LEPRINO FOODS COMPANY'S POST-HEARING BRIEF

In the Matter of:

Proposed changes in the Class 4b price formula as provided in the Consolidated Stabilization and Marketing Plan considered at the June 3, 2015 Hearing held by the California Department of Food and Agriculture in Sacramento, California.

Pending before the Secretary of the California Department of Food and Agriculture ("CDFA" or "Department") are proposed amendments to the Consolidated Stabilization and Marketing Plan concerning changes in the Class 4b price formula. The hearing on this matter was held June 3, 2015 in Sacramento, California. In accordance with California Food and Agricultural Code § 61903, Leprino Foods Company ("Leprino") is submitting this Post-Hearing Brief to clarify its testimony.

Limitations on Developing Viable Strategies to Hedge Overbase Price

Some members of the "Producer Coalition" contend that the current construct of the Class 4b price formula results in the inability to develop an effective hedge strategy for California dairy producers. In my testimony, I referenced that I believe that an effective hedge strategy can be constructed and referenced my post-hearing brief from the May 31 - June 1, 2012 hearing. I am attaching that post-hearing brief for reference as "Attachment A".

Testimony regarding Western United analysis on Wisconsin Premiums

As noted extemporaneously during my testimony at the hearing, my conclusions about the Western United's overstatement of premiums in Wisconsin on the bottom of page 6 of my testimony, while directionally correct, are overstated. When developing the written statement, I believed that the Western United witness had not adjusted the prices under comparison (All-Milk vs. Class III) to acknowledge that the All Milk price is at full farm level test and that Class III is quoted at lower "standard" tests. Shortly prior to delivering my testimony, I became aware that the Western United witness had adjusted to a common fat level but, due to lack of data regarding the other component levels reflected in the All-Milk price, had not adjusted for the higher levels of the other components in that price series. Based upon that, my conclusion remains that the premium levels inferred are overstated, but that the magnitude of the overstatement is not as great as inferred in my written testimony.

Amplification of Position

The Department should adopt the Dairy Institute proposal to increase the whey contribution to the Class 4b price consistent with the liquid condensed WPC market. This proposal accurately captures the market values for liquid condensed whey while recognizing that 77% of California cheese plants capture no value from whey. Adoption of a price level that is higher than that generated by the Dairy Institute proposal imperils the viability of the roughly 14% of cheese milk capacity that does not recover any value from the whey. Adoption of the price levels embodied in the Western United et al proposal under the mandatory pricing requirements of the California Order would imperil the long term competitiveness and viability of all commodity cheesemakers in the state and should be rejected.

Attachment A

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Pending before the Secretary of the California Department of Food and Agriculture ("CDFA" or "Department") are proposed amendments to the Consolidated Stabilization and Marketing Plan concerning changes in the Class 4b price formula. The hearing on this matter ("Hearing") was held May 31 - June 1, 2012 in Sacramento, California. In accordance with California Food and Agricultural Code § 61903, Leprino Foods Company ("Leprino") is submitting this Post-Hearing Brief to clarify its testimony.

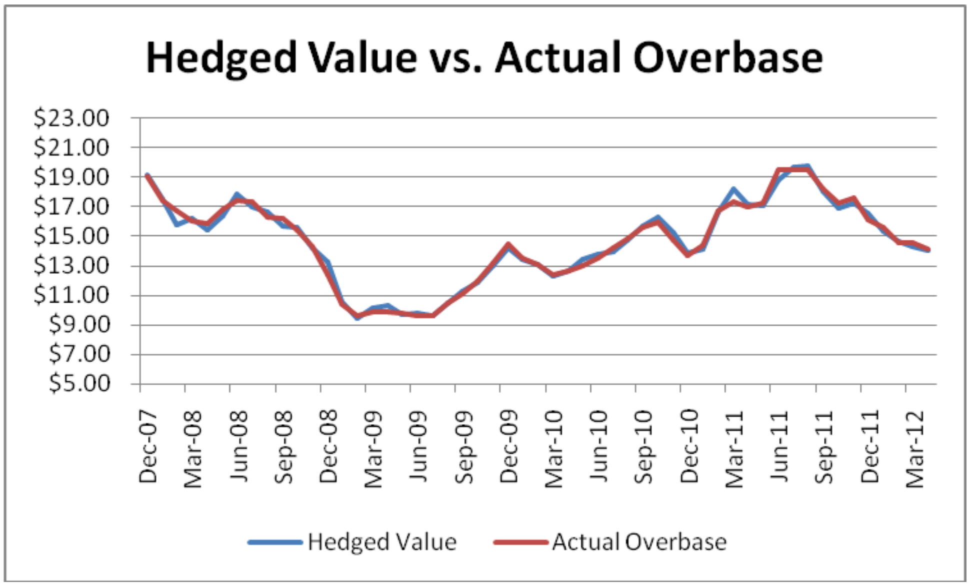
<u>Limitations on Developing Viable Strategies to Hedge Overbase Price</u>

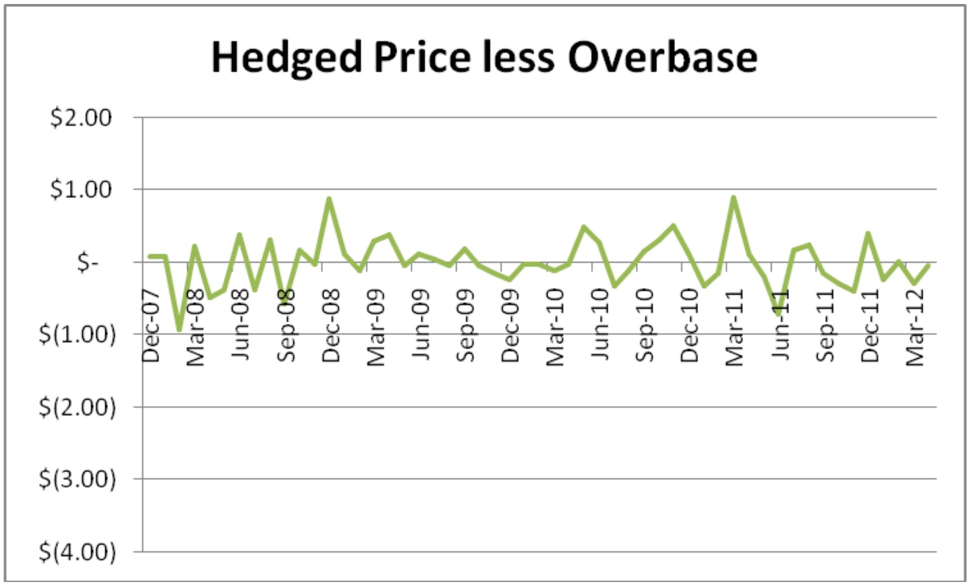
Several members of the "Producer Coalition" contend that the current construct of the Class 4b price formula results in the inability to develop an effective hedge strategy for California dairy producers. In my testimony, I extemporaneously explained that a hedge strategy can be better developed using the NASS Cheese futures contract rather than the Class III futures instrument that was referenced by the Coalition. The following further expands and illustrates that strategy.

The development of an effective hedge strategy must be rooted in an understanding of the factors that contribute in the movement of the price series for which the risk is being managed. In the case of the overbase price, primary contributors are Class 1, 2, 3, 4a, and 4b prices and utilizations. The following are my considerations relative to constructing an effective hedge:

- Class 1 milk: The use of the "higher of" construct reduces the ability to properly hedge the Class 1 contribution to the overbase price. Therefore, I will ignore this contributor and recalculate pool utilizations based upon SNF utilization in non-Class 1 products.
- Classes 2, 3, and 4a are priced relative to the butter and nonfat dry milk value of milk. Therefore, it is most logical to use the Class IV futures contract to hedge these utilizations.
    - The specific futures contracts to be purchased for Class 2 & 3 coverage should emulate the timing as applied under the Marketing and Stabilization Plan. Specifically, one would use the combination of December and January Class IV contracts to hedge the Class 2 and 3 contributions to the overbase price for February and March.
- Class 4b is most influenced by the cheddar price and the closest futures instrument that can be used as a surrogate is the NASS cheddar price.

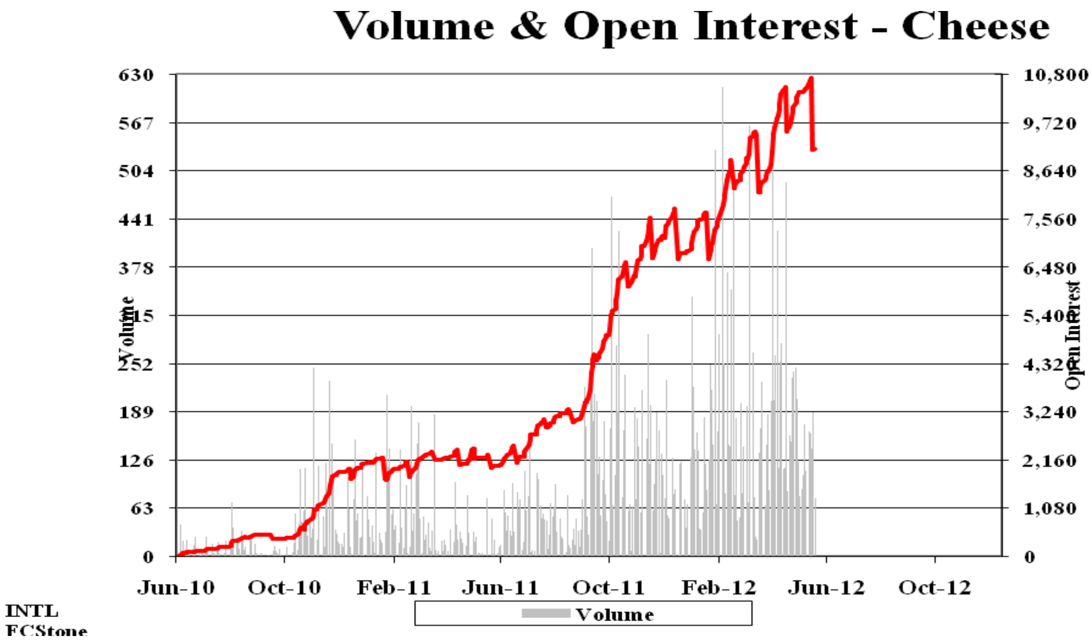
The effectiveness of using the referenced contracts can be evaluated by simply seeing how closely a price series calculated based upon the settled prices of those contracts emulate the overbase price. To create a simple example, I used the 2011 SNF annual utilization for non-Class 1 milk to weight the hedge tool reference prices. The hedge tools were as noted above (Class IV for Classes 2, 3, and 4a) and NASS cheddar (net of make and fob adjuster and multiplied by 10.084 yield) for Class 4b. A constant of $0.03 was added to the calculated hedged price and represents the average spread between the raw calculated price and the actual overbase for the period from December 2007 to April 2012. The standard deviation of the differences between the calculated hedge price and the overbase for that same period is $0.346 per cwt. The following graphs are representations of the methodology using the same scaling as Exhibit G-3 and G-5 in the "expert" testimony. The graphs start with December 2007 because it is inappropriate to test the effectiveness of a hedge strategy over a period during which the construct of the Class 4b price formula (and therefore, the hedge strategy) is significantly different. The table showing the data used in this analysis is attached for reference.





The "expert" testimony submitted by letter is flawed in several ways. First, it did not recognize the heavy influence of the butter / nonfat dry milk complex on the overbase price. Second, it did not use the proper tool to hedge Class 4b. And, finally, it assumed a static approach to hedging over an extended period during which there were significant changes in the milk price formulas. It should not be surprising that the resulting conclusions show a lower correlation than a similar analysis does that looks at cheese milk hedge across several markets dominated by cheese utilization in a regulatory framework that did not experience significant changes over the timeframe analyzed.

The liquidity of dairy hedge instruments has generally improved over recent years. To the extent that liquidity is constrained, particularly for the nonfat or Class IV futures, it tends to be related to lack of farm-side interest. The NASS cheddar futures contract has developed nicely since its inception. The following chart shows the volume of trades and open interest for the NASS cheese contract over the last two years.



Pooling / Depooling Observations

I also noted extemporaneously during my testimony that some Coalition witnesses promoted a narrow view of the safety valves that exist to clear the market in unregulated areas or in areas in Federal Milk Marketing Areas through distressed sales, depooling or simply not participating in the Orders. One witness drew a corollary between production within states that are within Federal Order geographies and the volume of cheese production that is subject to regulation. The location of a cheese plant within the boundaries of a Federal Milk Marketing Area does not mean that the cheese plant is regulated by the Order. As noted in my testimony, cheese plants are free to decide whether to participate in an Order regardless of where they are located outside of California. The same witness argued that, based upon their internal analysis, the milk price in the unregulated area of Idaho has changed and, if pushed backward, would have a greater than 95% correlation to the Class III price. While this may be true, it does not provide any information regarding whether it is above or below the Class III price. Additionally, it remains irrelevant. Unregulated prices are just that; they will change with the market conditions to allow the market to clear. This is not the case in California.

Amplification of Position

The Department should reject the Western United / Producer Coalition proposal and the entire industry should dedicate its energy and efforts toward longer term policy reforms that will benefit all sectors, including producers. With over 13% of U.S. milk is now exported in the form of various dairy products, the Secretary's efforts to encourage an industry dialog about revisions in the regulated milk pricing system that are needed in order for all sectors of the California dairy industry to thrive and leverage growing global opportunities is timely. Leprino and many other manufacturers have made significant investments to develop exports that will drive up demand for U.S. dairy products and, along with it, the demand and price for raw milk. These are the opportunities that will raise all ships and restore financial health to the industry. It is time that we ensure that our milk pricing system facilitates rather than inhibits leveraging this opportunity.