

Hearing Panel Report

*Based on a Public Hearing Held On
May 31 and June 1, 2012*

Addressing the Class 4b Pricing Formula
Contained in the
Stabilization and Marketing Plans
for Market Milk for the
Northern and Southern California Marketing Areas

Hearing Panel Report

Addressing the Class 4b Pricing Formula Based Upon a Public Hearing Held on May 31 and June 1, 2012

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plans for Market Milk for Northern California and Southern California (Plans) is based on evidence received and entered into the Department of Food and Agriculture's hearing record. The evidence includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held on May 31 and June 1, 2012, and written post-hearing briefs.

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INTRODUCTION/WITNESSES

California Food and Agricultural Code (Code) Section 61801, *et sec.*, provides the authority, procedures, and standards for establishing minimum prices by the California Department of Food and Agriculture (CDFA) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of Stabilization and Marketing Plans for Market Milk.

Two petitions were submitted by:

1. Western United Dairywomen (WUD)
2. The Coalition (Coalition)

One alternative proposal was submitted by:

1. Farmdale Creamery, Inc. (Farmdale)

A total of 37 witnesses testified including the Department's witness:

CDFA, Mike Francesconi

WUD, Michael Marsh

WUD, Annie AcMoody

*Coalition, Donna Melby

*Farmdale, Scott Hofferber

California Dairies, Inc. (CDI), Dr. Eric Erba

Milk Producers Council (MPC), Rob Vandenheuvel

*BESTWHEY, LLC, Barry Murphy

*Marquez Brothers International, Inc. (Marquez), Jose T. Maldonado (accompanied by David Villanueva)

California Dairy Campaign (CDC), Lynn McBride

Cacique Cheese, Inc. (Cacique), Gilbert de Cardenas

Rancho Teresita Dairy, Cornell Kasbergen

Airoso Dairy, Joey Airoso

El Monte Dairy, Art Van Beek

Land O'Lakes, Inc. (LOL), Tom Wegner

Farm Credit West, Jonathan Kennedy

*Dairy Institute (DI), Dr. William Schiek

*DI, Rachel Kaldor

*Hilmar Cheese Company (Hilmar), David Ahlem

*Kraft Foods (Kraft), Michael McCully

Saputo Cheese USA, Inc. (Saputo), Greg Dryer

Caseus Energy, Corey Travis

Dairy Farmers of America, Inc. (DFA), Elvin Hollon

*Dairy Producer, Arie H. De Jong

Mancebo Dairy, Stephen Mancebo

Alliance of Western Milk Producers (Alliance), William C. Van Dam

R. Doornenbal Dairy, Rien Doornenbal

Don Francisco Cheese, Rizo Lopez Foods, Edwin Rizo

*Leprino Foods Company (Leprino), Sue M. Taylor

Fern Oak Farms, Jared Fernandes

Two B Dairy, Patricia Van Dam

Special 3-Minute Testimony Given:

T-Bar Dairy, Tom Barcellos

Milky Way Dairy, John Gailey

Dairy Producer, John Moons

Ornellas Dairy, Kevin Ornellas

Rio Blanco Dairy, Jeff Wilbur

Couco Creek Dairy, Tony Machado

Also entered into the hearing record were additional written comments submitted by:

Imperial Valley Cheese of California, Dolores Gossner Wheeler

Rumiano Cheese Company, R. Baird Rumiano

Security Milk Producers Association, Ed Haringa

Sierra Nevada Cheese Company, Ben Gregersen

Los Altos Food Products, Inc., Raul Andrade

* Indicates submission of a Post Hearing Brief

SUMMARY OF THE PROPOSALS

PETITIONS:

Western United Dairymen

The Coalition (California Dairies, Inc.; Dairy Farmers of America-Western Area Council; Land O'Lakes, Inc.; Security Milk Producers Association; Milk Producers Council; California Dairy Campaign; Alliance of Western Milk Producers)

Both Petitioners proposed identical changes in the Class 4b pricing formula:

- Change the dry whey value based on the following schedule (corresponding to the monthly average Dairy Market News dry whey price):

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

ALTERNATIVE PROPOSAL:

Farmdale Creamery

In the Class 4b pricing formula

- Change the dry whey value to a fixed \$0.25/cwt. factor

ESTIMATED IMPACTS OF THE PROPOSALS ON CALIFORNIA CLASS AND POOL PRICES

Using historic commodity prices, estimates assume that the petitions, alternative proposal and current formulas were in effect from April 2007 through March 2012.

- Table 1 shows the impacts of the petitions and alternative proposal on class and pool prices relative to current prices, from April 2007 through March 2012.

Table 1 - Estimates of Proposals less Current Class 4b and Pool Prices
12-Month Averages: April-March and 5-Year Averages: April 2007 - March 2012

(Dollars per Hundredweight)

CLASS 4b	2007-08	2008-09	2009-10	2010-11	2011-12	5-Year Average
Coalition and Western United Dairymen	\$1.32	-\$0.06	\$0.39	\$0.70	\$1.58	\$0.79
Farmdale	-\$0.25	-\$0.02	-\$0.12	-\$0.17	-\$0.35	-\$0.18
POOL PRICES: QUOTA & OVERBASE						
Coalition and Western United Dairymen	\$0.65	-\$0.03	\$0.16	\$0.31	\$0.71	\$0.36
Farmdale	-\$0.12	-\$0.01	-\$0.05	-\$0.07	-\$0.16	-\$0.08

Please Note: Historic Prices are not necessarily a good predictor of future prices.

PREVIOUS AND CURRENT ECONOMIC CONDITIONS FACING THE CALIFORNIA DAIRY INDUSTRY

Prior to review of the proposals for changes to the whey factor in the Class 4b pricing formula, a general overview of the economic conditions facing the California dairy industry in the past few years is warranted.

Landscape of 2011 and 2012 Hearings

Prior to the current hearing, a Class 4a and 4b hearing was held on June 30 and July 1, 2011. In May 2011, two organizations petitioned the Department to propose changes to the manufacturing cost allowances and f.o.b. adjusters in the Class 4a and 4b pricing formulas and to the whey value in the Class 4b pricing formula. These changes were intended to update the pricing formulas to reflect the most current manufacturing cost studies and to more equitably share whey values with producers. One result of the hearing was the removal of the \$0.25/cwt. fixed whey factor in the Class 4b pricing formula. The whey factor was replaced with a sliding scale with \$0.05/cwt. steps that floors whey values at \$0.25/cwt. and caps whey values at \$0.65/cwt.

In March 2012, the Department granted the current hearing to again address proposed changes to the whey value in the Class 4b pricing formula. Producer organizations filed two separate petitions proposing to increase the whey factor to more closely align the California Class 4b price with the Federal Order Class III price. Additionally, a processor organization proposed returning to the \$0.25/cwt. fixed whey factor for the whey value in the Class 4b pricing formula.

Leading up to the 2011 hearing, the dairy industry in California was beginning to recover from the economic recession that impacted global income and demand in 2009 and 2010. Milk prices and dairy product demand began to improve along with increased margins on the dairy. Dairy commodity prices remained strong through the end of 2011. Throughout 2011, the dry whey market witnessed steadily increasing prices, and the Dairy Market News Dry Whey – West Mostly price peaked at nearly \$0.70 per pound in January 2012. Commodity prices and class prices have fallen in 2012 as national and international dairy product supply has grown.

Rising milk prices in 2011 were met with steadily rising milk production costs at the farm level, due primarily to the cost of feed. By the end of 2011, feed cost as a percentage of total cost of production reached a record high. Increasing volatility in milk prices and feed costs have caused the industry to consider risk management and hedging tools to protect their margins.

Milk Production and Supply

During 2011, California recorded its highest year of milk production and national exports of finished dairy products set a record in terms of volume and total value. In 2012, California production has continued to increase relative to 2011 production due to a number of factors: number of cows, milk per cow, availability of replacement cows, favorable weather, efficiency gains and management practices on the dairy. Exports of manufactured dairy products remain strong, and competition in the international market has strengthened.

According to the U.S. Dairy Export Council (USDEC), global milk production was up in 2011, with all major exporting regions including the U.S., Europe, Oceania, and Argentina experiencing growth in their milk supplies. Growth in international demand absorbed much of the increased milk supply as major importing nations including China, Mexico, Indonesia, Japan and South Korea posted solid import growth.

California milk production grew 2.7 percent in 2011 and was up 7.8 percent in the first quarter of 2012 compared to the same period a year ago. During the 2012 spring flush, some processing organizations enforced production bases and capped the amount of milk they would accept to limit production growth and address plant capacity issues.

Utilization of Pooled Milk

In the past few years, milk production growth in California has helped fuel an increase in the usage of milk for Class 4a and 4b products. In 2011, Class 4a and 4b utilization accounted for 78 percent of pooled milk. Class 4a utilization on a total solids basis was up 8.6 percent and Class 4b up 13.8 percent, compared to 2010. Meanwhile, pool utilization and total pounds of milk going into Class 1 production has declined. As California increases its production of manufactured dairy products, which typically have prices set to clear the market and are products sold in the global marketplace, the industry faces more volatility and sensitivity associated with global supply and demand conditions.

REVIEW OF THE PROPOSALS

There were three proposals presented at the current hearing to change the whey valuation in the Class 4b pricing formula. The specifics of these proposals can be found in the “*Summary of Proposals*” section of the Panel Report. WUD and the Coalition both proposed to replace the current dry whey sliding scale with a scale that closely models the values resulting from the variable factor in the federal order Class III pricing formula. Their proposed scale introduces one-cent ‘steps’ for the dry whey commodity price and establishes corresponding whey factor values for each step. The scale imposes a floor of \$0.00/cwt. on the whey value incorporated into the pricing formula when the Dairy Market News (DMN) dry whey commodity price is less than \$0.20 per pound and caps the whey value at \$4.00/cwt. when the dry whey commodity price is \$0.92 per pound or above. Although the petitioners’ proposals are constructed in the form of a sliding scale, the effect of the scale is similar to reinstating a variable factor that models the federal order Class III price, which resembles the type of factor that was in the Class 4b pricing formula from April 2003 to November 2007.

Farmdale proposed to replace the current dry whey sliding scale with a \$0.25/cwt. fixed whey factor. The proposal reinstates the dry whey factor that was in place in the Class 4b pricing formula from December 2007 to August 2011.

Impact of Proposals

To estimate the impact to the current Class 4b and California Pool (Pool) prices, the Department analyzed the three proposals assuming that the proposals had been in effect from April 2007 through March 2012. The petitioners’ proposals would have resulted in a five-year monthly average increase of \$0.79/cwt. in the Class 4b price and a \$0.36/cwt. increase in the Pool price. The alternative proposal would have resulted in a five-year monthly average decrease of \$0.18/cwt. in the Class 4b price and a decrease of \$0.08/cwt. in the Pool price.

INTRODUCTION

Similar to previous hearings, the hearing record contains opposing testimony regarding the appropriate level of the California Class 4b price, which is the price of milk paid by handlers for farm milk used in the making of cheese and whey products. In general, testimony supporting the petitioners’ proposal advocated for increasing the Class 4b price for reasons of producer equity and to narrow the gap between the Class 4b price and the federal order Class III price, which is the price of milk paid by handlers for farm milk used in making cheese and whey products in areas of the U.S. regulated by the United States Department of Agriculture (USDA). Testimony supporting the alternative proposal advocated for reducing the Class 4b price for competitive reasons, which would increase the gap between the Class 4b and Class III prices. Some testimony advocated for not making any changes, which would maintain the gap between the two prices.

When considering the appropriate level of the Class 4b price, the Secretary must take into consideration various important factors; such as, those factors cited in the “*Economic Considerations for the Proposed Changes to the Pricing Formulas*” (see Appendix G), relevant Code sections, relevant economic factors, analysis, information, and testimony contained in the hearing record. These important considerations are associated with various topics or issues raised in the hearing record and discussed in following sections of this Panel Report. These issues include: the mandates and directives given in the Code; the differences in pricing regulations between the California and federal order systems;

California milk production and dairy product marketing conditions; the price alignment of the Class 4b and Class III prices; and whey product marketing conditions and their effect on the whey factor in the Class 4b pricing formula. When analyzing these various issues, the Department has used the most current data available.

DISCUSSION OF PRICING REGULATIONS AND MARKETING CONDITIONS

California Food and Agricultural Code

In order to determine the appropriate level of class prices in California, the Code provides the Secretary (director) with the authority to set class prices and direction regarding what must be considered when determining the appropriate level of such prices. Representatives supporting the petitioners' proposal stated that Code Section 62062 provides the main directive when establishing the appropriate level of class prices, and more specifically, the level of the Class 4b price when compared to the Class III price. Using the Class III price as a measure of national prices, various stakeholder representatives argued that the Class 4b price needed to be increased in order to track more closely with the national price of milk (Class III price), which would be accomplished by adopting the petitioners' proposal. They testified that by doing so, there would be a reasonable and sound economic relationship between the Class 4b and Class III prices. As support for this position, representatives cited a portion of Code Section 62062 that states, "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." These representatives testified that this language should be the principle, overriding factor considered when making pricing decisions.

When reviewing the codified mandates and directives given to the Secretary by the Code, the Panel believes that the Secretary has been given the mandate to consider any and all economic factors available in order to set minimum prices in California. A review of the language found in Section 62062 and other Code sections support this view. The Panel believes that, as previously quoted, California prices shall be in reasonable and sound economic relationship with the national value of manufactured milk products. As further stated in Section 62062, when establishing prices, the Secretary also "shall take into consideration any relevant economic factors, including, but not limited to" other factors listed in this section. These other factors specifically listed in this section include the reasonable and economic soundness of market milk for all classes while considering the combined income from those classes in relation to the cost of producing milk (Section 62062(a)), the establishment of prices that ensure an adequate and continuous supply of milk in relation to the demand for milk for all purposes including consumer prices that are fair and reasonable when considering relevant economic criteria (Section 62062(b)), and the establishment of prices for the various classes of milk that bear a reasonable and sound economic relationship to each other (Section 62062(c)).

Furthermore, when establishing the appropriate level of prices in California, Section 62062 provides the Secretary with further directives and mandates. At the end of Section 62062, there is language stating that, "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." These sections provide further mandates to insure an adequate and continuous supply of market milk for consumption, develop and maintain satisfactory marketing conditions, and other high-level mandates affecting the state in the aggregate. A more detailed review of these sections can be found in Appendix A.

Ultimately, when reviewing the language found in Code Section 62062 and the other Code sections referenced therein, the Code gives the Secretary directives to consider specific economic factors and high-level, overarching mandates to ensure stability in the California marketplace for farm milk and dairy products. While pursuing the mandates cited in the Code with regards to establishing milk prices in California, the Secretary has been given the directive to take into consideration a myriad of specific factors cited within these Code sections and also any other relevant economic factors that affect California. Although a reasonable and sound economic relationship with the national value of manufactured milk products is one factor to consider when establishing milk prices, there are many other specifically cited factors and other relevant economic factors that affect the state that shall be considered as well when determining the appropriate level of milk prices.

Minimum Pricing Regulations in California and Federal Orders

The hearing record contains significant discussion regarding the comparison between the Class 4b and Class III prices. When determining the appropriate level of the Class 4b price in comparison to the Class III price, differences in the California and federal order pricing systems must be examined in order to determine if the two systems are similar enough to result in prices that are directly comparable. In general, organizations supporting the petitioners' proposal testified that the two pricing systems are similar in nature and function. As a result of these similarities in the systems, the differences in these prices should be narrowed. Conversely, organizations either opposing any changes or supporting the alternative proposal testified that the two pricing systems have important differences that support the idea of maintaining or expanding the differences in the Class 4b and Class III prices. The two main points of comparison of the two systems that were discussed at length in the hearing record are the ability, or lack thereof, to escape minimum pricing regulations and the differing marketing conditions found in California and in federal orders.

One key difference between the California and federal order systems is the ability in federal orders to 'escape' regulated minimum prices by paying a lower price for milk than the announced class prices for manufacturing milk (milk used to manufacture cultured and frozen dairy products, butter, dry milk powders, cheese, and whey products). In federal orders, manufacturing plants may voluntarily elect to de-pool or decouple their milk from the minimum pricing regulations so that they are not required to pay the minimum class price established by the federal order. A producer cooperative representative testified that the main reason for de-pooling in federal orders is primarily for pricing considerations, although de-pooling does occur for reasons such as poor milk quality or for not shipping the minimum quantity of milk required by the federal order's pool.

In addition to de-pooling, there are other circumstances that occur in federal orders that allow for milk to be purchased below the regulated minimum price. There are certain handler-to-handler transactions that occur when milk is purchased below minimum prices that often happen under temporary circumstances, such as over the weekend or during holidays, when milk is diverted away from bottling plants and into manufacturing plants in order to find a home for milk. Under other circumstances, such as when milk is "distressed" or when the milk supply exceeds the demand for milk by manufacturers in an area, milk will be sold below minimum prices. There are circumstances when a manufacturer is not willing to procure additional milk when there is a lack of demand for their finished dairy products at a cost commensurate with the regulated minimum price. As a result, excess milk supplies must be offered at prices lower than the minimum price in order to provide the economic incentive to

purchase additional milk. An example of this type of situation is during the spring flush when milk supplies are at their cyclically highest levels and often exceed the demand by manufacturers.

Within the federal order system there are circumstances that provide an opportunity for milk to be sold below regulated minimum prices in order to clear the market when milk supplies exceed demand. However, California statutes do not provide the same type of flexibility for milk to clear the market below regulated minimum prices. In California, manufacturers must legally pay at least the regulated minimum price for Grade A milk. Although it is possible for California manufacturers to de-pool, these manufacturers must continue to pay at least the regulated minimum price for milk regardless of their Pool status, which is different than in federal orders. Because of this, California Class 4a and 4b prices have to be set at levels that will clear the market of all milk that has not been processed in the higher valued usage milk (Classes 1, 2 and 3) in order to maintain orderly marketing conditions within the state. As a result of this major difference within the two systems, a strict comparison of the California Class 4b price to the federal order Class III, without considering other factors, is inappropriate.

The Panel believes that a review of the price alignment comparison between these two prices can serve as a starting point while examining the appropriate level of the Class 4b price and will be discussed in a later section. However, this comparison must also be accompanied by consideration of other relevant economic factors and the differences between the California and federal order systems. In essence, these other considerations beyond the simple price alignment comparison between the Class 4b and Class III prices are important to consider when determining the appropriate level of the Class 4b price. Appendix B of this Panel Report contains further discussion of the differences between the California and federal order pricing systems. This includes: data and analysis, contained in the hearing record, of the quantities and prices of milk sold in federal orders below the regulated minimum price; and Department analysis of milk sold below regulated minimum prices in federal orders. Appendix C contains a comparison of the marketing conditions of California and Wisconsin, the two largest cheese producing states in the U.S.

California Milk Production and Dairy Product Marketing Conditions

Plant Capacity

California has been the largest milk producing state since the early 1990s, with a well-documented, long-term growth trend in both milk production and milk cows. California has experienced an ever increasing milk production and milk cow growth trend over the course of various decades. As cited in the *“Background: California’s Dairy Landscape”* (Appendix G), California has been increasing its milk production capacity in general terms and has increased at a rate higher than the national average. In calendar year 2011, California produced approximately 41.4 billion pounds of milk, which was the highest milk production year on record. Additionally, through the first four months of 2012, milk production is approximately 6.6 percent higher compared to the first four months of 2011; milk production is on a current pace to exceed last year’s production.

In the face of California’s milk supplies is the issue of plant capacity or the state’s ability to process all of its milk supply. Department data and information show that in the early 1980s, California had some issues with the milk supply exceeding the plant capacity at the time, which caused some problems when handling the excess milk. By the mid-to-late 1980s, plant

capacity ceased to be an issue as the construction of new manufacturing capacity and the growth trend in the milk supply came into balance. It appears that there was a sensible balance between milk production growth and plant capacity growth over the course of various years until 2007 and 2008 when the milk supply once again exceeded the state's plant capacity. Although this situation was alleviated in 2009 and 2010 due to macroeconomic recession (see Appendix D), plant capacity became a concern again in 2011 and currently continues to be a concern.

The state's effective plant capacity can be viewed as having two components. The first is physical manufacturing facilities that have a maximum capacity to process a certain quantity of milk. If the state's milk supply exceeds this maximum capacity, then an imbalance occurs. The second component of the state's plant capacity is associated with the demand for dairy products at prices that correspond to a certain milk price. If a manufacturer does not have the demand for its dairy products at prices commensurate with the price of milk, then a manufacturer may not procure milk at a given milk price that correlates to a higher finished product price than what their customers are willing to pay, even if the manufacturer has available capacity to process milk. Therefore, plant capacity can be viewed as a combination of physical manufacturing capacity to process a certain quantity of milk coupled with the incentive (or lack thereof) that manufacturers have to procure additional milk depending on whether the price of the milk will correspond to the price of dairy products for which customers are willing to pay.

The hearing record from the current pricing hearing and the June 30 and July 1, 2011 pricing hearing contains testimony and evidence that the state's effective plant capacity has become an issue to the point of upsetting orderly and satisfactory marketing conditions of dairy products. During the 2011 hearing, testimony was given that manufacturing plants were running at or near capacity and that the state was reaching a point where plant capacity was going to become an issue. It was stated at that time that milk was leaving the state to be processed and that the overall plant capacity situation had not reached the same proportions as during 2007 and 2008, but that it was not far off. From May 2011 to April 2012, the Department is not aware of any significant, new manufacturing capacity in the state, but over this time period, California's milk production has increased 4.2 percent compared to the same time period of the previous year.

Testimony received at the current hearing and analysis of the relationship between the state's milk supply and the demand for dairy products provide evidence that there may be a current imbalance between the milk supply and plant capacity, or that an imbalance may be reached in the near future. First, as mentioned above, the state was close to reaching a point of imbalance last summer, and that situation can only have worsened in 2012 because of the increases in milk production and the lack of new manufacturing capacity. Second, some major proprietary manufacturers, processing producer cooperatives, and marketing producer cooperatives have instituted carefully monitored programs to limit or cap milk production in the state. These programs include base programs that: surcharge producers for milk produced above their base; reduce historical producer's base; strictly enforce milk contracts and drop producers that exceed their contract; refuse milk production above bases; and buy producer's base production in order to have them go out of business. In spite of these measures, the milk production of April 2012 was still approximately 3.8 million pounds of milk on a daily basis above April 2011, which was the highest milk production in the month of April previously. It is expected that milk production on a daily basis will continue to outpace last year's milk production, which was the highest milk production year on record. Third, excerpts from the DMN Weekly Report from USDA-AMS during January 2012 to May 2012 and other

publications cited in the hearing record, indicate that California and the Western Region of the U.S. have had problems handling the milk supply and have highlighted the supply imbalance that has occurred during 2012. Testimony and Department data show that there is milk that is leaving the state and it is suspected that this milk is being discounted in order to be processed. This evidence indicates that physical plant capacity in the state has been an issue during 2012 and that an adequate supply of milk to meet the manufacturing capacity has not been an issue.

During the spring flush, milk supplies are at their cyclical peaks and it is reasonable that there will be circumstances when milk supplies will exceed plant capacity or even the demand for milk by manufacturers at the regulated minimum price based on marketing conditions. However, when milk supplies consistently exceed the demand for milk due to marketing conditions, it would appear that a continuous supply of milk in relation to demand would be met or even exceeded. Department data suggest that the milk supply is exceeding the relative demand for dairy products across all classes of milk. Using dairy product production data for the 12-month period of May 2010 to April 2011 and comparing it to the 12-month period of May 2011 to April 2012, the production of products in the higher valued classes of milk (Classes 1, 2, and 3) has decreased collectively by approximately 1.0 percent, total cheese production has increased by approximately 2.0 percent, and butter and nonfat dry milk powders have collectively increased by approximately 14.0 percent.

When these dairy product data are compared to the California milk production increase of approximately 4.2 percent over the same time period, it seems that there is an imbalance between milk supplies and milk demand. Although producer cooperatives produce butter and dried milk powders to meet customer demand, these are also the products that are made from excess milk supplies when there are no outlets for excess milk in the other classes. When comparing the change in milk supply to the change in the production of dairy products, it is clear that fresh, less storable products that tend to be manufactured to meet consumer demand (Class 1, 2, and 3 products) have actually declined. This means that these classes are using none of the excess milk supply and less milk in general. Although cheese production has increased over the time period in question, its relative increase pales in comparison to the increase in Class 4a products. Based on the equivalent amount of milk required to produce cheese, butter, and nonfat dry milk powders, the vast majority of the excess milk supplies are being processed into butter and nonfat dry milk powders. Based on declining prices of butter and nonfat dry milk powders over the last 12 months, it appears that supply is outpacing the demand for butter and nonfat dry milk powders. This strongly suggests that over a time period that extends beyond just the spring flush when milk supplies are seasonally at their peak, the milk supply increase of the last 12 months is being directed into Class 4a products. These increases in Class 4a product production seem to be the current outlet for milk supplies that are in excess of the demand for milk for the other usages.

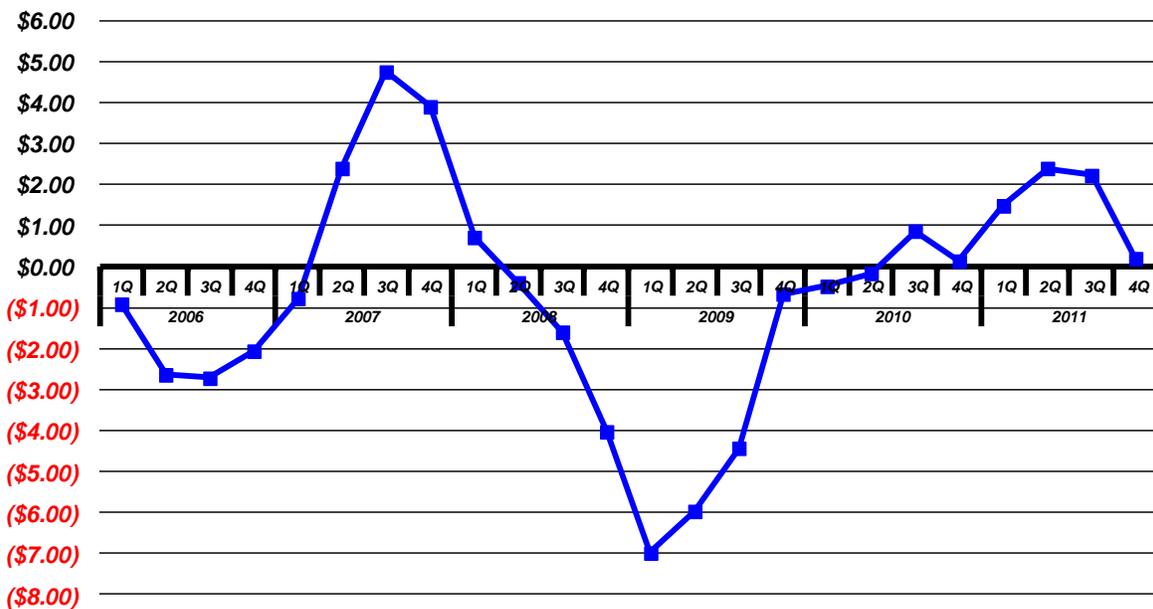
The Panel is concerned with effective plant capacity in California as it relates to its milk supplies. As discussed, excess milk supplies are being manufactured primarily into Class 4a products, while the dairy products in the other classes either decline or grow at relatively lower rates. Lack of demand for dairy products in these other classes, as it relates to milk production, is concerning. Currently, the Panel is aware of idle manufacturing capacity in plants that manufacture Classes 1, 2, and 4b products. In light of these current, observed conditions, it appears that there are more than adequate milk supplies in relation to demand in the state.

Factors Influencing Milk Production

Even though it seems that current milk supplies are more than adequate in relation to demand, an important consideration is whether or not the state's future milk production will be at satisfactory levels to maintain a sensible level of stability and prosperity in relation to demand. A review of the financial condition of dairies is needed in order to evaluate the expected future production of milk.

One principle measurement of the condition of milk production is the cost of producing milk in relation to the income or price received for milk. Using the Department's Cost of Production Survey, Figure 1 below shows the estimated difference between mailbox prices received for milk and the cost of producing milk, which is a measurement of margins on the dairy, for each quarter beginning with the first quarter of 2006 to the fourth quarter of 2011. The mailbox price includes quality payments, component and yield premiums, bonuses and monthly distribution of cooperative earnings and is a measurement of the actual income received by producers participating in the Cost of Production Survey. It has been adjusted to reflect marketing costs, which are included in the estimated cost of production. The cost of production measurement includes allowances for return on investment and return for management.

**Figure 1: Difference between California Mailbox Milk Price
Less California Cost of Production
Based on California Production Cost Survey
January 2006 through December 2011 - \$/cwt.**



The comparison between the adjusted mailbox price and the cost of production including returns for investment and management, shows that 2006 was a financially challenging year but that margins turned positive in 2007, which was primarily caused by high milk prices. By the end of 2008 to the middle of 2010, dairy farms experienced a period of severe financial difficulties due to low milk prices and relatively high feed costs that led to continual negative margins. This time period has been documented as one of the most challenging times for producers in recent history, which caused some dairies to close their operations, while

weakening the financial condition of dairies that remained in business. By the third quarter of 2010 through the end of 2011, producer margins turned positive again due to higher milk prices and lower feed costs.

Over a long-term time horizon, margins on the dairy are indicative of whether milk production will remain constant or change. Economic theory states that in order to produce a particular product over a long-term time period, financial margins (which include some level of economic profit) must be at least at break-even levels. Over the long term, an operation cannot survive with negative margins. When comparing milk production growth with dairy margins, it is not surprising to note that in 2007, 2008, and 2011 milk production growth was increasing when margins were positive, and milk production growth decreased or became negative when margins were negative.

At the time of the hearing, the Department's Cost of Production Survey data for the first half of 2012 were not available in order to review producer margins. However, the hearing record contains cost of production estimates from USDA and various accounting firms that indicate the costs in 2012 have continued at relatively similar levels in the face of declining milk prices, which indicate that producer margins may become negative again. Some representatives testified that financial conditions on the dairy are worsening and that dairies may continue to struggle financially and go out of business. Feed costs are a primary driver of deteriorating financial conditions. Dairies that grow little or none of their own feed are especially impacted by rising feed costs that include the cost to transport feed into California from other areas of the U.S., where feed is primarily grown.

In reviewing the health of dairies and the milk production capacity of the state, the Panel continues to believe that milk production will continue at adequate levels in the future. Department data show that the negative margins of second quarter 2008 to second quarter 2010 had an adverse affect on dairy operations. During that time period, there were dairies that could not continue to operate because of the individual financial condition of those dairies. Additionally, there were other dairies that were able to remain in business during that time period, but had their financial condition weakened to the point that any future decline in margins could inevitably cause the dairies to shut down. On the other hand, Department data also show that there are other dairies that are in a better financial condition to continue their operations due to factors such as: efficiencies of size, economies of scale, lower debt burdens, less leveraged positions at the beginning of the period of negative margins, etc. Cow numbers data and anecdotal evidence show that in the face of dairies going out of business, there are other dairies that have been expanding their cow numbers and increasing milk production, which show that not all dairies are on the brink of shutting down. Additionally, Department data show that there are certain dairies that have average costs below the statewide average that are in a better financial situation than others. Although there are dairies experiencing financial difficulties to the point of going out of business, there are others that are in better financial circumstances. There are other factors influencing milk production choices in California, beyond margins on the dairy, which are indicative of future milk production. These factors include management practices and other economic motivations that are detailed in Appendix E.

In the end, it should be recognized that the collective milk production decisions of many individual dairy producers at the farm level determine the size of the state's total milk supply that must be related to demand. Only dairy producers have the collective ability to directly influence the number of cows on dairy farms and the quantity of milk produced. The hearing record contains testimony from producer representatives stating that it is the individual dairy's

decision how much milk to produce and how many cows to milk. However, the aggregate result of the individual milk production decisions on each dairy influences the state-level milk supply in relation to the demand for milk and dairy products. In light of all of these factors, which include the cost of feed, factors influencing milk production, and margins on the dairy, the Panel expects that milk production should continue at adequate levels in the future as it relates to demand for milk.

Orderly Marketing of Dairy Products

Economic theory dictates that for intelligent production and orderly marketing of dairy products to occur, there must be a sound, economic relationship between milk production and the marketing conditions of the products manufactured from milk. The regulated milk price, such as the Class 4b price, must allow for dairy products to be marketed to the customers and consumers of the dairy products. When milk supplies exceed demand or are not soundly related to general marketing conditions, then negative economic outcomes occur.

When milk supplies do not correlate well with demand for dairy products, there are risks to marketplace stability and order. If milk supplies outpace the demand for the dairy products, then manufacturers will not procure the entire milk supply leaving an issue of how to clear the market of excess farm milk. In the face of current demand conditions for farm milk among the various classes, in order to clear the market, milk supplies must either leave the state to be processed or be manufactured into larger quantities of butter and nonfat dry milk powders, regardless of the demand for these two products. There are negative economic consequences of these situations that affect all industry stakeholders. First, when excess milk is manufactured into butter and nonfat dry milk powders above the demand for these products, these product prices are depressed and the milk price declines, which negatively affects producers in the long run. When milk leaves the state to be processed, both producers and processors are negatively influenced. When excess milk leaves the state at discounted prices, producer revenue declines. Additionally, out-of-state manufacturers processing that milk are able to produce dairy products at a relatively lower cost and then use that lower cost as a competitive advantage over California manufacturers. If too much excess milk were to consistently leave the state, then California manufacturers would lose customers for this product, which would require them to procure less milk. By procuring less milk, the excess milk supply would grow and the situation could be exacerbated.

Given the statutory requirement in California that all manufacturers must legally pay at least the regulated minimum price for Grade A milk, it is critical that the price of the manufacturing classes of milk in California (which includes the Class 4b price) be established at a level that will ensure California's total milk production will clear the market by finding effective plant capacity that has a sound economic relationship to demand. Failure to do so will place pressure on the minimum pricing system and result in economic waste. The Panel believes that the establishment of minimum prices that clear the market of milk supplies is important and that market clearing prices are a relevant economic factor requiring consideration. Based on the factors influencing milk production, including margins on the dairy and other economic motivations, the Panel believes that future milk supplies will be adequate to meet the demand conditions in the marketplace given the current milk pricing levels. However, it is difficult to predict future conditions affecting milk production and how the general supply and demand for farm milk may change in the future, so future consideration of this issue could be addressed again if supply and demand conditions were to change significantly.

DISCUSSION OF ISSUES AFFECTING THE CLASS 4b WHEY FACTOR

The Whey Factor in the Class 4b Pricing Formula

In view of various Code mandates for establishing class prices, California and federal order differences in regulatory systems, and marketing conditions present in the California dairy industry, establishing a Class 4b price based on relevant economic conditions involves thorough investigation. In particular, structuring the whey factor in the Class 4b pricing formula involves properly evaluating market conditions for whey proteins including market prices, manufacturing costs, production levels and demand and sales in addition to considering the relationship with the national value of manufactured milk products.

The whey factor in the Class 4b pricing formula was first implemented as a result of a hearing held in January 2003 and was designed to reflect the value associated with further processing dry skim whey. The whey stream has historically been viewed as a waste by-product of the cheese making industry, and investing in whey processing was a method for recovering a value for whey while mitigating increasing environmental regulations.

As the number of applications for whey has grown, the industry has recognized that whey is a marketable product with value rather than just a costly by-product. The whey stream can be processed into a number of different forms depending on the desired protein content and other specifications and can be used in a wide variety of food and non-food products. However, the process of recovering the milk solids (fat, protein, and milk sugars) from the whey stream requires significant investments in technology and equipment. The economies of scale necessary to realize a positive return on whey processing has hindered most small and medium-sized cheese plants from making these investments.

The inclusion and structure of a whey component in the Class 4b pricing formula has been a major topic of discussion and has undergone three fundamental transformations in the past decade. Prior to 2003, there was no whey factor included in the valuation of Class 4b milk. In early 2003, a variable whey factor with a yield and make allowance similar to the federal order pricing formula was established and remained in place for over four years. During this time the make allowance for dry whey was updated periodically as the Department released annual manufacturing cost data. Following the cost study released in 2007, the Department was no longer able to publish cost data for dry whey because of confidentiality rules.

As a result of the hearing held in October 2007, a fixed whey factor of \$0.25/cwt. replaced the variable whey factor and remained in the pricing formula for nearly another four years. The Department concluded that the variable whey factor was no longer a viable pricing method and implemented this change to address the highly volatile whey market, provide constant value to producers, and limit the negative impact on cheese plants that do not process whey. The Department was specifically concerned with dry whey being the commodity used in the pricing formula because most California plants did not process the whey stream into a dry form of whey, and those plants making a dry form manufactured products other than dry whey.

Following the hearing in June and July 2011, the Department removed the fixed dry whey factor and implemented a sliding scale with a floor of \$0.25/cwt. and a cap of \$0.65/cwt., based on movements in the dry whey commodity price. The scale allowed the dry whey

factor to be market-driven while striking a reasonable balance between producers and processors.

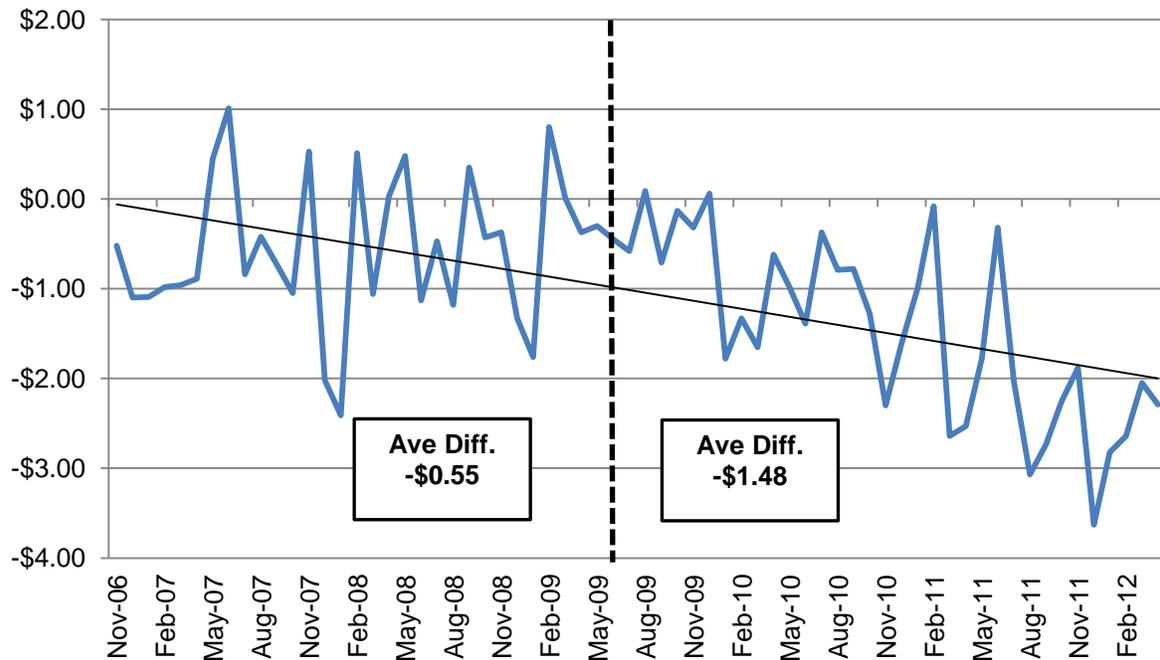
Price Alignment

One of the central themes in the testimony provided in the hearing record was the price alignment between the California Class 4b and the federal order Class III pricing formulas and how the whey values in these pricing formulas affect alignment. The petitioners proposed changing the whey factor to increase the whey value in the Class 4b pricing formula and reduce the difference/spread between the two prices. The alternative proposal returns the whey value to a fixed \$0.25/cwt. in the Class 4b pricing formula and increases the difference between the two prices. As discussed in previous sections of this report, there are a number of relevant economic factors that the Department must take into consideration when establishing prices, and differences in the regulatory and marketing conditions of the California and federal order systems preclude a strict comparison of the two class prices. However, a comparison of how the Class 4b and Class III prices have performed historically provides a basis for ensuring that calculated prices are in a reasonable and sound economic relationship with the national value of manufactured milk products.

Data show that during the past few years, the average spread between the Class 4b price and Class III price has grown, partly due to the difference in the methods used to calculate the whey value. To review price alignment, the Department examined historical Class 4b and Class III prices from November 2006 to April 2012. November 2006 was a month in which changes to the Class 4b pricing formula took effect following a hearing, and April 2012 was the most recent month of available class price data. This timeframe was divided into two time periods that are of similar length and that exhibit intervals of both high and low values for whey commodity prices. The two time periods under consideration are: (1) November 2006 to June 2009 and (2) July 2009 to April 2012.

Figure 2 shows the difference between the historical Class 4b and Class III prices from November 2006 to April 2012. Analysis shows that from November 2006 to June 2009, the historical Class III price was on average \$0.55/cwt. higher than the historical Class 4b price. For the more recent period from July 2009 to April 2012, the Class III price was on average \$1.48/cwt. higher than the Class 4b price. This indicates that the difference between the two class prices has grown by \$0.93/cwt.

**Figure 2 - Historic Price Difference: Class 4b less Class III (\$/cwt.)
November 2006 to April 2012**



The discussion of price alignment from the hearing record mainly focuses on the differences in how the two pricing formulas establish a value for whey. There are a number of other variables that contribute to differences in the Class 4b and Class III prices including: different commodity price series for Cheddar cheese and butter; manufacturing cost allowances and yields for each commodity; structure of the pricing formulas; and time periods. However, testimony emphasizes that the whey factor is the main source of the growing difference in the two class prices. From November 2006 to June 2009, the whey factor accounted for roughly 37 percent of the difference between the historical Class 4b and Class III prices. From July 2009 to April 2012 the whey factor was about 75 percent of the difference. For the entire period November 2006 to April 2012, the whey factor was responsible for 65 percent of the historical difference in the two prices.

When comparing the historical difference between the Class 4b and Class III prices, it is important to take into consideration that since November 2006 there have been three different whey factors in place in the Class 4b pricing formula. A variable dry whey factor with a make allowance and yield was in the pricing formula until November 2007, followed by a \$0.25/cwt. fixed whey factor until August 2011, and finally a dry whey scale with steps ranging from \$0.25/cwt. to \$0.65/cwt. that is currently in place. During this time, the dry whey make allowance in the federal order Class III pricing formula was also updated three times. Other revisions to make allowances in both the Class 4b and Class III pricing formulas and f.o.b. adjusters for butter and cheese in the Class 4b pricing formula were implemented during this time as well. As a result, a direct comparison of historical prices introduces an array of variables into the analysis.

Examining the relationship between Class 4b and Class III prices, assuming both current pricing formulas were in effect from November 2006 to April 2012, allows for a comparison of how the current dry whey scale in the Class 4b pricing formula, which has been in place for less than one year, would perform when the whey market is at different levels. This method of observing the current sliding scale in effect for the entire period can help indicate what future

alignment between Class 4b and Class III prices might be assuming all other pricing formula changes (make allowances, f.o.b. adjusters, etc.) are held constant and as the current dry whey scale responds to variations in the dry whey commodity price.

An analysis of current Class 4b and Class III pricing formulas validates the fact that the spread between the two prices has grown in recent years. However, when the current dry whey scale is in place for an extended length of time and the dry whey commodity price fluctuates, the growth in the difference between the two class prices is substantially reduced compared to the performance of the two historical pricing formulas. The following table summarizes the Class 4b and Class III price alignment under two scenarios:
 Scenario 1 - uses historic announced class prices for the time period; and
 Scenario 2 - uses historic commodity prices and assumes the current pricing formula was in effect for the time period.

Table 2 - Class 4b and Class III Alignment: Historic Prices and Current Pricing Formulas - November 2006 to April 2012

Class 4b less Class III:	Nov 06 - Jun 09 (\$/cwt.)	Jul 09 - April 12 (\$/cwt.)	Change in Alignment Between Periods (\$/cwt.)
Scenario 1	-0.55	-1.48	-0.93
Scenario 2	-0.85	-1.34	-0.49

When looking at Scenario 1, the spread between the Class 4b and Class III prices increased by \$0.93/cwt. during the two time periods (November 2006 to June 2009 compared to July 2009 to April 2012). When looking at Scenario 2, the spread between the two prices increased by \$0.49/cwt., a considerably smaller change. This indicates that the growing spread in the class price alignment is influenced by several interrelated factors, with the whey factor being just one element.

Although it is evident that the alignment between Class 4b and Class III prices has changed in recent years, this change has occurred at the same time that the dairy industry has undergone fundamental changes, with dairy prices and marketing conditions in California, the U.S. and the global market becoming more integrated and more volatile. Changing economic factors within the California market include milk production increases, excess milk supply flowing into Class 4a products, and fluctuating input costs such as feed costs. Factors influencing the national and international dairy markets include fluctuations in demand for dairy products, growing milk supply and production levels of manufactured dairy products in other countries, and the occurrence of extreme weather events. Volatility due to these and other factors seem to create conditions that exert greater influence on dairy markets than strict price alignment issues.

Whey Commodity Markets

When considering the proposed changes to the dry whey sliding scale in the Class 4b pricing formula, the Panel continues to have many of the same concerns that influenced the decision following the 2011 hearing. First, dry whey is not universally produced by California cheese processors that process their whey, so establishing a whey factor based on a commodity for which limited relevant price and cost data is available continues to be an inexact science. If the price of dry whey does not move with the prices of whey products that are made by

California cheese processors, then the whey value incorporated into the Class 4b pricing formula is not representative of actual manufacturing conditions. Second, the price of dry whey is strongly influenced by international market conditions including supply, demand, and exchange rates, and these influences may not correlate with the manufacturing and marketing conditions of California processors. With more than half of the dry whey produced in the U.S. marketed internationally, it is difficult to accurately predict prices and associated volatility. Third, the whey factor imposes a direct cost on manufacturers that do not process whey. Incorporating a value for whey in the Class 4b pricing formula that is not representative of the California market must be done cautiously so as not to disrupt orderly marketing conditions.

As part of the discussion of whey valuation, price alignment, and maintaining satisfactory marketing conditions, the Department analyzed dry whey prices from November 2006 to April 2012. An explanation of the Department's analysis can be found in Appendix F. From November 2006 to June 2009, dry whey commodity prices moved within a fairly large range, but more than half of the observations were concentrated between \$0.10 and \$0.30 per pound (see Figure 3 in Appendix F). During the more recent period from July 2009 to April 2012, dry whey prices remained in a much tighter range and roughly two-thirds of the observations fell between \$0.30 and \$0.50 per pound (see Figure 4 in Appendix F).

The change in distribution of dry whey prices between the two periods highlights the evolving nature of the whey market. Analysis shows that although extreme lows and highs in dry whey values are possible, it is more likely that future prices will move within a \$0.30 to \$0.70 range. The dry whey scale proposed by the petitioners establishes steps for dry whey commodity prices that move within a range of \$0.20 to \$0.92 per pound. Given historical whey prices, the proposed range appears to be fairly wide with the floor price being reached on occasion and the ceiling being reached rarely, if ever. The alternative proposal to return to the fixed whey factor of \$0.25/cwt. in the Class 4b pricing formula suggests that whey values should be scaled back to more conservative levels.

In evaluating the current dry whey sliding scale in the Class 4b formula and proposed changes to the scale, it is important to recognize that a number of factors have driven recent changes in the whey protein market. First, global demand for dry whey and other whey protein powders has increased as emerging economies in Asia and throughout the world adopt more western-style diets and as food companies find more uses for whey products. As referenced in testimony from the hearing, it is generally recognized that whey protein has a market value, and it is commonly added to products including health foods and functional beverages. Second, the supply of dry whey in the U.S. has remained fairly constant over the past three-to-five years even as demand has strengthened. Some production has shifted away from dry whey to whey protein concentrates and isolates as customers demand higher protein content and more specialized products. In California, most of the cheese plants that process their whey stream produce something other than dry whey. Finally, the majority of U.S. whey production is exported, so the whey market is heavily influenced by both national and international market conditions. For example, dry whey sales and price levels can fluctuate with exchange rates, the income levels of consumers in developing countries, natural disasters such as flooding or drought in countries that produce and export dairy products, and food shortages in countries that import dairy products.

Current Whey Factor Sliding Scale

The current dry whey sliding scale in the Class 4b pricing formula was implemented by the Department following the hearing held in June and July 2011 to balance the needs and concerns of all industry stakeholders and to maintain satisfactory marketing conditions among producers, cooperatives, and small and large proprietary cheese plants. The Department established the scale based on an analysis of the likely values of dry whey commodity prices. While it appears that dry whey prices and demand for whey proteins have strengthened in recent years, this movement is impacted by a number of regional, national, and international factors. The Panel continues to believe that the implementation of the current dry whey sliding scale was justified when considering all relevant economic factors. Additionally, many of the needs and concerns voiced at the current hearing were similar to testimony presented at the 2011 hearing, indicating that it continues to be difficult to establish a fair and reasonable value for whey in the Class 4b pricing formula.

The dry whey scale implemented in 2011 was intended to be more gradual and less volatile than a variable end-product pricing factor while also providing a more market-oriented value than a fixed factor, and it was implemented with the idea that it could be revised and updated based on California conditions. The previous proposals in the 2011 hearing were much closer to the current scale than the proposals introduced at the current hearing. The Panel believes the current petitioners' proposed scale does not appear to balance the needs of stakeholders to ensure orderly marketing. The proposed scale is based on the end-product pricing factor in the Class III pricing formula, indicating that it introduces both volatility and non-California marketing conditions into the whey valuation in the Class 4b pricing formula. The alternative proposal's fixed factor is also not representative of California or any other marketing conditions because it is not tied to the whey markets and does not respond to market signals. Both producer and processor organizations testified in 2011 that a sliding scale was preferable to a fixed factor because the pricing formulas should be market-driven.

The price floor, cap, and range of dry whey values in the current sliding scale were put in place by the Department to allow the whey factor to respond to changes in the market while limiting financial burden. The floor and cap were established to protect both producers and processors from extreme fluctuations in the dry whey commodity price rather than to artificially floor or cap the value for an extended period of time. An analysis of the correlation between the Class 4b and Class III prices shows that the current Class 4b price is highly positively correlated and moves closely with the current Class III price. A positive correlation implies that as one price moves up or down, the other price moves in the same direction. Although the spread between the two prices has grown in recent years, the correlation has remained relatively consistent, indicating that the two prices continue to maintain a reasonable and sound economic relationship. Additionally, the implementation of the current sliding scale in the Class 4b pricing formula significantly increased the correlation with the Class III whey factor compared to the historical formula.

One of the major concerns among industry stakeholders is the ability to use risk management tools to hedge the price of milk. Producers, cooperatives, and producer trade organizations testified that the Class III futures market is the tool most often used by producers to hedge milk. However, differences between the whey values in the California Class 4b and federal order Class III prices preclude California producers from hedging effectively because of additional basis risk. When the relationship between the two pricing formulas varies significantly, specifically with regard to the whey valuation in the two formulas, California producers are at a disadvantage to producers in the federal order.

Adopting a Class 4b price that more closely resembles the Class III price, as proposed by the petitioners, would somewhat improve basis volatility by allowing the two prices to be closer to parity. However, California producers are paid based on a combination of prices received from Classes 1, 2, 3, 4a and 4b milk rather than based solely on the Class 4b price, meaning that any hedging strategy should be based on the overbase or mailbox price. In 2011, California's Pool utilization was 43 percent Class 4b and 35 percent Class 4a. Since milk going into cheese (Class 4b) and butter and powder (Class 4a) together account for more than three-quarters of the Pool utilization, it is reasonable to conclude that hedging strategies among producers in California should include a combination of Class III and Class IV contracts (which are the equivalent classes in the federal order).

According to Department analysis, hedging using a combination of Class III and Class IV futures is a much more effective hedging strategy for California producers than using just the Class III futures market. Even when setting the Class 4b price equal to the Class III price, basis volatility remains the lowest when using a combination of the two futures markets. Correcting for differences in the Class 4b and Class III prices only partly addresses the issue of basis volatility because the Class 4b price is just one of the prices included in the price paid to California producers.

While establishing a hedging strategy based on a combination of Class III and Class IV futures would help reduce basis volatility for California producers, the Department is aware that the Class IV futures market is very lightly traded compared to the Class III market. Consequently, California and all federal orders which have lower Class III utilization than the Upper Midwest (which had a Class III utilization of 82 percent in 2011) face the challenge of using risk management tools that are not responsive to their specific markets. The problem with risk management tools available to dairy producers is therefore more an issue of the availability and liquidity of those tools rather than the regulated pricing structure.

Impact of Whey Sliding Scale on Industry Stakeholders

Changes to the dry whey factor in the Class 4b pricing formula would result in direct financial impacts to both producers and processors, and the Department must consider all regulatory impacts to ensure that policy promotes, fosters, and encourages the intelligent production and orderly marketing of market milk. Increasing the dry whey factor as proposed by the petitioners would increase producer revenue in proportion to Class 4b utilization in the Pool and increase processor costs by the same level as the change in the whey factor. Reducing the dry whey factor as proposed by the alternative proposal would have the opposite effect on producer revenues and processor costs.

Many of the arguments for changing the current whey factor in the Class 4b pricing formula focused on the issue of equitably sharing the whey stream revenues among industry stakeholders. Those that supported the petitioners' proposal testified that as whey values have risen, more of that value should be returned to the producers through the whey factor in the Class 4b pricing formula. Conversely, those in support of either the alternative proposal or making no change testified that frequent changes to the regulatory environment discourage plant investment, product innovation, and long term business decisions.

The topic of competitive advantage was discussed at the hearing as an important consideration in establishing the level of the dry whey factor. Testimony supporting the petitioners' proposal noted that cheese manufacturers in California experience significant

advantages and pay a lower price for milk than manufacturers in federal orders. Those opposing the petitioners' proposal testified that the price difference between the California and federal order systems has not been substantial and that cheese makers in recent years have invested outside of California despite the relatively higher price of milk in federal orders. According to Department data, California cheese production numbers do not indicate that significant resources have been shifted to take advantage of the price of Class 4b milk. Although the difference between the Class 4b and Class III prices has grown in the past few years, cheese production in California has grown at a slower pace than milk production as a whole. California and other top cheese producing states in the federal orders have experienced similar growth in cheese production. This may indicate that cheese production is influenced less by the price of milk than market demand, sales, or other factors. These other factors include regulatory and environmental factors associated with the construction of new cheese manufacturing capacity in California, which industry stakeholders have described as unfavorable compared to other states. Meanwhile, butter and powder production have grown at a higher rate than milk production while the combination of Class 1, 2, and 3 production has declined.

Organizations in support of the petitioners' proposal testified that the whey factor impacts the competitiveness of producers, and failure to capture the full value of whey in the Class 4b pricing formula negatively impacts the viability of California producers. The producer community is still struggling to recover from the losses incurred during the global economic recession that negatively impacted producer prices and margins in 2009. Even as prices have improved, cost of production has been increasing since 2010 which has caused difficulties for some producers to regain and rebuild lost equity. One organization testified that in the event of another economic downturn, California producers will be increasingly financially vulnerable.

The ability of small and medium-sized cheese processors to adjust to increases in the Class 4b price was also debated at the hearing. Most small and medium-sized cheese plants either do not process whey or struggle to return a profit from the whey stream. One medium-sized cheese plant testified that while it invested in the facilities to manufacture whey protein concentrate in 2005, it has not seen a return on the investment mainly due to lack of volume. Another medium-sized cheese plant testified that it is attempting to develop a whey protein concentrate plant, but that increasing the price of Class 4b milk as proposed by the petitioners would make the project unfeasible. According to Department data presented at the pre-hearing workshop, only 11 of 57 cheese plants in California process whey in some form, and these plants are among the largest in the state. For most small and medium-sized cheese processors, production volume is not large enough to provide financial incentive to invest in whey processing facilities. Similarly, transportation costs prohibit whey being shipped long distances to be processed at other locations. Testimony indicated that transporting whey to a central location for further processing in the Upper Midwest is a viable option for small cheese plants because of proximity; however, cheese plants in California are separated by much greater distances which make the shipment of their whey streams increasingly uneconomical.

As evidenced from this discussion, it is difficult to balance the needs of all industry stakeholders while maintaining satisfactory marketing conditions. The Department analyzed a range of issues at the individual dairy and plant level as well as at the aggregated market level. At the individual plant and dairy level, input costs and profit margins, which are largely influenced by the price of milk, play an important role in producing milk and marketing dairy products. At the aggregate level, orderly marketing involves an adequate and continuous

supply in relation to the demand for dairy products. In addition to the price of milk, the aggregate market is influenced by imbalances such as shortages or oversupply of milk and dairy products that occur as a result of the interaction among production volumes, processing capacity, and consumer demand and sales. The Department continues to believe that while the financial situation and production decisions of individual entities will vary based on each organization's size, debt burden and financial structure among other characteristics, milk production in California will continue at adequate levels while processing capacity will remain constant. Significantly increasing the whey factor in the Class 4b pricing formula as proposed by the petitioners or decreasing the whey factor as proposed by the alternative proposal would distort rather than promote intelligent production and orderly marketing.

CONCLUSION

In reaching a recommendation, the Panel considered factors cited in the *“Economic Considerations for the Proposed Changes to the Pricing Formulas”* (see Appendix G) section of this Panel Report and examined all relevant Code sections, economic factors, analysis, information and testimony in the hearing record and Panel Report. After careful consideration of current conditions and the above listed factors, the Panel has determined that a change to the whey factor in the Class 4b pricing formula is not warranted. The current Class 4b pricing formula maintains a sound economic relationship between the state's milk production and marketing conditions for manufactured dairy products.

Panel Recommendation

The Panel recommends that no changes be made to the whey factor in the Class 4b pricing formula at this time.

This Hearing Panel Report has been prepared and submitted by:

Original Signed by:

Original Signed by:

Candace Gates, Branch Chief

Hyrum Eastman, Dairy Economic Advisor

Original Signed by:

Amber Rankin, Agricultural Economist

California Food and Agricultural Code

Sections 61801 and 61802 provide a mandate that states that the production of milk is a business affected with a public interest, that milk is a necessary food for human consumption, and that health regulations alone are not sufficient to prevent economic disturbances in the production of milk; therefore, as stated in Section 61802(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.” Section 61805 states that the Secretary should determine prices based on varying factors like the cost to produce milk, health regulations, transportation, and other factors, and with the aid of the state, should enable the dairy industry to develop and maintain satisfactory marketing conditions while bringing about and maintaining a reasonable amount of stability and prosperity in milk production. These two sections provide the Secretary with (1) the authority and (2) the overarching mandate to promote overall stability in the marketplace by ensuring the intelligent production of milk at the farm level and a corresponding orderly marketing of dairy products made from farm milk.

Sections 61806 and 61807 seem to provide the Secretary with broad power in setting prices and the mandate to facilitate the state’s milk supply. Section 61806 states that, “It is the intent of the Legislature that the power conferred in this chapter shall be liberally construed.” Section 61806 is found in Chapter 2, Part 3, Division 21 of the Code along with Section 62062 and other sections of the Code mentioned above, which indicates that the Secretary has been given liberal authority in establishing prices. Section 61807 states that prices should be established that, “under the varying conditions of production, ensure an adequate and continuous supply of pure, fresh, wholesome market milk to consumers of the market milk.” This indicates that prices should be set at levels that will allow for an adequate amount of milk to meet the needs of consumers of market milk.

Sections 62076 and 62077 provide factors for consideration in establishing prices that are associated with Class 2, 3, 4a and 4b milk and the minimum price laws of California. When establishing prices for Class 2, 3, 4a, and 4b milk, Section 62076 states that the Secretary “shall take into consideration any relevant economic factors” that include, but are not limited to the value of the various products manufactured from milk (Section 62076(a)), the price of other milk used for the same purposes in the respective classes listed above (Section 62076(b)), and the value of manufacturing milk while “giving consideration to any relevant factors including, but not limited to, product prices, product yields, and manufacturing costs of Class 4a or Class 4b” (Section 62076(c)). This section reiterates the concept of considering any relevant economic factors available in order to make appropriate pricing decisions. Additionally, this section mandates the consideration of the prices of the dairy products manufactured in the state along with the value of milk used in the various classes. Section 62077 states that handlers in California shall not pay any producer less than the regulated minimum prices for milk. This section cites current law that all handlers must pay at least the regulated minimum price for market milk for the various classes, regardless of the dairy products manufactured from the milk or the Pool status of the handler.

Minimum Pricing Regulations in California and Federal Orders

There are certain plants in federal orders that choose to always remain outside of the federal order's pool to escape minimum prices. The Panel is aware of a cheese manufacturer in California that also has a cheese plant located in a federal order that does not participate in the federal order's pool at any time. By doing so, this plant is able to procure milk at levels under the minimum Class III price and negotiate milk prices independent of the regulatory system of the federal order. A representative of this cheese manufacturer testified that there are long-term milk contracts that have been executed at values below the Class III price. Therefore, there is evidence that some manufacturers always remain outside of the federal order's pool to negotiate milk prices independent of the pricing system.

However, it is probably unlikely that such plants are able to always negotiate prices lower than the regulated minimum price. Undoubtedly there will be times during the year when the demand for milk will exceed the milk supply or when the needs of manufacturers to procure milk to meet their customer's needs for their dairy products will cause negotiated milk prices to come in line with the minimum regulated class price. Representatives of two different producer cooperative organizations testified that in unregulated areas, such as Idaho, and in federal orders there are manufacturers that must pay at least the regulated minimum price in order to compete with other manufacturers that do pay the regulated minimum price. Although economic theory would suggest plants would have to pay at least the regulated minimum price during certain parts of the year, there is the flexibility to pay below the regulated minimum price when the circumstances allow it.

In order to empirically evaluate the effect on federal orders of milk sold below minimum prices, one could analyze the quantity of milk sold below minimum prices and the actual prices paid for this milk. The hearing record contains data obtained from the United States Department of Agriculture's Agricultural Marketing Service (USDA-AMS) that show the percentage of milk across all federal orders that was de-pooled for pricing reasons for the years 2000-2011. The data show that the percentage of de-pooled federal order milk ranges from approximately 2.11 percent to approximately 7.70 percent, except for 2003 and 2004 when the approximate percentage of de-pooled milk was 13.47 percent and 16.86 percent respectively. Various representatives testified that there was no available data showing the actual prices paid for this de-pooled milk. Data showing the actual prices paid for de-pooled milk would allow for further analysis to determine the effect the de-pooled milk had on the pricing system overall. However, in the absence of data showing the price paid for de-pooled milk, representatives supporting the petitioners' proposal asserted that the effect of de-pooled milk is minimal because the percentage of de-pooled milk to the total milk is relatively small. As a result, they asserted that the differences in the federal order and California systems are not substantial.

When reviewing the issue of milk sold below the regulated minimum price in federal orders, it is important to consider not only milk de-pooled as mentioned previously, but also: milk purchased from manufacturers that never pool their milk, distressed milk, and milk that must be sold during times when milk supplies exceed demand (i.e. during the spring flush, holiday periods, etc.). The hearing record indicates these other circumstances, besides de-pooling, do occur when milk must be sold below minimum prices in order to clear the market. These other circumstances must also be taken into consideration in conjunction with de-pooling in order to evaluate the combined effect they have on the federal order pricing system.

In an effort to empirically analyze the total amount of non-pooled milk produced in federal orders, and therefore specifically not required to be priced at least at the regulated minimum price, the Department estimated the quantity of milk produced within federal orders that is not pooled. The milk not pooled in federal orders would include de-pooled milk, distressed milk, milk purchased/sold when milk supplies exceeded demand, and milk that was never pooled at all. By using annual state-level milk production data and pooled milk data published by United States Department of Agriculture (USDA), the Department estimated the total quantity of milk produced within federal orders and subtracted the quantity of milk pooled within federal orders from it. First, each individual state's production was accounted for based on whether or not the state is located within a federal order. The milk production of states that lie partially within federal orders were adjusted for using annual statistical material from each federal order that summarizes individual state milk production associated with the order. With regards to pooled milk quantities, the pooled milk production of states located outside of a federal order boundary were also adjusted for using the annual statistical material from each federal order. This method yielded an estimated non-pooled milk production in all federal orders in 2011 of approximately 9 percent, of which approximately half (4.3 percent) is de-pooled milk for pricing reasons as estimated by USDA-AMS.

Unfortunately, there does not appear to be public or USDA compiled data available that show the quantities or prices of milk sold below regulated minimum prices in these other circumstance besides de-pooling; however, there is information in the hearing record that indicates these other circumstances do occur and the effect on the federal order pricing system is relevant. The hearing record contains excerpts from various editions of the DMN Weekly Report from USDA-AMS during January 2012 to May 2012. These excerpts cite many different weeks during this time period when milk supplies were sold below minimum class prices in the magnitude of up to \$5.00/cwt., in order to clear the market of the milk supplies that were either in excess to the demand for milk at regulated prices and/or in excess to available plant capacity. In some cases, the excess milk from one state was displacing local milk in another state furthering the need to discount milk below minimum prices.

In addition to USDA-AMS, stakeholder representatives provided evidence of milk being discounted below minimum prices in order to clear the market. A representative of a manufacturer with plants both inside and outside of California testified that the organization found itself in circumstances this spring when discounted milk was being offered to them from a source looking to clear the market of excess milk and when they needed to offer milk at discounted prices in order to clear the market. During these occasions the milk in question ranged from \$3.00/cwt. to \$7.00/cwt. below minimum prices. A producer cooperative representative with plants both inside and outside of California testified that occasionally this organization has had to offer milk at discounted prices in order to have the milk sold and processed. Although neither representative provided specific data regarding the quantity of milk that was discounted in these occasions, it is clear that discounted pricing of milk does occur and plays an important role in clearing the market of excess milk supplies that otherwise would not be purchased and processed.

The hearing record shows various explanations, which assert that the differences between the California and federal order are minimal and allow for direct comparisons between the Class 4b and Class III prices. First, USDA data show that the percentage of de-pooled milk has decreased dramatically from their relatively higher levels in 2003 and 2004 to the present. The reason for this is that federal order regulations changed specifically in order to

limit the amount of milk that could de-pool. By making it more difficult to de-pool, some representatives argue that this change has minimized this key difference between the two systems. Second, some representatives cited the economic incentive that handlers, especially producer cooperatives, have to pool their milk. Since producers that pool their milk are paid a blended Pool price that is generally higher than the Class III price due to the impact of higher Class I (milk used for fluid purposes) prices on the pool, producers and their cooperative organizations would generally have the incentive to make sure their milk is pooled. This economic incentive provides the motivation for producer cooperatives to pool as much of their milk supplies as possible. Third, since any of the manufacturing classes (Classes II, III, and IV) in federal orders can de-pool it is possible that some of the de-pooled milk in federal orders comes from the other classes besides Class III. This would then lend evidence to the idea that the effect of de-pooled milk on the Class III price is less than what would be indicated by the de-pooled milk data presented in the hearing record. The hearing record provides some empirical analysis of class prices, Pool prices, the effect of Class I prices on Pool prices, and the ultimate economic incentive to de-pool milk in Federal Order 30 (an area covering primarily the Upper-Midwest states of Minnesota and Wisconsin). This analysis indicates that over the last 5 years there has been more of an incentive for milk used for Class II and IV purposes to de-pool than Class III, which would suggest that de-pooling has had a minimal effect on the Class III price.

When reviewing relevant economic factors, the Department's analysis of non-pooled milk and the information, analysis, and data found in the hearing record, the Panel believes that the federal order system has flexibility to allow milk to clear the market when necessary, while the California system does not. Even though there is an economic incentive for producer milk to be pooled to receive higher Pool prices, there are circumstances when milk must be offered below minimum class prices, as outlined previously, in order for the market to clear. This is evidenced by the testimony stating that at times milk must be discounted in order to have it be sold and processed. Further evidence of the flexibility of the federal order system is the fact that non-pooled milk can find its way into plants of all manufacturing classes. Even if there is a greater economic incentive for Class II and IV milk to de-pool compared to Class III, the fact that de-pooling occurs in these other classes and the fact that other non-pooled, excess milk supplies may find an outlet in these other classes indicates the added flexibility of the federal order system. By having any plant of manufacturing milk, including Class III plants, take in excess milk supplies at discounted prices when necessary, a type of 'safety valve' is present that helps to facilitate stability in the overall marketplace and orderly marketing conditions. This type of 'safety valve' does not exist in the current California regulations.

Additionally, whether or not the estimated quantity of all non-pooled milk in federal orders is closer to the de-pooled milk estimate of 4.3 percent as observed in the USDA-AMS data cited previously or the estimated 9 percent of total non-pooled milk by Department analysis, flexibility in the pricing system is an important and relevant economic consideration. When milk supplies are out of balance with demand for any reason, even when the imbalance amounts to only a small percentage of the total production, the effect on the system is great. Evidence of this is the circumstances that faced the California marketplace during 2007 and 2008. A review of the October 10 and 11, 2007 hearing record, shows that California milk supplies during that time exceeded the state's effective plant capacity by an estimated 2 to 3 percent. Reports of the resulting effects in the marketplace were excess milk supplies being shipped far distances out of state to find processing capacity, milk being dumped, milk being sold to calf ranches, producers losing a 'home' for their milk, and general marketing conditions that were described as not orderly and unintelligent. Based on estimates of the

available physical manufacturing capacity in the state at the time and assuming the ability to discount milk below the regulated minimum price (as available in federal orders but not the California system), it is feasible to argue that some of the excess milk supplies could have been processed within the State of California in the form of cultured and frozen dairy products and cheese. If this were to have occurred, then it is very plausible to believe a portion of the adverse marketing conditions observed at that time could have been alleviated. All in all, the flexibility to discount milk in certain circumstances is a relevant, key difference in the two systems in question that does appear to make simple comparisons of regulated minimum prices in the two systems inappropriate.

Comparison of the Marketing Conditions of California and Wisconsin

The hearing record contains information comparing Wisconsin to California in order to assert that milk prices prevalent in the Wisconsin area of the country should serve as a point of comparison to California prices. Because Wisconsin, which is the largest part of a federal order in the upper Midwest, and California are the two largest cheese producing states in the U.S. with relatively similar total cheese production, some representatives assert that the price for cheese-milk in Wisconsin should be directly relatable to the price of cheese-milk in California. However, California and Wisconsin have very different marketing conditions, which make direct comparisons inappropriate. To begin with, Wisconsin is a milk deficit state, which means that it has to import milk in from outside the state in order to meet the demand for farm milk. The hearing record shows estimates of this deficit between 10 and 16 percent. As a result of this deficit, manufacturers are forced to compete to procure milk and must pay premiums to procure milk. This is supported by testimony from a representative with ownership interest in dairies in both California and Wisconsin. The representative advised that competition for milk supplies is fierce and that multiple buyers are available to buy milk, which indicates that demand for milk drives the market and milk prices would be relatively high. Conversely, California has been troubled with the issue of excess milk supplies in relation to demand, which is outlined previously in this Panel Report. As a result, milk supplies drive the California market, which would seem to necessitate relatively lower milk prices based on economic theory.

In addition to differing marketing conditions for farm milk, California and Wisconsin have differing conditions with regard to finished dairy products. To begin with, California is located on the West Coast of the U.S., but the national markets where dairy products are sold are located in the Central, Midwest and East Coast regions of the U.S. This requires California to incur transportation costs in order to reach these markets, which is a cost that must be factored into the price that manufacturers are able and willing to pay for milk. Wisconsin is located closer to the national markets for dairy products, which allows for reduced transportation costs and a competitive advantage over California manufacturers. Even if neither state had any milk price regulations whatsoever, economic principles related to transportation would indicate that the cost of milk for manufacturers in these two states would not be the same. Furthermore, there is evidence that Wisconsin produces more varieties of specialty or non-commodity cheeses that can be marketed differently. Economic principles show that for non-commodity or specialty products (that by definition are differentiated from other products in order to develop a brand loyalty for customers willing to pay a premium for the product), prices tend to be higher than homogenous, commodity products. Wisconsin appears to produce more of these types of cheese that command a higher price in the marketplace, and therefore, allow for a high manufacturing cost in the form of higher milk prices. USDA's Dairy Products 2011 Summary shows that 72 percent of California's total cheese production consists of Cheddar cheese and mozzarella, while only 55 percent of Wisconsin's total cheese production consists of these two cheeses. Although mozzarella cheese has many different variations and product formulas, it is primarily used in commercial outlets such as the pizza and restaurant sectors. The types and varieties of cheeses made outside of these categories tend to be specialty in nature and are made in greater quantities in Wisconsin than California. In sum, the different marketing conditions in Wisconsin and California do not allow for a direct comparison between the cheese-milk prices in these two states.

As stated previously, there are important, codified issues that must be taken into consideration when establishing the appropriate level of any class price, and in particular the Class 4b price, which is the focus of this hearing. Consideration must be given to the specific economic conditions in California, whether they are marketing conditions or others. Although analysis and comparisons with other states or regions of the U.S. are important to consider, they are a few of many important economic factors affecting pricing issues in California.

Plant Capacity

Due to national and global macroeconomic recession, the demand for dairy products decreased precipitously in the face of increasing milk production, which caused the prices of dairy products and milk prices to decrease. As a result of low milk prices relative to the cost of producing milk, producer margins turned negative, which eventually had a negative effect on milk production. During a 19-month period from October 2008 to April 2010, California milk production decreased every month when compared to the same month of the previous year, and as a result, the imbalance between the milk supply and plant capacity was eliminated as the milk supply decreased to the point where it was either equal to or lower than plant capacity. However, during 2010 milk prices began to increase as the domestic and global demand for dairy products recovered from macroeconomic recession. As milk prices increased, producer margins improved and milk production began to grow again. By the summer of 2011, the milk supply had increased to the point that plant capacity was becoming a concern again.

Factors Influencing Milk Production

In addition to margins on the dairy and the current financial circumstances facing producers, there are other factors that influence milk production and indicate that milk production levels will continue at adequate levels in the future. Based on USDA data, California milk per cow is one of the highest in the nation regardless of relative cost of production, feed cost, or margins when compared to other regions in the U.S. Some reasons for this are good management practices, efficient milking and feeding practices, and favorable weather conditions. These reasons facilitate cow comfort and favorable milk producing conditions. Other factors such as improved genetics of milking herds, availability of replacements, purchase of “higher” milk producing cows from dairies shutting down by dairies still in operation, and the use of sex semen to increase birth rate of heifers all contribute to maintaining a high milk producing herd.

There are also other current, economic motivations to produce milk that support future milk production. First, increasing milk production is one way to improve cash flow conditions on the dairy. When milk production is increased, the additional income associated with the production can be used to lower average fixed costs and increase cash flow conditions. This can be accomplished through management practices, feed ration adjustments, adding additional milking cows, or even milking three times daily. Second, banks that have provided loans to dairies generally require dairies to maintain a certain milk cow herd size or require a certain income level based on the individual dairy’s characteristics. As a result, dairy producers testified that meeting certain banking requirements affects milk production business decisions.

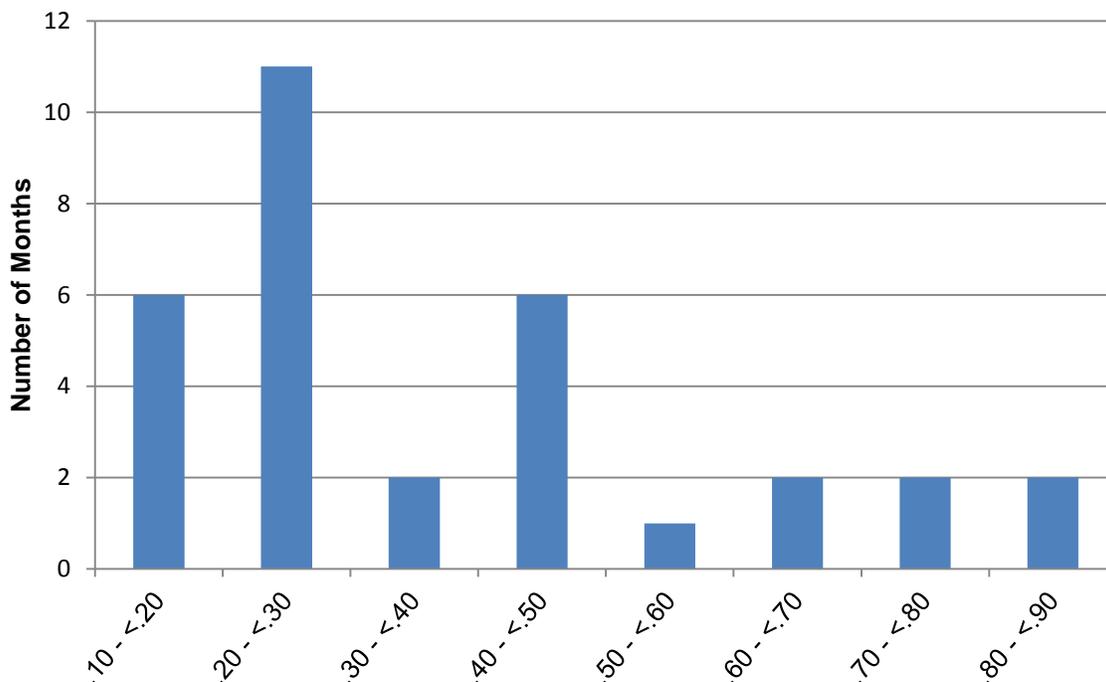
Third, as discussed in the McKinsey & Company Report, published in 2006 and 2007 and commissioned by the California Milk Advisory Board that studied the California dairy industry, producers are generally paid a Pool price for their milk, which is an average price rather than a marginal price, and this can provide an incentive to produce excess milk. In an unregulated, competitive market producers of any product are paid the value or price for each individual unit of the product produced, based on the prevailing supply and conditions in the market. As a result, each additional unit of a product produced is valued at a price commensurate with the demand for just that last unit. The price of this last unit is referred to as the marginal price. However, in California’s regulated dairy industry, each additional unit of milk produced is paid a Pool price, which is an average price based on the total revenue and quantity of all milk from all producers that participate in the statewide Pool. Generally speaking, the average price (Pool price) for additional units of milk will be greater than the marginal price (competitive price barring price regulation), especially when milk supplies are in excess of demand for milk. Therefore, even when supply and demand conditions indicate that additional units of milk would be valued at relatively low prices (marginal price), producers are paid a Pool price that is higher than the marginal price and this results in an economic incentive to increase milk production at the individual dairy level. All in all, these factors provide the incentive to increase milk production regardless of whether or not there are favorable financial margins at the dairy and contribute to the overall milk supply situation of the state.

Whey Commodity Markets

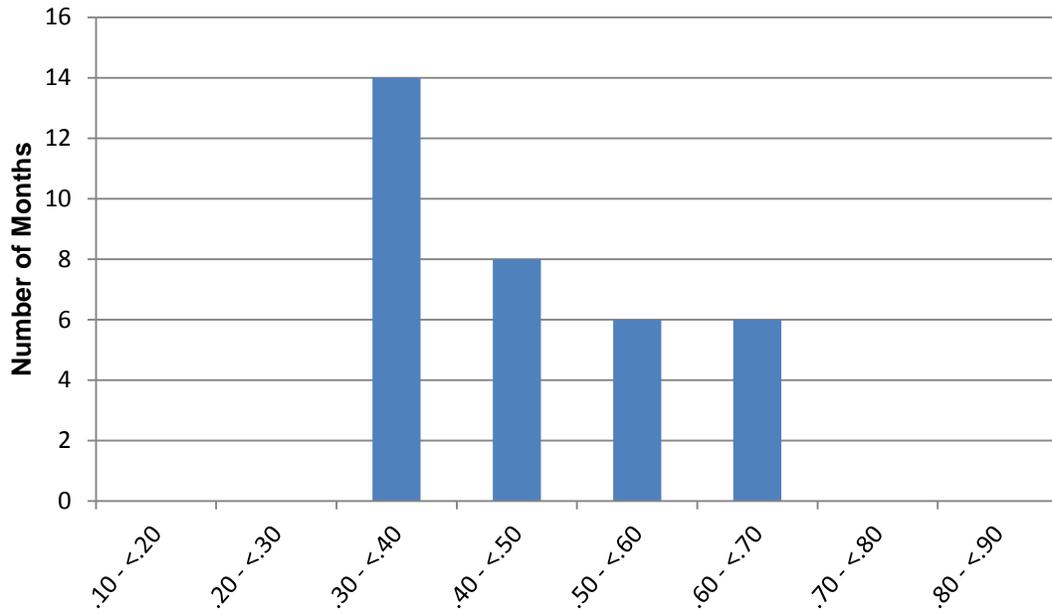
Dry whey commodity prices have exhibited large fluctuations since November 2006. The DMN Dry Whey-West Mostly price peaked above \$0.80 per pound in the spring of 2007 and then fell to just below \$0.15 per pound in January 2009. Over the past few years, the dry whey price has experienced steady growth and has consistently remained above average prices observed prior to 2006. This recent trend of higher average dry whey prices has impacted the alignment between the Class 4b and Class III prices and tends to suggest that the whey protein market is undergoing structural changes.

As part of the discussion of whey valuation, price alignment, and maintaining satisfactory marketing conditions, the Department analyzed dry whey prices from November 2006 to April 2012. The following two figures (Figures 3 and 4) show the distribution of the monthly average DMN Dry Whey-West Mostly prices during the same two time periods outlined previously: from November 2006 to June 2009 (32 months) and from July 2009 to April 2012 (34 months). The horizontal axes create ranges of \$0.10 per pound to show how many months in each time period the dry whey price falls into different price ranges. During the first period, dry whey commodity prices moved within a fairly large range, but more than half of the observations were concentrated between \$0.10 and \$0.30 per pound. During the more recent period, dry whey prices remained in a much tighter range and roughly two-thirds of the observations fell between \$0.30 and \$0.50 per pound.

**Figure 3 - Distribution of Monthly DMN Dry Whey Prices (\$/lb.)
November 2006 to June 2009**



**Figure 4 - Distribution of Monthly Dry Whey Prices (\$/lb.)
July 2009 to April 2012**



ECONOMIC CONSIDERATIONS OF THE PROPOSED CHANGES TO THE PRICING FORMULAS

Each and every public hearing involving the milk pricing formulas can impact the economic interest of dairy producers, producer cooperative organizations, dairy processors, distributors, retailers, and consumers. The careful consideration of each pricing issue and the implementation of appropriate policy require impartial balancing of all interests involved. At the same time, the Panel believes it is important to set as accurate a pricing formula as possible that reflects full consideration of all the key economic factors impacting the California milk market. To achieve this, the Panel considered relevant economic factors, including statutory requirements, for all of the issues covered in the following sections, some of which are listed below:

- Milk production costs;
- Milk supply;
- Manufacturing costs;
- Product yields in converting bulk milk into finished products;
- Markets for California commodities;
- Transportation costs;
- Price volatility and lags in the release of different datasets;
- The competitiveness of California commodities compared to other major supply regions;
- The prices received by California processors for their finished commodities;
- The differences in the pool obligations for processors in the California order and the federal orders;
- The state's processing capacities;
- California's long-term history of milk expansion;
- Greater distance to domestic markets for finished dairy products compared to other regions;
- The relationship of California class prices and federal order class prices;
- The effectiveness of risk management tools;
- The supply/demand forces of the domestic and international markets;
- The reasonableness and economic soundness of market milk prices for all classes, giving consideration to combined income from those classes;
- Whether prices will 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; and
- Whether prices for the various classes of market milk bear a reasonable and sound economic relationship to each other.

BACKGROUND: CALIFORNIA'S DAIRY LANDSCAPE

The following economic data and statistics reflect the California dairy situation at the time of the hearing and were considered when examining and evaluating the proposals and testimony submitted at the hearing.

Cost of Producing Milk

- For 2011, the cost of producing milk increased in all four areas of the state when compared to the same period for the previous year, with statewide average costs at \$15.79 per hundredweight (cwt.) (up \$2.09/cwt. from 2010). When including return on investment and management, the cost of producing milk in 2011 was \$17.40/cwt. (up \$2.21/cwt. compared to 2010).
- For the first quarter of 2012, the statewide average cost of producing milk was \$16.63/cwt., up \$1.48/cwt. from 2011 first quarter costs of \$15.15/cwt.

Mailbox Milk Prices

- California mailbox milk prices for 2011 averaged \$18.13/cwt., an increase of \$3.76/cwt. compared to the average 2010 mailbox price of \$14.37/cwt.
- For the first two months of 2012, the California mailbox milk prices averaged \$15.79/cwt., a decrease of \$0.62/cwt. compared to the average mailbox milk price for the same time period in 2011 of \$16.41/cwt.

California Milk Production

- California's annual milk production has increased at an average annual rate of 2.2 percent over the last 10 years, compared to the 10-year U.S. average annual rate of 1.7 percent.
- For the twelve months ending April 2012, California milk production has shown a 4.2 percent increase over the same time period ending April 2011.

Milk Cows

- Annual California cow numbers have increased at an average rate of 1.1 percent over the last 10 years – while U.S. cow numbers have increased 0.1 percent over the last 10 years.
- Most recent USDA cow number reports indicate that for April 2012 compared to April 2011, California reported an increase in the number of dairy cows by 23,000 head to a total of 1.79 million cows.

Class 1 Usage

- For 2011, 13.5 percent of California's total pooled milk production was used to produce packaged fluid milk.
- For May 2011-April 2012, Class 1 sales showed a decrease of 1.8 percent when compared to May 2010-April 2011.
- For the first four months of 2012, Class 1 sales have shown a decline of 2.2 percent compared to the same time period in 2011.

Cheese Production (Class 4b)

- In 2011, 43.1 percent of California's total milk production was used to produce Class 4b products.
- For January-April 2012, total cheese production was up 4.2 percent when compared to January-April 2011.

- For 2011, California cheese production increased to 2.5 billion pounds, close to 2007 levels.

Butter and Nonfat Dry Milk (NFDM) Production (Class 4a)

- In 2011, 35.0 percent of California's total milk production was used to produce Class 4a products.
- For January-April 2012, total butter production was up 14.7 percent and total NFDM production was up 39.9 percent compared to January-April 2011.
- For 2011, California NFDM production totaled 775.1 million pounds and butter production totaled 622.4 million pounds.

Cottage Cheese, Yogurt, Ice Cream, as well as other soft and frozen dairy products (Class 2 and 3)

- For 2011, 8.4 percent of California's total milk production was used to produce Class 2 and 3 products.
- For 2011 compared to 2010, frozen dairy product production showed an increase of 2.3 percent to 173.9 million gallons, total cottage cheese production increased to 101.0 million pounds, and yogurt production decreased to 626.7 million pounds.
- For January-April 2012 compared to January-April 2011, total frozen dairy product production was down 5.5 percent, total cottage cheese production was up 21.6 percent, and yogurt production was down 4.9 percent.

SUMMARY OF TESTIMONY AND POST HEARING BRIEFS

WESTERN UNITED DAIRYMEN, Mike Marsh / Annie AcMoody

Testimony

- Support the Coalition petition.
- Oppose the Farmdale proposal.
- Replacing the fixed whey factor with a sliding scale, effective September 1, 2011 represented an improvement for producers but fell short of a fair method to determine the value of whey in the Class 4b pricing formula.
- Whey factor should more closely reflect the federal Class III formula.
- Code Section 62062 requires that prices are in a reasonable and sound economic relationship with the national value of manufactured milk products.
- Last 12 months show that federal Class III price averaged \$2.18/cwt. higher than the Class 4b price.
- Since April 2007, 74 percent of the difference between Class 4b and Class III was attributable to the whey value.
- Producer revenues since implementation of the current Class 4b plan were \$212 million lower than if the proposed plan were in place.
- Federal milk order pricing formulas do not incorporate a price floor or ceiling; continued use of a price ceiling in the Class 4b pricing formula will place California producers at a competitive disadvantage.
- Proposes using Dairy Market News Dry Whey mostly prices rather than NASS to avoid the lag issue.
- Due to increased costs, California dairymen have lost much of their competitive position relative to the rest of the nation and failing to capture the value of whey hurts their competitiveness further.
- Code Section 62062 requires the Department to consider any relevant economic factors.
- Plant capacity has been an issue but base programs have been put in place to address it.
- Lower Class 4b prices and fixed whey factor makes Class III futures contracts a less effective hedge.
- Many products now come out of the whey stream; producers should receive a fair share of the basic raw commodity.
- Producers and processors should both benefit from higher prices in whey products market.
- Depooling in federal orders is an issue; however, nationally, milk depooled due to price represents a very small percentage of milk production (2.2 percent in 2010, 4.3 percent in 2011).

THE COALITION, Donna Melby (Attorney, Paul Hastings)

Testimony

- The Coalition represents 64 percent of the state's milk producers and approximately 78 percent of California's total milk production.
- Highlights provisions of Code Section 62062 requiring that prices be in a reasonable relationship with national value of manufactured milk products and that in determining

milk prices the Department shall consider relevant economic factors including cost of management and a reasonable return on investment.

- Highlighted Code Section 61805(d) concerning a reasonable amount of stability and prosperity in the production of market milk.
- Language of the Code is mandatory and Class 4b must bear a reasonable and sound economic relationship with the national value of manufactured dairy products.
- Current Class 4b milk pricing formula results in prices that under-value the milk produced in California and creates instability and lack of prosperity for producers.
- Improper valuation of milk can be traced to the “whey solids” factor and failure of Class pricing 4b formula to reflect increases in the market price for whey.
- Producers are experiencing weaker equity position in their dairy operations, mounting debt, tightening credit lines and defaults on existing lines of credit.
- FMMO Class III is the correct benchmark for Class 4b milk pricing, specifically with respect to the value of whey.
- Proposed that Department use a simple average of the Dairy Market News “West” price range for dry whey.
- Coalition proposal is based on calculation of 95 percent of the FMMO Class III dry whey factor.
- Coalition proposes a \$0.00/cwt. floor and \$4.00/cwt. cap.
- Those processors in California that process whey currently benefit from whey values that are below market prices.

Post-Hearing Brief

- Attached the testimony received at the hearing and included in the hearing record from: Donna Melby (the Coalition); Eric Erba (CDI); Rob Vandenheuvel (MPC); Elvin Hollon (DFA); Thomas Wegner (LOL); Lynne McBride (CDC); Cornell Kasbergen (Dairy Producer); Mike Marsh and Annie AcMoody (WUD) (two separate DRAFT copies).
- Attached Code Sections 61805; 62062; 47; 61802.
- Wanted to amplify three points: unprecedented size of community of milk producers supporting the petition; current price is inconsistent with California law and the reasonable and sound economic relationship to national value of manufactured products; and cheese processors testimony should not preclude Department from adopting petition.
- Producers testified on the severe impact of the Class 4b price on day-to-day operations.
- Evidence demonstrated that California producers lost significant revenues and some lost their dairy farms.
- Processors did not produce hard data documenting harm that may occur if proposed petition was adopted.
- FMMO Class III price is the optimal benchmark price in comparing to the national value of manufactured milk products.
- Costs of production and marketing milk have substantially reduced producer revenue and net income.
- Coalition proposal asks that the price be set to a reasonable level.
- Coalition disputes validity of statements made by cheese processors that price change was not necessary, nor urgent.
- Discrepancy between Class 4b and Class III milk prices leave producers struggling to respond to market milk volatility.

- Current adopted whey factor scale has fallen short of goal of being market driven because of the \$0.65/cwt. cap.
- Proposed whey scale contributes more value to the milk price when the value is present in the marketplace.
- The CME cheese contract allows the producer to hedge only the protein and butterfat components of the pay price leaving whey value unhedged.

FARMDALE CREAMERY, Scott Hofferber

Testimony

- Farmdale has 80 employees, makes sour cream and buttermilk products, and processes average 19.8 million pounds of milk (360 loads) per month into Cheddar and Jack cheeses.
- Alternative proposal of fixed \$0.25/cwt. whey factor will prevent the loss of about 9 percent of California cheese processing capacity and 75 percent of cheese makers.
- Proposes that the Department return the whey factor to \$0.25/cwt. for Class 4b milk and individual producers determine appropriate service charges to processors of higher valued whey products.
- Under Coalition petition, cannot continue to make cheese profitably with existing annual whey program.
- The number of cheese plants has declined from 60 in July of 2007 to 57 currently and total cheese-milk utilization has fallen from 1.60 billion pounds per month to 1.55 billion pounds per month.
- As a result of the August 2011 Class 4b hearing decision, cheese processors shifted \$24.8 million from the processor's bottom line to the Pool with no corresponding increase in revenue potential to offset the cost.
- For the last 4 months of 2011, the Coalition proposal would have transferred an additional \$111.1 million with no recuperative path for cheese makers. This could cause the 81 percent of California cheese makers not processing whey into a value-added product to have no reason or ability to continue in the cheese business.
- Increasing the value of whey will only worsen the oversupply situation.
- Believes that the Coalition proposal would disincentivize plant capacity expansion in the Class 4b sector.
- Growing Farmdale's cheese business by 10 percent requires making changes to whey processing capabilities.
- Argues that a higher return, than a positive 6.038 percent, should be reasonably expected from a risky, vertical investment.
- With the adoption of the Coalition proposal, analysis of Farmdale whey project indicates potential average net loss before tax of -11 to -17 percent. These negative outcomes are a disincentive from going forward with project.
- The sliding scale, end-product whey formula being proposed is not based on characteristics of California operations – but uses high percentage of federal make allowance and yield found in Class III formula.
- Cheese makers have always had the responsibility of dealing with the whey stream.
- Setting a minimum regulated price at a high level to compensate producers for a higher valued end-product puts all processors of lower-valued products out of business or certainly headed that way.

Post-Hearing Brief

- A four-year window is not sufficient to take a whey-processing project from idea through development into production and be stable and profitable.
- The outcome of a whey plant project could not be characterized as a “windfall” given all the costs and risk borne by the plant.
- Submitted Cheese Market News June 1, 2012 article, “Letter to the Editor: America’s independent dairy farmers need not fear the free market.”
- Submitted copy of Land O’Lakes Cheese & Whey surplus auction flyer.
- Regulatory system should set prices at bare minimum levels and allow other market mechanisms to find the true value of milk in the end-products.
- Cheese makers need adequate profit incentive to take the risk and make the capital outlays required for whey processing.

CALIFORNIA DAIRIES INC., Eric Erba

Testimony

- Supports the Coalition proposal.
- CDI represents the interests of 420 producer-members who account for 43 percent of the milk produced in California.
- Has invested over \$500 million in large processing plants, projected to produce about 400 million pounds of butter and 800 million pounds of powdered milk products in 2012.
- The sliding scale approach adopted in 2011 adjusted the whey contribution to the Class 4b pricing formula according to market conditions, but was immediately maxed out and at only the very lowest market prices of dry whey.
- Because the Department lacks specific authority to establish a ‘whey credit,’ an appropriate mechanism to value whey must apply to either all cheese plants or none of them.
- The issue of the whey contribution to the Class 4b pricing formula and the subsequent value to producers cannot be ignored.
- The additional value of dry whey being captured in the Class III formula is not, for the most part, getting captured in the Class 4b pricing formula; this can be remedied by adopting the Coalition proposal.
- California dairy producers are vulnerable to feed cost increases as most dairy producers purchase a high percentage of their feed.
- The cost of milk cow hay is 68 percent higher and cost of milk cow grain mix is 50 percent higher over the last five years.
- Supply management program actively managed can adjust with market conditions.
- USDA milk-price ratio, considered by many to be a barometer of the health of the production side of the dairy industry, has shown a stark trend away from the 3.0 favorable milk-price ratio.
- In 2011 alone, 32 CDI members resigned, nearly all due to financial pressures.
- Cheese makers have had ample time to make operational changes such that more value can be achieved from a unit of milk and a higher price can be paid to dairy producers.
- Cheese plants in other states have continued to operate while paying a higher price for the milk used to make their products.
- Low regulated whey prices have not attracted cheese processing capacity to California and higher regulated whey prices have not discouraged cheese plants from being built outside of California.

- Appreciate changes that the Department made to the Class 4b pricing formula in 2011 to begin to close the gap between California's Class 4b price and federal order Class III price – however data shows that there is considerable work to be done to get closer alignment.

MILK PRODUCERS COUNCIL, Rob Vandenheuvel

Testimony

- Supports the Coalition and WUD proposals.
- Average cost of production in California from 2007-2011 was \$16.77/cwt. while the average price paid for milk during the same period was \$15.96/cwt. This equates to a 1,000-cow dairy that can reasonably expect a net loss of \$850,000 during that time period.
- Forty percent of milk produced in California goes to cheese manufacturers; regulated minimum prices that must be paid have a direct impact on the ability/inability of the state's dairies to generate a reasonable return on investment.
- Over the past 5 years, the proposed Class 4b pricing formula would have resulted in a minimum price that is \$0.42/cwt. below the federal order Class III price.
- CDFA is bound by Code Sections 61805, 62061-62079, resulting in a Class 4b price that is in a reasonable and sound economic relationship with the national value of manufactured milk products.
- Discounted regulated prices in California have not attracted significant additional investment in processing capacity in the State.
- As evidenced by recently implemented base plans, it is clear that only the dairy producer sector of the industry has the tools to regulate the regional supply/demand balance.
- The Coalition proposal will achieve the mandated standard of bringing Class 4b price into a reasonable and sound economic relationship with the national value of manufactured milk products.
- In determining the national value of milk being sold to cheese manufacturers, FMMO Class III price is best benchmark.
- The Code does not state that manufacturing class prices must be set at market-clearing prices.

BESTWHEY, LLC, Barry Murphy

Testimony

- Coalition and WUD proposals are not valid because they claim the California Class 4b price has no reasonable or sound economic relationship with the national value of manufactured milk products.
- Federal Class III formula is out of touch with realities of milk pricing and that cheese milk buyers outside of California can buy milk below the minimum price.
- More than 85 percent of milk marketing is controlled by cooperatives focused on milk clearing rather than marketing.
- All California cheese manufacturers pay a premium over minimum price, though dairymen selling their milk through a cooperative system rarely see a milk benefit.
- Under current Class 4b milk pricing formula, the return on investment for a large commodity cheese plant without whey processing is negligible and would not attract investment for further growth of the California cheese industry.

- By leaving the current Class 4b pricing mechanism untouched, or by eliminating the whey factor, there is hope that based on moderate returns there would be additional cheese capacity investment in the State.
- Most small cheese plants lack the economies of scale to justify investment of \$10 to \$30 million to process whey.
- A cheese plant needs at least 1 million pounds of whey per day to invest in a small protein drying plant and then about 90 percent of the whey solids are lost as permeate to animal feed.
- Recent and temporary spikes in the whey powder values in 2007 and 2011 should not be the drivers for dairies to request adjustment to milk price formulas.
- No significant cheese plant capacity has been built in California for almost ten years and any further adjustment to the Class 4b whey factor will eliminate future investment at a time when it is badly needed.
- Co-operatives should use milk premiums, rather than minimum pricing as a way to improve producer income based on supply and demand of milk.
- Three private entities looking to build new cheese and whey operations in California, representing investments of more than \$100 million, are holding their positions in anticipation of the outcome of this hearing.
- CDFA granting another Class 4b whey factor hearing within one year of the last resolution is troubling and has created high degree of uncertainty for the future and investment in California's cheese industry.
- Urges CDFA to maintain a whey component in the Class 4b price formula of \$0.25/cwt. and grant no further hearings on the issue for at least five years.

Post-Hearing Brief

- Corrected testimony: "Smaller cheese plants pay \$150.00-\$400.00 per load to dispose of whey, the equivalent of \$6.00-\$16.00/cwt., and they pay for the whey factor of up to \$0.65/cwt. as well." This should read \$0.30-\$0.80/cwt. for hauling charges.
- DFA and LOL testified that they had no problem selling their liquid unfinished WPC from Orland and Turlock plants – this outlet is made possible because other companies have made the investment in advanced membrane processing and drying capacity. LOL and DFA have not made investment in further concentration technology or dryers for the WPC.

MARQUEZ BROTHERS INTERNATIONAL, INC., Jose Maldonado

Testimony

- The frequency of hearings on the Class 4b price is causing great concern and hindering the ability to plan for growth.
- Favors reverting to the fixed Class 4b whey factor of \$0.25/cwt.
- Opposes the Coalition and WUD proposal.
- Supports the Farmdale alternative proposal.
- In 2005, invested approximately \$20 million in a whey processing plant and have yet to see a return in investment – don't have enough volume.
- Invested in whey processing plant to reduce cost of disposing of the whey and because of rising environmental concerns with whey disposal.
- In order to justify whey processing investment, a typical small cheese plant must produce from 1 to 1.2 million pounds of whey per day to break even.
- Adoption of the Coalition and WUD petitions will result in small and medium size cheese manufacturers not only being unable to recoup investments in whey

processing equipment but also will mean the extinction of California's small- to-medium size cheese manufacturers.

- Of the 57 total cheese plants in California, 33 are producing less than 664,000 pounds of liquid whey per day. These plants are too small to dry or process whey to get at whey proteins, and they lose money every month on this portion of the Class 4b milk price.
- Of the 57 cheese plants, 6 are producing less than 1.19 million pounds of liquid whey per day.
- All 57 cheese plants would be severely financially impacted by the increase in milk price proposed by the Coalition and WUD; 33 plants will never recover their investment and 6 others will break even if they were to build a whey plant.
- There is no allowance in the Class 4b price to cover whey disposal costs, and no recognition of processor's losses due to these costs reflected in milk pricing formula.
- Adoption of the Coalition and WUD proposals will discourage cheese plant investment and place near-term plant capacity at risk - at a time when additional plant capacity is needed.
- Installation of the whey processing plant has led us to make another \$200K/month investment in a waste water pre-treatment plant.
- The whey component factor in the Class 4b pricing formula distorts our margins and pricing mechanisms.
- Cites John Umhoefer, Executive Director of Wisconsin Cheese Makers Association, who characterizes the inclusion of a whey factor in Class III as a "nine-year-old mistake." He states that cheese companies not processing whey are being charged the full price of whey in the milk price with no means to recover.
- Inclusion of the whey factor in Class 4b price is a recipe for disaster threatening the ability of cheese manufacturers of all sizes to continue in the dairy business – investments will be limited, innovation will be hindered, buyers on the global scale will not view California companies as reliable suppliers.

Post-Hearing Brief

- Pricing information the Panel requested on WPC 80 percent and WPC 34 percent is proprietary data and the entity that supplies this information will not release the dataset.

CALIFORNIA DAIRY CAMPAIGN, Lynne McBride

Testimony

- Supports the Coalition and WUD proposals because they will pay producers a whey value that is based upon prevailing market demand.
- In spite of an improvement in dairy producer prices in 2011, 47 dairies went out of business, illustrating that the toll of a price collapse like 2009 reverberates for years afterward.
- This year, 17 dairies have closed their doors in Tulare and Kings counties.
- Despite prices in 2011 as having improved, 47 dairies went out of business that year.
- Dairy farms continue to struggle to make up for the unprecedented loss of equity in 2009 and are facing financial crisis because producer prices do not cover production costs.
- Feed costs increased 28.8 percent from 2010 to 2011, representing 63.9 percent of total cost of production.
- California dairy producers do not have the ability to pass on these higher feed costs.

- Feed and other input costs are at historically high levels, it is critical that dairy producers are paid a fair value for their milk based upon the price paid for the milk in the market today.
- Despite the fact that California milk is less expensive than milk sold in other states, processors are choosing to locate in other states.
- Cheese processing can be profitable at the same time that dairy producers are paid a fair whey value.
- Adoption of the Coalition proposal's 'sliding scale' will be an important step toward making the Class 4b pricing formula more market oriented and more equitable.
- California producer price is equivalent in some cases to the price paid to producers for distressed milk in federal order states.
- The price paid to California producers does not adhere to the requirement of Code Section 62062 that producer prices bear reasonable and sound economic relationship with the national value of manufactured milk products, adoption of the Coalition proposal would increase the price paid to California dairy producers for Class 4b milk and put California prices in a more reasonable relationship with surrounding states and federal milk marketing orders.

CACIQUE CHEESE, INC., Gilbert de Cardenas
Testimony

- California has become a very difficult state to do business in.
- As a family-owned company focusing on the Hispanic cheese market, they have encountered more competition from out-of-state processors in the past three years than at any other time during their 40-year history.
- Out-of-state processors have some sort of economic advantage that allows them to compete where Cacique cannot.
- Any increase in cost of milk will further compromise Cacique's ability to compete.
- If costs continue to increase Cacique will no longer invest in California operations and may look at servicing the area from a more favorable market.

Cornell Kasbergen
Testimony

- Supports the Coalition and WUD proposal.
- A California dairyman for over 35 years, also operating a Wisconsin dairy in partnership for the past 13 years.
- The difference in prices received by Wisconsin and California dairies is substantial; the average Wisconsin price advantage was \$4.07/cwt. in 2011 and \$4.33/cwt. for the first 4 months of 2012.
- California and Wisconsin are the number one and two cheese producing states; pricing formulas in both states have a basis in current market values but the price received by California dairymen is over \$4.00/cwt. lower.
- Wisconsin dairy is very profitable, while California dairy is in a dire situation; the Upper Mid-West continues to expand plant capacity and competition for milk is fierce and all this in an environment where input costs are 20-25 percent higher than California.
- The milk market in Wisconsin is dynamic and many cheese plants that do not process whey operate very successfully; the market price paid for milk in Wisconsin is the true market value.

- The Department has the responsibility to be the referee for the dairy industry and until 2008 it managed the industry equitably.
- The current California pricing system is causing economic hell and is in direct conflict with statute 318101-E requiring the Department 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.'
- The Department must recognize the inequity in the Class 4b pricing formula and give dairy families a chance to continue to do business in California, the playing field must be level, and statute requires it.
- The co-ops have and will continue to manage the volume of milk to best match the capacity.
- California dairy families should not receive less than Class III prices for their Class 4b milk with no caps or floors.
- Leprino, Saputo, and Hilmar as well as national cooperatives all have plants in the federal orders and they all pay more than the Class III for milk in those out of state plants and yet they complain about California pay prices.
- The Department's inaction has led to over \$500 million dollars of producer money being transferred to the processors of this state.
- If CDFA fails to correct the inequity between the Class 4b and 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.

Joseph Airoso

Testimony

- A fourth generation dairyman in Tulare County whose family has been in the business for 100 years.
- Pricing system is based on end-product pricing but processors seem to want to pick and choose which products impact the price.
- The use of corn as a fuel source has changed the landscape of the dairy industry.
- Dairy farmers cannot continue to subsidize processing in California.
- Would like to see California milk pricing more in line with the rest of the U.S.

Art Van Beek

Testimony

- Supports the Coalition proposal.
- A second generation dairyman in Tipton whose family has been in the business for over 30 years.
- The true value of whey and whey products are not reflected in the milk price.
- The cheapest milk in the nation is in California, which is why processors are here.
- The largest industry in California is agriculture, the largest segment of that is dairy, over 99 percent of dairy farms in California are family owned and operated.
- There were about 2,100 family dairy farms in California in 2008, that number has dropped to 1,628 recently.
- LOL, Tulare employs 500 people in one of the largest processing plants in the nation. During the month of April, 17 family dairies supplying milk to this plant have ceased to exist, if this trend continues LOL would likely close its doors and put 500 people out of work, along with thousands of dairy employees.
- California dairy farms are in a great depression.

LAND O'LAKES, INC., Thomas Wegner

Testimony

- Supports the Coalition and WUD petitions.
- LOL has 240 California member-owners who supply over 16 million pounds of milk per day, primarily processed at plants in Tulare and Orland.
- Current Class 4b pricing formula contains a whey factor sliding scale capping the contribution of whey at \$0.65/cwt., regardless of whey's price in the Western Whey markets.
- In calculating the Class III price, the contribution of whey moves directly with market price of whey with no artificial cap.
- During the eight months following the Department's adoption of the sliding scale whey factor, Class III minimum prices averaged \$17.44/cwt., \$2.54/cwt. higher than the Class 4b average price of \$14.90/cwt.
- The gap between the two minimum prices for milk used in cheese has become too large and is unfair to California dairy farmers.
- The Coalition proposal would amend the Class 4b pricing formula by including a market-based whey factor resulting in Class 4b prices that meet the statutory requirement of a reasonable and sound economic relationship to the national value of manufactured milk products.
- The Class 4b price is out of alignment with the federal order Class III price.
- Unregulated cheese plants are not required to pay the federal order Class III minimum price, in practice these plants enter into supply agreements that stipulate the milk price paid will be at or above federal order Class III minimum price.
- LOL and other handlers who depool milk must continue to compete for milk supplies and must remain competitive.
- California dairy farmers have gone through trying financial times since December 2007 when the \$0.25/cwt. fixed whey factor was implemented: in 2008 income over feed dropped 32 percent; in 2009, margins over feed dropped to a low level of \$2.74/cwt.
- The whey factor has severely hindered California dairy farmer's ability to make effective use of the Class III futures market to hedge their milk price.
- The \$0.25/cwt. fixed whey factor provided a financial incentive for small cheese makers to develop a whey business.
- California dairy industry has proven that the industry has the tools and programs to manage milk supply with plant capacity and market demand.
- Recent record of cheese plant investments inside and outside California suggest that farm level prices may not be as critical a factor when processors invest in new or expanded plants.

FARM CREDIT WEST, Jonathan Kennedy

Testimony

- Farm Credit West has been financing the dairy industry in California for the past 95 years and currently has over \$1.1 billion in outstanding loans to California dairymen.
- Asks that the Panel review the current pricing formula and make adjustments to ensure that California dairy producers are fairly compensated and that there is parity in the formula so that both the dairymen and processors have the opportunity to earn a reasonable return on their investment.

- USDA's Economic Research Service monthly and annual milk production costs and returns for 2011 reflect California having the lowest milk price and the second highest feed cost in the nation and lowest milk income over feed cost margin; these statistics support the inequality between what dairies are receiving for milk in California compared to those in the federal order.
- Severe downturn in milk prices that started in 2008 and into 2009 coupled with high feed prices, dairies in San Joaquin Valley region lost \$962/cow in 2009 according to "Dairy Farm Operating Trends – December 31, 2011" (Frazier, LLP).
- The recovery in 2010 and 2011 has only partially recovered what was lost and we are entering another year of losses in 2012 if the current pricing trend continues the remainder of the year.
- Dairy operations have experienced a decline in the market value of their livestock and dairy facilities; dairy cows and replacements decreased from an average price of \$1,760/head in 2007 to \$1,200/head in 2009, and dairy facilities in the past 3 years have experienced declines in excess of 50 percent in some cases.
- There has been a material decline in the credit quality of the dairy portfolio due to devaluation of livestock and facilities that are the collateral base, coupled with losses being capitalized into additional borrowings causing advance rates to be above acceptable levels in some situations.
- Due to the volatility of milk prices received and the cost of feed, the level of risk has increased to dairy operations and the lenders that finance them, as a result, well-managed operations with low debt and adequate liquidity to survive down cycles will continue to be financed.
- The operations that came out of 2009 very leveraged not only have to contend with high feed prices but also must service high debt loads as lenders try to force the repayment of principal on loans that were created to fund the losses in the last downturn.
- Should interest rates increase in the near term and milk prices stagnate, dairy operations face the additional burden of higher interest costs.
- Many successful operators are not expanding their California operations or building new facilities; they are looking at moving or growing out of state, converting their land based assets to alternative uses or exploring an exit of the dairy business altogether.
- The significant inequality in returns for California producers, partially due to the state's pricing structure, threatens survival of many operations over the short term.
- Attachment, Farm Credit West – Written Testimony
- Attachment, Exhibit A – USDA Economic Research Service Milk Production Costs and Returns
- Attachment, Exhibit B – Dairy Farm Operating Trends, December 31, 2011, Frazer, LLP, Certified Public Accountants and Consultants

DAIRY INSTITUTE OF CALIFORNIA, William Schiek & Rachel Kaldor
Testimony

- Opposes the WUD and Coalition petitions.
- Dairy Institute represents 30 dairy companies which process approximately 75 percent of the state's fluid milk and manufacture 80 percent of the state's cheese and 75 percent of its cultured dairy products and ice cream.
- Orderly marketing is the stated purpose of dairy regulation in California; achieving this is primarily manifested in the local market for milk, if California is to embrace the policy

goal set forth in Section 61802 (e) then the California market for milk must be functioning in a way that is orderly.

- The Coalition's assertion that the current formula violates the law is erroneous in that their proposal's sole focus on a small part of Section 62062 would require the Secretary to ignore many other legislative directives governing the pricing and regulation of milk.
- As stated in the Department's Hearing Panel Report from 2011: Price parity with Class III is inconsistent with the broader goals of California dairy policy, namely: the ability of manufacturing processors to de-pool in the federal system, instances where handler-to-handler transactions occur when milk is sold below minimum class prices in the federal system, and finally that California statutes provide no similar flexibility, all Grade A milk is purchased by processors at state established minimum class prices.
- There do not appear to be any real economic arguments supporting the notion of Class 4b / Class III price parity.
- In federal orders, there are mechanisms whereby excess milk supplies may clear to cheese plants at less than regulated minimum prices.
- California's lack of a safety valve combined with oversupply means that California prices must be set at levels that clear the market, which for a variety of reasons will be lower than federal order prices.
- The role of regulated prices should be to provide some stability, yet leave room for market forces to work; there should be room under the state's pricing regulations for market-based premiums to allocate milk according to the market's needs.
- Stability in the regulated pricing system is of paramount importance; to processors stability means that pricing rules do not keep changing so that existing investments are put at risk and new investments are discouraged.
- Last year's Class 4b increase put potential investors in a 'wait and see' mode, another increase to the regulated price at this time will send the signal to potential investors in cheese and whey plants that the Department is engaging in a process of escalating the Class 4b price and will eventually give producers all they are asking for.
- Making a decision that keeps the current formula or one that moves in the opposite direction from the proposal of the petitioners will let potential investors know that the Department is serious about creating an environment that favors new plant projects.
- There is tremendous investment potential in cheese manufacturing in California, due to growing foreign demand; our regulated pricing system should encourage, rather than discourage, investment that will increase the demand for California milk.
- Prices have fallen in 2012 because milk supplies are over-abundant and the market is sending signals to slow production.
- The greatest risk in any minimum milk price regulation decision is setting prices too high, which might lead to enhanced producer income in the short run but will lead to loss of product sales and manufacturing capacity in the longer run.
- There is nothing that prevents California plants from paying more than the regulated minimum price for milk, and most cheese plants do so; when it is necessary to attract milk, plants can and will pay more than the regulated minimum as the market conditions dictate, provided the regulated price is truly a minimum price.
- For the first four months of 2012 milk output is up 5.7 percent on a daily average basis compared to 2011, this production growth has strained plant capacity and led to milk moving outside the state to find processing homes at a discount and in some cases not being marketed.

- As noted by the Department in its Hearing Background Resource, from 1950 to 2011 milk production increased from 6.0 billion pounds to 41.4 billion pounds while during the same time period the number of dairy farmers declined from 19,428 to 1,668.
- Base plans and over-base penalties, while commendable as a mechanism to deal with emergency conditions, are not a viable long-term solution to the state's need to attract additional plants or accommodate producer's desire and economic incentives to expand their operations.
- When all of the differences between the California and Upper Midwest cheese manufacturing industries, pricing systems, local supply/demand issues in the different regions are taken into account, the petitioners' proposal cannot be considered seriously.
- Current trends for the supply and demand of milk in the state and the scarcity of plant capacity suggest that increases to current Class 4b pricing formula price are not warranted.
- The continued viability of California's end-product based regulated pricing system is in jeopardy due to changes in the market and industry consolidation.
- Attachment, Exhibit A1 – California Milk Production, 2009-2012 Average Daily Basis
- Attachment, Exhibit A2 – California Milk Production and Number of Dairies, 1996-2011
- Attachment, Exhibit A3 – Understanding Dairy Markets, Milk Production, California, 1992-2011
- Attachment, Exhibit A4 – Understanding Dairy Markets, Milk Production, Wisconsin, 1992-2011
- Attachment, Exhibit A5 – California Milk Production and Effective Plant Capacity, 2006-2012
- Attachment, Exhibit A6 – “The West Coast is Swimming in Milk” *Hoard's Dairyman*, April 25, 2012
- Attachment, Exhibit A7 – excerpt from a letter to Land O'Lakes Dairy members from Peter Garbani, Director of Milk Supply Western Region, March 16, 2012
- Attachment, Exhibit A8 – a letter from CDI President & CEO Andrei Mikhalevsky and Chairman of the Board Brian Pacheco to CDI membership, March 19, 2012
- Attachment, Exhibit A9 – California Milk Income and Production Costs, 2006-2011
- Attachment, Exhibit B1 – USDA Milk Cost of Production by State, 2010
- Attachment, Exhibit B2 – Genske & Mulder Large Farm Cost of Production Study
- Attachment, Exhibit B3 – Milk Production Costs, Genske-Mulder Clients, January-September 2011
- Attachment, Exhibit B4 – Milk Production Costs, Top 25 percent Genske-Mulder Clients, January-September 2011
- Attachment, Exhibit B5 – Genske & Mulder Average Income and Expenses of Dairy Clients for the nine months ended September, 30, 2011

Post-Hearing Brief

- Attached data from Genske, Mulder & Company (Genske-Mulder), LLP and Frazer, LLP as requested by the Panel.
- Genske-Mulder report includes dairies averaging greater than 1,600 milking cows – Upper Midwest data would not be representative of region as a whole. With this information and Attachment 3 (“Low Costs Drive Production to Large Dairy Farms”), conclude that cost of production in Upper Midwest is greater than what is shown on the Genske-Mulder report.
- Attached background information on USDA cost of production data collection methodology.

- Attached documentation for USDA Agricultural Resources and Management Survey Costs and Returns Report.
- Attached Dairy Today Western “Production Overload” article.
- Attached article: “Location Matters” a comparative analysis of state tax costs on business.
- Attached CNBC Special Report “America’s Top States for Business.”
- USDA cost of production estimates do not account for changes in input mix and input substitutions that might be made by farm operators to lower their costs.
- CDFA cost of production data comes from actual surveys of dairy farms providing an accurate picture of costs.
- California has lower costs to produce milk when compared to most other regions of the country.
- Lower-cost milk producing regions tend to specialize in commodity dairy products and tend to see lower local milk prices because of high costs of transporting fluid milk.
- California has more than adequate milk supplies as evidenced by movement of milk and components out of state.
- California has run out of additional plant capacity and the costs of marketing milk supplies in excess of capacity are borne by both producers and processors.
- California’s end-product pricing formulas have effect of transferring market signals directly to producers.
- Producers choosing to switch to Grade B status is not a viable method for clearing distressed or surplus milk.
- Plants in the federal order can “step out” of the regulated system to clear the market.
- Important point that in the federal orders there are mechanisms whereby excess milk supplies may clear to cheese plants at less than regulated minimum prices. Because California does not have this flexibility, California prices must be set at levels that clear the market, and for a variety of reasons, oversupply of milk being one, this leads to prices lower than federal order prices.
- When market for producer milk does not clear locally (within California), it can lead to disorderly marketing and economic waste.
- Code Sections 61802(e) and 61802(h) direct policy to encourage and promote the intelligent production and orderly marketing milk.
- Department must be concerned with establishing policies that promote adequate capacity and market clearing within the state.
- Term “reasonable and sound economic relationship” gives Secretary considerable latitude.
- California market factors should determine state’s regulated minimum prices, not regulated prices in federal orders.

HILMAR CHEESE COMPANY, INC., David Ahlem
Testimony

- Opposes the WUD and Coalition petitions.
- Hilmar Cheese Company processes over 12 million pounds of milk per day (more than 10 percent of the milk produced in California) and purchases milk from over 200 dairies.
- Supports a low regulated minimum price that allows the market to efficiently set high market driven prices.
- Current milk supply exceeds the state’s processing capacity.

- In April 2012, California milk production was 3.3 percent higher than the same month last year; more than 3.5 million pounds per day or enough to fill a medium-sized plant.
- Since April of last year, dairy producers in California have added an estimated 23,000 cows to the state herd; this growth in cow numbers outpaces all other states.
- Milk supplies have grown every month since late 2009, the same is not true of farm numbers; the consolidation trend has yet to curtail supply growth in aggregate.
- Since the beginning of the year, Hilmar has regularly moved milk out of state as there were no available buyers within the state, and rigidly enforced contract caps.
- Many of our producers have sold loads of milk to calf ranches because no buyers for their milk existed.
- It is imperative that California establish a regulated price that is low enough to allow surplus milk to clear the market.
- An artificially high minimum price will encourage continued over supply and prolong periods of low prices during over supply conditions.
- Current market conditions do not warrant an increase in the regulated minimum price.
- Processing capacity growth has not kept pace with growth in supply, the state's cheese processors have not had financial incentive to expand in California.
- Natural American cheese production and processing capacity within the state has fallen.
- Demand for cheese is growing domestically and abroad, while processing capacity in California declines.
- Increasing the regulated minimum price will further discourage investment in capacity in California.
- The petitioner's financial comparisons assume all processors pay the Class 4b minimum price. For example, Hilmar pays market driven premiums for protein, whey and quality.
- A regulated minimum price should be a market clearing price, not a market making price; if allowed to function, the marketplace will drive premiums and establish a value for milk above and beyond the regulated price.
- A low regulated minimum price allows us to pay high market driven prices, sending premium dollars directly to the producers who have invested in facilities, genetics and management practices that generate the high value milk the marketplace desires.
- Increasing the regulated price will effectively pool premium dollars being paid by handlers, creating a further disconnect between the marketplace and the price signals a producer receives.
- End product pricing formulas are a hindrance to innovation and new product development, increasing minimum prices will stifle innovation and new product development even further.
- Develop a regulatory system that incentivizes and rewards both processors and producers to invest, innovate and develop new products, increasing the value of milk long-term.
- When comparing California and federal orders it is important to recognize some distinct differences in the pricing systems: cheese processors out of state are not always required to pay Class III even when they operate within the boundaries of FMMOs; FMMOs have a mechanism (diversions to non-pool plants) for milk to clear the market by allowing manufactured milk to be sold below minimum regulated prices.
- When comparing California prices to other regions, we must consider regional supply and demand characteristics; in California, milk supply is chasing capacity, while in other regions of the country capacity is chasing supply.

- Class III price is not an optimal solution for cheese processors in high whey markets, cheese plants in the federal orders that don't process their whey are unable to make up this revenue in the marketplace.
- Outside of California, most cheese and whey processors operate, or have the option to operate outside the confines of federal/state price controls; if we choose to increase the regulated minimum price above the market price to pursue parity with the pricing of another region, we run the risk of being uncompetitive in the marketplace we currently operate, if we become uncompetitive, California will lose business to competitors out of state who are not subject to the same constraints.
- Regulatory uncertainty impedes investment; in the past 10 years there have been 25 milk price hearings in California.
- As individual companies consider long-term investments that require massive amounts of capital, this frequently changing regulatory environment discourages investment by creating uncertainty.
- Instead of trying to extract value from the regulatory system, it is time to let market signals reign and turn our focus towards customers, markets and growing the value of milk; insulating the industry from market signals will not benefit dairymen.
- The McKinsey Report and the Innovation Center Report on Globalization concluded that there is tremendous opportunity for California and the U.S. in the global marketplace, however both suggest that the industry adopt market oriented policy initiatives and pricing reform.
- The proposed increase in the Class 4b price is a step in the wrong direction for both processors and producers, now is the time to embrace a market oriented approach and work together to capture the opportunity that exists in the global marketplace.
- Attachment, Appendix A - "The West Coast is Swimming in Milk" *Hoard's Dairyman*, April 27, 2012
- Attachment, Appendix B - "Rags to riches (and back again?)" *Dairyherd Network*, February 23, 2012. "Milk production rises, analyst watch global trade" *Capital Press*, May 24, 2012.
- Attachment, Appendix C - excerpt from a letter to Land O'Lakes Dairy members from Peter Garbani, Director of Milk Supply Western Region, March 16, 2012. Letter from CDI President & CEO Andrei Mikhalevsky and Chairman of the Board Brian Pacheco to CDI membership, March 19, 2012. Letter to Pacific Gold Milk Producers membership from General Manager Leonard Vandenburg, February 29, 2012.
- Attachment, Appendix D - Excerpts from *USDA Dairy Market News Weekly Reports - 2012*, January 20, January 27, February 17, March 16, March 23, March 30, April 27 and May 4, 2012.
- Attachment, Appendix E - "Wisconsin facing a dairy deficit" *GazetteXtra*, April 25, 2011. "DBA Talks to Congressman Duffy about Supply Management" *Dairy Business Association*, April 25, 2011. "The Other Solids Price Crush" by John Umhoefer, Executive Director Wisconsin Cheese Makers Association, January 6, 2012.

Post-Hearing Brief

- Supports low regulated minimum price that allows market to efficiently set high market driven prices.
- Would welcome any move to simplify the regulatory system to make hedging easier for producers and proprietary processors.
- Current regulatory environment in California prohibits (due to minimum price requirement) proprietary processors from offering hedging mechanisms to eliminate basis risk.

- Price alignment with Class III is not solution to basis risk issue.
- Submitted a table displaying correlations of CDFA mailbox price series to Class III.
- Allowing fixed price forward contracting options would do more to address basis risk issue.
- Hilmar experience is that milk is regularly purchased at values below class. Discounts/premiums to class driven by seasonal conditions and overall supply/demand conditions.
- California milk must be shipped out of state when there is surplus and cannot clear the market.
- FMMO cooperatives have option to sell milk to cheese processors at whatever price the market will bear in any given month.
- Mailbox prices in federal orders are often well below the federal order blend prices.
- Wrong to assume that producers don't receive increase in milk payments when market price for whey increases. Many processors are currently paying out premiums above the minimums.
- Increasing regulated price redistributes revenue created by value-added products to the Pool rather than return dollars to those processors/producers who invested in the technology.

KRAFT FOODS, Michael McCully

Testimony

- Opposes the WUD and Coalition petitions.
- If California's dairy industry is to remain competitive in a domestic as well as growing global market, it is imperative the regulated pricing system foster, not impede, the development of new processing capacity.
- An important difference between the regulated pricing systems in the federal orders and California is the ability for processors to depool milk in the federal orders; California does not have such a mechanism to act as a relief valve for milk supplies, when supply exceeds manufacturing demand in California, milk leaves the state to find a manufacturing outlet, usually incurring a severe loss due to transportation cost and a discounted sales price.
- From January to May 2012, on a regular basis, milk was being discounted \$2.00-\$5.00/cwt. under class in the Midwest in order to clear the market.
- There has been discussion for several years about allowing manufacturing plants in California to depool milk in order to clear the market; given the lack of new manufacturing capacity coming on-line in the next few years, this should be given serious consideration.
- Analysis of the California all-milk price versus Class III prices shows California milk price basis variability is less than other states over the last 5 years; of the top 10 milk producing states, California basis variability ranks the fourth least out of 10.
- A policy solution could improve the situation by allowing cooperatives or producers to forward contract with processors, this would remove a lot of the basis variability, as California prices would be used for contracting.
- The addition of a whey factor to the Class 4b price has a long and contentious history; in early 2003 the whey factor was added to the formula, hearings in 2005, 2006 and 2007 addressed the issue, at each hearing the Panel's recommendation was the same—remove the whey component from the Class 4b pricing formula.

- Proposals have been made regarding the addition of whey protein concentrate or other whey proteins into the formula; unlike cheese, butter and nonfat dry milk, there is not one standard whey product that is appropriate to use in pricing formulas.
- The 2007 hearing resulted in a move to a fixed factor of \$0.25/cwt. for whey; that solution worked for several years and provided producers a higher milk price compared to the prior formula; however by mid-2011 another hearing was held and a new sliding scale was adopted for whey pricing.
- Within 7 months of adopting the sliding sale, producers have petitioned for another hearing two separate times, proposing to return Class 4b milk pricing to where it was in 2007 and generate the same problems as it did then.
- It is evident the addition of the whey component to the Class 4b pricing formula has introduced a multitude of problems; this is true not only in the California pricing system but also in the federal order system.
- Milk production in California continues to grow while in-state processing capacity has not kept up with this growth; for the industry to prosper in the future it needs to look beyond the current whey issue and consider broader regulatory and policy reforms.
- Regulated pricing systems in California and the federal orders were established many years ago with vastly different market dynamics than exist today; dairy markets have evolved from local to regional to national to global in nature.
- With 95 percent of the world's food consumers outside the U.S., the potential market is enormous; outdated regulated systems are holding back the U.S. dairy industry from realizing the full potential of this opportunity.
- The competitive advantage enjoyed by the California dairy industry over the past 25 years is gone; to compete in the marketplace of the future, the California dairy industry needs to adapt to these new realities or get left behind.
- Attachment, Appendix 1 - Excerpts from *USDA Dairy Market News Weekly Reports - 2012*, January 6, January 20, January 27, February 10, February 17, February 24, March 9, March 16, March 23, March 30, April 6, April 13, April 20, April 27 & May 4.
- Attachment, Appendix 2 – “The Dry Whey Gap” *Cheese Market News*, August 3, 2007
- Attachment, Appendix 3 – “The Other Solids Price Crush” *Cheese Market News*, January 6, 2012

Post-Hearing Brief

- Supplied spreadsheet displaying dataset of USDA All Milk Prices and FMMO Class III and California Class 4b prices, January 2007-March 2012.

SAPUTO CHEESE USA, INC., Greg Dryer

Testimony

- Saputo has five plants in California, four of which purchase milk for the manufacture of cheese. The fifth plant utilizes cheese from our plants and that of other customers for further processing and packaging.
- Oppose the WUD and Coalition petitions.
- Cooperative leaders know that in a surplus production environment, raising prices would cripple their ability to market all their milk – other manufacturers with available capacity could lure away their direct ship producers simply by offering a guaranteed home for their output.

- Dairy producers are faced with falling milk prices and high feed costs similar to 2009; however California producers are better positioned to overcome these challenges given the September 2011 adjustment to the whey factor along with the cost advantage they currently enjoy.
- An average California dairy farm produces more than eleven times the milk of an average Wisconsin farm and six and one half times the national average. According to published reports, their cost advantage, due largely to scale, vastly outweighs their price disadvantage to Wisconsin or other regions.
- Punishing those who have no influence over supply is both inequitable and ineffective and simply prolongs the duration of the required correction.
- The cost to ship milk from California to the higher-priced Midwest region exceeds \$10.00/cwt, which makes it uncompetitive.
- The Upper Midwest is deficit in milk (10-15 percent) and surplus in manufacturing capacity. Plants must compete to obtain an adequate supply, which has resulted in higher milk costs.
- There is no shortage of whey processing capacity in the Upper Midwest. There is fierce competition to procure additional whey solids based on its incremental value.
- Small Midwest cheese operations can earn a reasonable return on their whey stream without having the scale or capital required for a whey processing venture.
- In recent years, cooperatives have generally down-sized or abandoned their involvement in the cheese business in California.
- One solution for California to increase milk prices would be to stimulate increased demand by encouraging expansion of existing plants or of constructing new plants – this might be taking place now if not for the fear that regulatory changes could dramatically discount or make worthless investments in California’s cheese industry.
- A small percentage change to the cost of milk translates into a very large percentage impact on a typical cheese maker’s bottom line. There is not enough margin in cheese to insulate producers from price swings resulting from supply and demand imbalances.
- Our position is that the \$0.25/cwt. fixed whey factor established in December 2007 was a reasonable compromise. We have elected to align with the majority of our counterpart members of Dairy Institute and request the Department to make no further changes until a viable long-term solution can be identified.

CASEUS ENERGY, Corey Travis

Testimony

- Caseus utilizes a variety of sugar rich waste streams such as whey and whey permeate, a low value byproduct of cheese production.
- Caseus creates an economically sustainable outlet for the value added processing of waste streams.
- Our business model rests on the health and vibrancy of both the California dairy industry as well as the California cheese industry.
- Process high BOD whey and whey permeate streams from those cheese producers that do not individually have the financial or operational resources to adequately process or convert these whey streams into value added products.
- In Wisconsin, we have found that small-to-medium sized companies either lack whey processing capabilities or have limited whey capabilities – processing whey into animal feed grade proteins, a low margin item, as opposed to human food grade proteins, a high margin item – such as WPC 80 or WPI.

- Small-to-medium cheese companies in Wisconsin that lack economies of scale are definitely feeling the pressure of the current price escalation in the regulated cost of milk due to high whey markets. Similar situation exists in California.

DAIRY FARMERS OF AMERICA, INC., Elvin Hollon

Testimony

- Support the Coalition and WUD proposals.
- DFA represents 320 farms marketing milk in California producing 20 percent of the state's milk supply, marketing milk to 30 buyers in the state and operate two plants.
- DFA members believe that the Class 4b pricing formula does not value whey properly and in recent times has undervalued it significantly.
- Cap placed on formula has proven to be inadequate in times of higher whey prices and is not reflective of national milk pricing conditions.
- Existing formula resulted in a shortfall to producer revenue in California for 2011 of approximately \$300 million – and an equal gain to processor revenue.
- Producers comparing milk checks from their farms in California to their farms in federal order markets do not conclude that the requirement that California Class 4b bear a reasonable and sound relationship with the national value of manufactured milk products has been met.
- Federal order Class III price is benchmark for comparison to Class 4b price.
- Federal order system administered milk prices for 65 percent of the nation's milk supply in 2011. Within that system, 38 percent of the milk supply was Class III in 2011.
- Cheese output: California 21.5 percent; Utah and Idaho 8.8 percent; Southwest Order 6.5 percent; Mideast Order 1.9 percent; Northeast Order 12.6 percent; Central Order 2.7 percent; Upper Midwest Order 33.7 percent; other states and federal order 12.6 percent.
- 75 percent or more of the nation's cheese production has a base price that is or tracks closely with the federal order Class III price.
- Reasons for removing milk from an order's pricing pool and not paying in any value nor collecting any payments from the month's pooled returns: producer quality; failure to meet producer touch-base standards; failure to meet handler performance standards; reason of price (class price charged for milk is higher than the blend price).
- In 2011, 126.9 billion pounds of milk were pooled on federal orders, 5.4 billion pounds was not pooled.
- Between 2000 and 2005 hearings were held in Pacific Northwest, Central, Upper Midwest and Mideast Orders to tighten performance standards and make it more difficult to depool milk.
- In Order 30 (largest collective body of milk competing with California cheese plant operators) handlers pay mailbox prices in excess of the Class III price, even in months when they depooled milk.
- A table was attached that outlined the Order 30, pounds in the pool, price, butterfat, other solids, protein and test percentages, price per pound.
- Conclude that the general level of pay over a multi-month period remained about the same regardless of the pooling status.
- Asking that the Class 4b price return values closer to Class III to California dairy farm families.
- A non-pool plant has all the characteristics of a pool plant, except they cannot produce Class 1 fluid use products.

- The seller either collects at least the minimum class value from the buyer or pools the milk and settles with the pool at the minimum class value.
- In California market, only producers bear the burden of dealing with excess supplies of milk.
- The DFA Turlock plant produces Italian variety cheeses and processes liquid whey via a fines saver process, a separator process, a filtration process and produces a pasteurized product for sale in condensed liquid form. Sell this product as food grade whey and the byproduct as animal feed. Do not manufacture any dry whey products.
- There is an ongoing campaign to recruit California dairy farm families to invest or even move their farms to the I-29 corridor in South Dakota.
- Attachments included in testimony:
Letter from Edward W. Gallagher, DFA Risk Management
Table displaying Annual Milk Production United States and Federal Orders
Table displaying Calculation of Mailbox Price at Standard Test, Adjusted for Producer Price Differential Value and Compared with Class III

DAIRY PRODUCER, Arie de Jong

Testimony

- Operates dairies in California and Arizona.
- If a cooperative owns and operates a cheese plant, and also sells to other cheese plants, they would be competing with their customers for the same outlet for their product.
- Almost certain that with the exception of Hilmar, all cheese manufacturers are in full supply contracts with local cooperatives – they provide full loads of the best quality milk available.
- These cheese plants are free from negotiating separate contracts with producers who might not be in close proximity to their cheese plants who might not ship high protein milk.
- Not the job of the Department or cheese manufacturers to manage my supply of milk.
- Cooperatives have to own and operate large clearing plants for the volume of milk that at times has no home.
- Actual production cost on a western style dairy in Wisconsin is just over \$16.00/cwt.
- Urge this committee to support the Coalition proposal and level the playing field – not only for dairy producers in this state but also for cheese producers in other states.

Post-Hearing Brief

- Attached a copy of Fraser & Torbet's 2011 Cost Study for California and other states that was requested by the Panel. Data compiled from dairy operations in Southern California, San Joaquin Valley, Kern County, Arizona, Idaho, New Mexico, Panhandle, and Pacific Northwest (Washington and Oregon).
- If cheese plants want to run extended schedules, they can; if they want to order more milk, they can.
- Cheese plants are insulated from costs of balancing milk supply.
- Co-ops are producing dairy products for overseas market – these products must be available all the time, not just when there is surplus milk.
- Other states have higher production increases than California and are getting paid fairly.
- Producer groups have come together to urge the adoption of the changes proposed by the Coalition.

ALLIANCE OF WESTERN MILK PRODUCERS, William C. Van Dam

Testimony

- Is a member of and supports the proposals put forth by the Coalition.
- California producers are frustrated with a pricing system that they feel has left them with a price that is far below the price levels paid to producers in other parts of the country.
- Producers understand two reasons why California producer milk prices cannot be as high as those in the Midwest: the Midwest is over 1,000 miles closer to the East Coast customer and costs of doing business in California are higher than other areas.
- The higher whey values are being paid by nearly all milk used to make cheese in other parts of the country.
- Producers appreciate the adjustments made to the formula last year as it was a significant improvement in the recognized value of whey and provided a framework for establishing a formula that can be adjusted to give workable and fair alternative estimate of proper whey value.
- Opposes the Farmdale proposal.

LEPRINO FOODS COMPANY, Sue M. Taylor

Testimony

- Oppose the Coalition and WUD proposals.
- Leprino has three plants located in California and all whey from these California plants is processed into protein concentrates and lactose.
- Understand that dairy producers are under financial stress after experiencing losses in 2009, followed by a couple of recovery years and to what has become a negative cash-flow period for many this Spring.
- Net returns to dairy producers in California must be competitive with alternative milk producing regions over the long term – but regulated minimum milk prices are only one of several factors that drive the level of net returns, they are not the sole solution to farm financial stress.
- Overall supply and demand balance drives finished product values that determine the overall market value of milk including the regulated price and over-order premiums.
- Cost structures of intermediaries such as cooperatives and haulers, and milk production cost structures impact farm profitability.
- Regulated minimums should be set at levels that contribute to orderly marketing of milk – the regulated prices for hard manufactured products be set at levels that clear the market.
- The California end-product formulas should generate a milk value representative of the most generic products that can be universally produced by entities subject to the price regulation.
- Whey processing is a highly capital intensive operation that is not economically viable on a small scale basis and therefore cannot be considered a product that can be universally produced by entities subject to the price regulation.
- The Coalition and WUD proposals set the whey portion of the Class 4b regulated minimum milk price at a level that exceeds returns achievable through sweet whey production in California.

- The Coalition and WUD proposals jeopardize the California cheese plant capacity associated with operations that cannot economically process their whey into a product that is at least as commercially viable as sweet whey.
- Manufacturers in California must pay the minimum regulated price for all Grade A milk processed, whereas manufacturers outside of California can choose whether to participate in minimum milk price regulations.
- In California, a producer could not opt for the economically rational choice of selling Grade A milk at below the minimum price to his neighborhood cheese plant even if it nets him more than paying for the haul to the next closest market.
- The existence of an explicit whey factor is problematic for cheese makers without whey processing capacity regardless of whether they are operating in the federal orders or California.
- WUD and Coalition proposals overvalue the whey stream even for those who produce sweet whey in California. The values would exceed the levels justified based upon the CDFA cost studies that were published when an explicit whey factor was in the formulas (approximately five years ago).
- Leprino and other manufacturers have made significant investments in developing exports that will drive up demand for U.S. dairy products and the demand and price for raw milk.
- Small and medium scale plants investing in California will find it difficult to achieve the cost structures provided for in the make allowances.

Post-Hearing Brief

- Hedge strategy for producers would be to use the NASS cheese futures contract rather than the Class III futures.
- With the overbase price, primary contributors are Class 1, 2, 3, 4a and 4b prices and utilizations.
- The “higher of” construct of the Class 1 price reduces its ability to hedge the Class 1 contribution to the overbase price.
- Classes 2, 3, and 4a are prices relative to the butter and nonfat dry milk value of milk.
- Class 4b is influenced by the Cheddar price and the closest futures instrument is the NASS Cheddar price.
- The testimony on hedging submitted by letter at the hearing did not recognize the heavy influence of butter/nonfat dry milk complex on the overbase price, did not use the proper tool to hedge Class 4b, and assumed a static approach to hedging over an extended period during which there were significant changes in the milk pricing formulas.
- Location of a cheese plant within a federal milk marketing area does not mean the cheese plant is regulated by the federal order.
- Cheese plants are free to decide whether to participate in an Order regardless of where they are located outside of California.
- Industry should direct its energy toward longer term policy reforms that will benefit all sectors, including producers.
- Leprino and other manufacturers have made significant investments to develop exports that will drive up demand for U.S. dairy products and the demand for and price for raw milk.
- Supplied dataset of hedging possibilities and outcomes.

Testimony given but no “printed testimony material” submitted to Panel:

DAIRY PRODUCER, Stephen Mancebo

Testimony

- Last three or four years have been a struggle with feed input costs up and prices down.
- Producers have no control over input costs on fuel, corn.
- Have no control over price I am paid for milk.
- California is losing dairymen at an alarming rate.
- If my facility has room to squeeze in more cows, I have to do that.
- Rest of the nation is getting paid for the whey.
- As dairy producers, we get the same price for our milk whether we are a large or small dairy, cheese processors whether they are large or small, they are still whey manufacturers.
- The only way to stay in business is to take every new product or technology and benefit from it.
- I am no longer competitive with producers in other states.

DAIRY PRODUCER, Rien Doornenbal

Testimony

- Supports the Coalition and WUD proposals.
- Dairy producers respond very well to market signals that indicate it is time to expand. For example, when Hilmar sent signals that they wanted more product.
- When Leprino expanded the Lemoore plant producers responded with more milk production.
- Once a producer borrows the money, builds the facility, buys the cows, they cannot reverse that process.
- If the market signals are showing too much milk, there is nothing an individual dairyman can do by himself, regardless of the milk price or decision by the Department.
- During 2009, there was nothing we could do to slow down production on the dairy that would lower costs enough so that we would be losing less money.
- Dairy loans are not non-recourse.
- Feel that we have exactly the right amount of milk in the state right now.
- Dairies today have a base or cap on their production.
- At one time, a cooperative sent a letter warning that there could be deductions of \$3.00-\$6.00/cwt. for going over a cap. Producers will respond to this and reduce cows if needed.
- Processors are only accepting the milk they need and milk may go out of state where it is needed with the dairy producer bearing the cost.
- There are 1,625 dairymen in California and the average dairy has 1,100 cows. If you divide the 23,000 cows by 1,625 dairymen, each dairyman is up on average 14.15 cows – not a lot of cows.
- I focus on being right at my production base and whether or not my cooperative is penalizing for going over the cap.
- Agree that some processors in unregulated milk price areas depend on the federal milk marketing price to negotiate a price that they contract with producers. I am aware of some producers that are contracted with their Idaho/Utah processors that are using

the FMMO Class III price. They are being paid the Class III plus or minus \$0.25/cwt. depending on quality.

RIZO LOPEZ FOODS, Edwin Rizo

Testimony

- Rizo Lopez Foods is a cheese company producing Mexican-style cheeses under Don Francisco label.
- Purchase milk through Pacific Gold and CDI, producing approximately two million pounds of cheese per month.
- Receive no income from the whey stream.
- Costs about \$140,000 per year to dispose of the whey.
- Difficult to maintain competitive edge when whey factor was \$0.25/cwt.
- In the process of building a new facility and will be processing our whey through a reverse osmosis system but only concentrated at about 26 percent, mostly going for cow feed.
- Any increase in the price will put us at a loss on whey.

DAIRY PRODUCER, Jared Fernandes

Testimony

- Trying to minimize the risk on our dairy.
- Dairy producers in California don't hedge their milk – they have too much basis.
- Hedged 45 percent of my milk into a Call Option of \$15.00 for the floor and \$18.00 for the top.
- If we could get the price closer to the Class III price it will reduce risk of hedging our milk.
- Class III is used because of its liquidity.

DAIRY PRODUCER, Patricia Van Dam

Testimony

- Dairy industry contributes \$8 billion to the State of California.
- Over the past four years, we have gone from 800 cows to 500 cows because of economics.
- Hope the Department takes the emotional part of the issue too.

Special 3-Minute Testimony Session

T-BAR DAIRY, Tom Barcellos

Testimony

- Supports the WUD and Coalition petitions.
- Last 20 months has been perfect weather conditions, leading to more milk per cow and cows staying in the herd longer.
- Too many dairies going out of business.

MILKY WAY DAIRY, John Gailey

Testimony

- New technology of sex semen giving high percentage of female calf offspring.
- So many replacement animals now that the value of those cows has dropped the supply and demand.

- You either milk the cows or have to sell them at low prices.

DAIRY PRODUCER, John Moons

Testimony

- Member of the CDI Board of Directors.
- Difficult to hedge milk prices with the discrepancy between California Class 4b and Federal Order Class III.
- Support the Coalition and WUD petitions.

ORNELLAS DAIRY, Kevin Ornellas

Testimony

- Economic situation has caused us to grow 100 percent of our forages; purchase trucks to pick up reject fruits and vegetables for feed – still in a negative cash flow.
- Feed bill continues to increase and we are operating at a negative cash flow.

DAIRY PRODUCER, Jeff Wilbur

Testimony

- Supports the WUD and Coalition petitions.
- Dairies in the Midwest have a greater incentive and better hedge position than the dairy producers in California.
- The margins are hardly breaking even to \$0.10 margin on a cash basis, not having any return on investment to return to operator or depreciation costs.

COUCO CREEK DAIRY, Tony Machado

Testimony

- Currently have cost to maintain our herd of \$10.00/cwt., then add \$4.00/cwt. for fixed costs – at \$12.00 we cannot exist.
- Four dairies around us have gone out in the last few months and some of the land is being bought by cheese makers.

Written Testimony Received and Entered Into the Hearing Record

IMPERIAL VALLEY CHEESE, Dolores Gossner Wheeler

Testimony

- Does not produce sufficient whey volume to justify the cost of a concentration system.
- Are charged an “Inspection tonnage tax” of \$0.08 per ton for whey they give away.
- Consultants, soil analysis, monthly waste water analysis, monthly crop analysis, other direct and indirect costs have burdened the operation.
- Will be forced to close this plant if the cost of milk increases significantly.

RUMIANO FINE NATURAL CHEESE, R. Baird Rumiano

Testimony

- Opposes the Coalition and Western United Dairymen petitions
- Invested \$4,000,000 in a whey protein concentrate system.
- Concerned that an increase of the Class 4b price would threaten the existence of many small cheese factories in California.

SECURITY MILK PRODUCERS ASSOCIATION, Ed Haringa

Testimony

- Supports the Coalition and WUD proposals to the Class 4b pricing formula.
- Points to a difference over the past 12 months of over \$2.00 per hundredweight between California Class 4b and Federal Class III prices.
- Matching supply with demand is the responsibility of the producer community, not the Department
- Opposed to Farmdale proposal.

SIERRA NEVADA CHEESE COMPANY, Ben Gregersen

Testimony

- 80 percent of their cheese, butter and yogurt production consists of specialty cheese.
- Does not utilize whey and struggles with current disposal costs.
- Any increase in the whey cost formula would be passed on to consumers in their pricing of specialty cheese products.
- Supports the Farmdale proposal.

LOS ALTOS FOOD PRODUCTS, Raul Andrade

Testimony

- Opposed to the Coalition and WUD petitions.
- As a result of September 1, 2011 whey factor increase, this plant pays an additional \$0.40/cwt. for milk.
- The plant does not utilize whey and currently pays \$200,000 a year for its disposal.