR cheddar cheese price data for Wisconsin/Minnesota shows a large and increasing spread versus the CDFA audited cheddar cheese price

Year	NDPSR WI/MI cheddar avg. price per lb.	CDFA audited cheddar avg. price per lb.	Difference per lb.
2002	$1.2025	$1.1719	-$0.0306
2003	$1.3278	$1.2857	-$0.0420
2004	$1.6542	$1.6138	-$0.0405
2005	$1.5281	$1.4773	-$0.0508
2006	$1.2861	$1.2276	-$0.0584
2007	$1.8119	$1.7145	-$0.0974
2008	$1.9720	$1.8757	-$0.0964
2009	$1.3680	$1.2733	-$0.0946
2010	$1.5876	$1.4939	-$0.0938
2011 (Jan - Aug)	$1.8855	$1.7762	-$0.1094

Source: USDA/NDPSR, CDFA

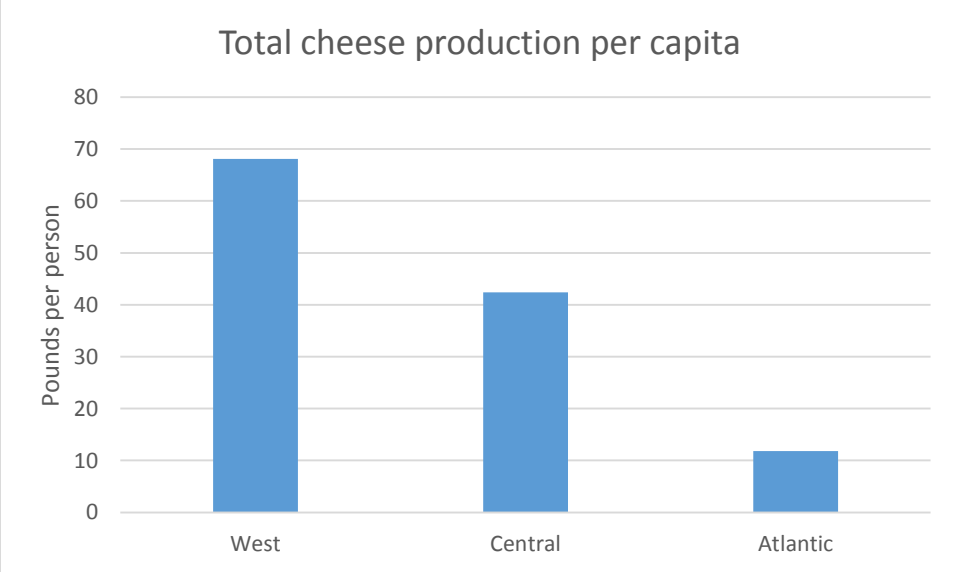
Because cheese is more valuable in Wisconsin and Minnesota than the NASS and NDPSR US average price, Upper Midwest plants enjoy a greater effective return on investment (ROI) – the margin built into the make allowance that allows for a return – which may be used to enhance returns on investment or pay higher milk premiums than US average or California plants, as shown in the table below (Figure 3):

Figure 3: FMMO Effective return on investment: 2002 – 2010, WI/MN vs. California cheese plants



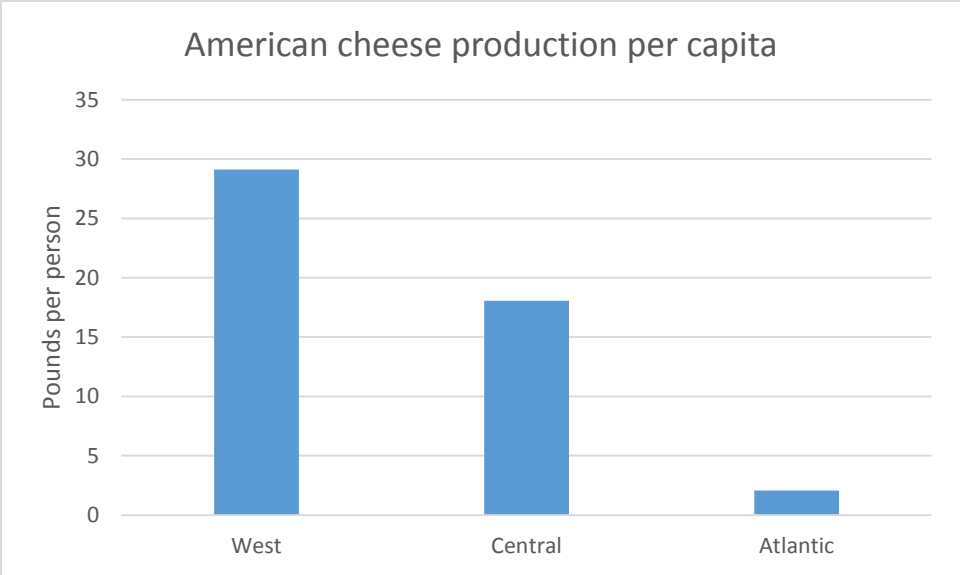
Regional NASS M-W and CDFA-reported cheddar cheese prices, minus NDPSR / NASS US average price, plus FMMO cheese ROI of $0.082 per lb.

Figure 4: There is a large surplus of total cheese production in the west versus the population. Per capita production calculated by total cheese production by region divided by population of region



Source: 2015 USDA cheese production, 2015 US Census

Figure 5: There is a large surplus of American cheese production in the west versus the population. Per capita production calculated by total cheese production by region divided by population of region



Source: 2015 USDA cheese production, 2015 US Census

The New Mexico mailbox pay price is a better comparison to California mailbox prices

New Mexico, like California, is located in the Western US with substantial cheese production that needs to move east to find a market. New Mexico plants are predominately represented by proprietary manufactures with a cooperative supply base. If lower mailbox prices in New Mexico are the result of higher Class I transportation costs, as one cooperative witness suggested, and not a result of lower available revenue from proprietary cheese manufacturers, this suggests pooling efforts and shipments to fluid plants in the area are not effective in generating additional producer revenue. The logical course of action would be to stop pooling producer milk, or ask for greater premiums from Class I milk buyers. The Southwest FFMO 126 Class I utilization ranged from 27% to 50% in 2015, so there should be opportunity for pooling.

Higher regulated minimum prices in lieu of premiums do not provide effective marketplace and economic signals.

One cooperative witness commented that premiums are unreliable, but higher minimum milk prices in the proposed Class 4b price formula would be reliable. As

explained below, this view would undermine the function of premiums to respond quickly to marketplace changes, and to reward producers who have invested heavily in milk production practices for which premiums are paid.

Cheese product manufacturers in California process cheese for different markets, have different utilizations of their whey stream, have variable costs of whey product production, and variable markets for their products.

Producer milk is not fungible in some uses, particularly in Class 4b where protein content and quality rather than SNF content drives milk's value to the manufacturer. HCC pays premiums based on the difference between regulated minimums and a combination of milk quality, components, cheese markets, whey protein markets, and lactose markets. Higher minimum pricing would be damaging to HCC and its producer-suppliers because it 1) subtracts from HCC's ability to pay quality premiums, 2) subtracts from our ability to pay premiums for higher cheese yielding milk, 3) lowers milk prices for producers who invested in higher component herds, 4) further disconnects our actual product revenue from milk costs which creates volatile income and difficulty in attracting capital, and 5) it can create inadequate or negative returns on investment.

Furthermore, high minimum prices can create economic distortions that make dairymen indifferent to where they ship milk, despite the fact there is clear differences between milk quality/components and differences between processors' ability to create value from milk. If both Class 4a and 4b minimums were set to market clearing level and allowed for premiums, over time milk would tend to flow to its highest value use.

Minimum prices need to be set low enough for milk to clear the market, allow reasonably efficient plants to earn a return on investment and reward producers that provide milk that has added value specific to that plant's use. In fact, a high mandatory minimum price for a manufacturer making cheddar for domestic markets and producing dry whey may not even be market clearing or allow for a return on investment if the make allowances are not kept up-to-date.

Regulated minimum prices that are too high also risk creating a situation where there is unwilling capacity to process all of the milk, as happened in California from 2006-2007. This is to the detriment of dairymen. Nearly 80 years ago, in a case that approved the Milk Standardization Act (Jersey Maid Milk Products Co. v. Brock, 13 Cal. 2d 620, 654 (1939)), the California Supreme court found, "…if the price of fluid milk be fixed too high, the effect would be to increase unduly the supply of fluid milk with the result that many producers would be unable to market their product, and for that reason would be forced out of business."

In order to prevent irrational utilization of milk and create a situation where there is unwilling capacity to process milk, minimum prices need to be set conservatively to allow premiums to fill in the gap when warranted.

WPC-34 better indicator of higher concentration WPC products than dry whey

Last summer, the Hearing Panel made the following finding on pages 11-12 of its report: "Compared to dry whey, it appears that a whey factor based on WPC34 could relate better to a larger portion of California cheese plants." Based on market experience, HCC believes WPC-34 moves together more directionally with higher value WPC products than dry whey. Further, we have found that Class 4b dry whey based scales, especially when constructed aggressively as is the case with trade association proposal and temporary scale, can overestimate the value of milk to a plant making WPC.

Summary

On behalf of Hilmar Cheese Company, Inc., I urge the Department to not implement the trade associations proposed whey scale, or any other whey scale that risks creating inadequate returns on investment for reasonably efficient cheese makers. Such a decision would deviate from previous CDFA precedent, challenge the legal standards for price regulation, and risk damaging California's cheese makers for the short term price enhancement of dairymen.

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

Sincerely,

James De Jong

Dairy Policy and Economic Analyst