

Hearing Panel Report

*Based on a Public Hearing Held On
September 12, 2013*

Addressing the Class 1, 2, 3, 4a, and 4b Pricing Formulas
Contained in the
Stabilization and Marketing Plans
for Market Milk for the
Northern and Southern California Marketing Areas

Hearing Panel Report

Addressing the Class 1, 2, 3, 4a, and 4b Pricing Formulas Based Upon a Public Hearing Held on September 12, 2013

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 (Department) hearing record. The evidence includes the Departmental exhibits, written statements and comments received from interested parties, and written and oral testimony received at a public hearing held on September 12, 2013.

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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 Department for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of the Plans for Market Milk.

A total of 28 witnesses testified including the Department's witness:

Department Witness, Erica Sanko

California State Senate, Honorable Anthony Canella

California State Senate, Honorable Tom Berryhill

California State Assembly, Honorable Adam Gray

California State Assembly, Honorable Kristin Olsen

California State Senate, Honorable Edward Hernandez

California State Assembly, Honorable Richard Pan, MD

California State Senate, Chair of the Senate Agricultural Committee,
Honorable Cathleen Galgiani

+California Dairies Inc. (CDI), Eric Erba

+Milk Producers Council (MPC), John Moffatt

+California Dairy Campaign (CDC), Lynne McBride

+Western United Dairymen (WUD), Tom Barcellos

T-Bar Dairy, Tom Barcellos

*University of California, Davis Agricultural & Resource Economics, Richard Sexton, PhD

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

AdamsCows Dairy, Lantz Adams

*AdamsCows Dairy, Rick Adams

Kraft Foods (Kraft), Renee Peets

Joseph Gallo Farms (Gallo), Joe E. Paris

Los Altos Food Products, Inc. (Los Altos), Adolfo Sanchez

Duarte Dairy, Inc., Antoinette Duarte

Farmdale Creamery, Inc. (Farmdale), Scott Hofferber

Hilmar Cheese Company, Inc. (Hilmar), David Ahlem

*Dairy Institute of California (DI), William Schiek, accompanied by John Lemmon

Land O'Lakes, Inc. (LOL), Pete Garbani

Dairy Family, Producer, Rob Vandenheuvel

Leprino Foods (Leprino), Sue Taylor

+ Indicates Co-Petitioners

* Indicates submitted a Post-Hearing Brief

**CALL OF THE HEARING AND
ESTIMATED IMPACTS OF THE HEARING PROPOSAL ON
CALIFORNIA CLASS 4b AND POOL PRICES**

On July 22, 2013, the Department received a request from co-petitioners for a public hearing proposing:

- a permanent modification to the sliding scale that is utilized to determine the dry whey factor in the Class 4b pricing formula;
- removing the current six-month temporary price adjustments across all milk classes resulting from the May 20, 2013 public hearing; and
- implementation of a temporary price adjustment only on the Class 4b milk solids-not-fat of \$0.0528 per pound for a 12-month period.

The Call of the Hearing

On August 5, 2013, the Department issued a Notice of Public Hearing for September 12, 2013, to consider the three proposed amendments to the Plans and requested the proponents of the petition and any alternative proposal address the following in regards to the amendment in question. There were no alternative proposals submitted.

- 1) Temporary Price Adjustment – At a minimum, the economic conditions that have changed that would warrant adjustments to the current temporary price established as a result of the May 20, 2013 hearing.
- 2) Whey Valuation – The sufficiency of the calculation of the whey factor by reference to quantifiable economic data and methodologies; such as but not limited to: manufacturing cost data, marketing and sales data, and whey stream valuation directly applicable to California plants. As well as, the economic substantiation of the implementation of the petition and any alternative proposal.
- 3) Evidentiary Support and Legal Compliance – Include the factual basis, economic and other evidence and legal authority in support of the whey factor, any temporary price adjustment and any proposed amendments to the Plans. In relation to the whey factor, the extent to which the factor can be transparently calculated as a component of the Class 4b and fairly imposed upon processors.

The hearing record showed that 28 parties testified at the hearing, four being the co-petitioners of the proposal. Those parties that supported the proposal were representatives of producer cooperative organizations, representatives of or on behalf of producer trade organizations, individual dairy producers, and members of the California Legislature. Testimony in opposition to the proposal was presented by milk processing companies and representatives of a processor trade organization.

Estimated Impacts of the Hearing Proposal on California Class 4b and Pool Prices

In order to estimate the impact of the proposal to the current Class 4b and Pool prices, the Department analyzed each aspect of the proposal individually, assuming the proposal was in effect over the five-year period of August 2008 through July 2013. Since each portion of the proposal centered on different timeframes (permanent and 12-months), the Department also evaluated the impacts of each proposed aspect simultaneously over the respective five-year period (see Table 1).

The table below shows the impacts of the proposed amendments on Class 4b and Pool prices relative to current prices from August 2008 through July 2013. The analysis assumes that the proposed amendments and current formulas were in effect throughout the entire period. The current formulas exclude any temporary price increases resulting from the May 20, 2013 hearing. When a change is a "plus," the proposal would have increased the price and when a change is a "minus," the proposal would have decreased the price.

Table 1 - Estimated Impacts on Class 4b and Pool Prices if the Hearing Proposal had been in Effect for the Five-Year Period: August 2008 - July 2013

Five-Year Averages		
Proposal	Class 4b (\$/cwt.)	Pool¹ (\$/cwt.)
Dry Whey Factor Scale Adjustment		
5-year average	+\$0.14	+\$0.06
Temporary Price Adjustment		
5-year average	+\$0.46	+\$0.20
Combined Adjustments		
5-year average	+\$0.60	+\$0.26

¹ Quota and overbase price.

The proposed permanent adjustment to the whey factor scale would have resulted in the smallest monetary impact with a five-year monthly average increase of \$0.14 per hundredweight (cwt.) in the Class 4b price and \$0.06/cwt. to the Pool price. The proposed temporary price adjustment would have resulted in a five-year monthly average increase to the Class 4b and Pool prices of \$0.46/cwt. and \$0.20/cwt., respectively. Of note, the only impacts on the remaining milk classes would be the removal of the temporary price increases implemented across all milk classes from the May 20, 2013 hearing. The largest impact is when both the permanent modification to the whey scale and temporary price adjustment on the Class 4b price are applied. This resulted in a five-year monthly average increase of \$0.60/cwt. to the Class 4b price and \$0.26/cwt. to the Pool price.

TEMPORARY PRICE ADJUSTMENT

The call of the hearing states that proponents of the proposal and any alternative proposals shall address, at a minimum, the economic conditions that have changed that would warrant adjustments to the current temporary price established as a result of the May 20, 2013 hearing. Similar to the May 20, 2013 hearing, testimony at the September 12, 2013 hearing referenced the ongoing financial challenges confronting California dairies. Witnesses testified that the upward trend in feed costs have continued to pressure margins on California dairies. A number of witnesses stated that high feed costs and ensuing negative margins have continued to erode equity for many of the state's dairies and have contributed to some dairies exiting the industry. However, other witnesses testified that dairies outside of California have also been impacted by higher feed costs over the last few years and have experienced reduced margins as a consequence. In addition, these witnesses stated that other states have experienced declines in dairy farm numbers as well.

The Code mandates that relevant economic factors must be considered when setting minimum class prices and to determine if economic conditions have changed to justify the proposed changes. These economic factors consist of, but are not limited to, maintaining an adequate and continuous supply of milk in relation to the demand for milk and considering the combined income from class prices in relation to the cost of producing market milk. These and other applicable economic factors are evaluated in this section.

Feed Costs

Feed costs and corn prices have been on the rise since mid-2010 and have been the primary basis for the temporary price increases resulting from the December 21, 2012 and May 20, 2013 hearings. The rise in corn prices has had a significant impact on California dairies since 1) corn is the primary component of the California dairy feed ration, 2) California is a corn deficit market that is subject to higher prices for corn and corn feeds, and 3) feed costs essentially account for a significant portion of the total cost of production.

Data from the Department's cost of production survey for the first quarter of 2013 indicated the total cost of feed, on average, was \$11.84/cwt., \$0.40/cwt. lower than the average cost of feed for the fourth quarter of 2012 and \$0.25/cwt. lower than the average cost of feed for the third quarter of last year. The final cost of production survey for the second quarter of 2013 was not available at the time of the hearing, however preliminary figures suggest second quarter 2013 feed costs should continue the downward trend. The hearing record is absent of any specific data pertaining to feed costs for California dairies that extended beyond the Department data for the first quarter.

The impact of the 2012 drought on available corn supplies combined with the uncertainty of this year's corn crop fueled corn prices through early summer 2013, compared to 2012. However, in July 2013, the corn futures market signaled that corn prices were falling below last year's level and trending downward. Although futures markets are highly volatile and uncertain, they provide direction in regards to trends and movements in commodity cash prices because the futures and cash markets are correlated. The relationship between the futures and cash market prices becomes stronger in those months leading up to corn harvest as the two market prices move toward convergence.

At the time of the hearing, the corn harvest was underway and indications for a larger U.S. corn crop and lower corn prices appeared more likely. USDA had forecasted a record large

corn crop with projections for 2013/14 corn prices to average in the \$4.40 to \$5.20/bushel price range. If realized, that would translate into a 30 percent year-over-year decline compared to last year's average corn price and over 20 percent lower than the 2011/12 average corn price. Witness testimony referenced USDA and market analyst projections for larger corn supplies and lower corn prices compared to 2012, with witnesses testifying lower corn prices would suggest relief in feed costs relative to prior years. Even though corn accounts for the largest portion of the dairy feed ration, prices of other feed components such as alfalfa hay are still uncertain at this time. Although harvest acreage is projected by USDA to be slightly larger than last year, when combined with stronger exports and concerns regarding water availability in California, hay prices for 2013/14 may not deviate from their historically high levels.

Since at the time of the hearing, corn prices were trending lower and when taking into account USDA projections for corn production and price, it would appear that corn prices are expected to decline for the remainder of 2013. The hearing record does not contain any new California feed cost data beyond the Department's first quarter cost of production data, which would indicate this economic factor has deteriorated since the May 20, 2013 hearing.

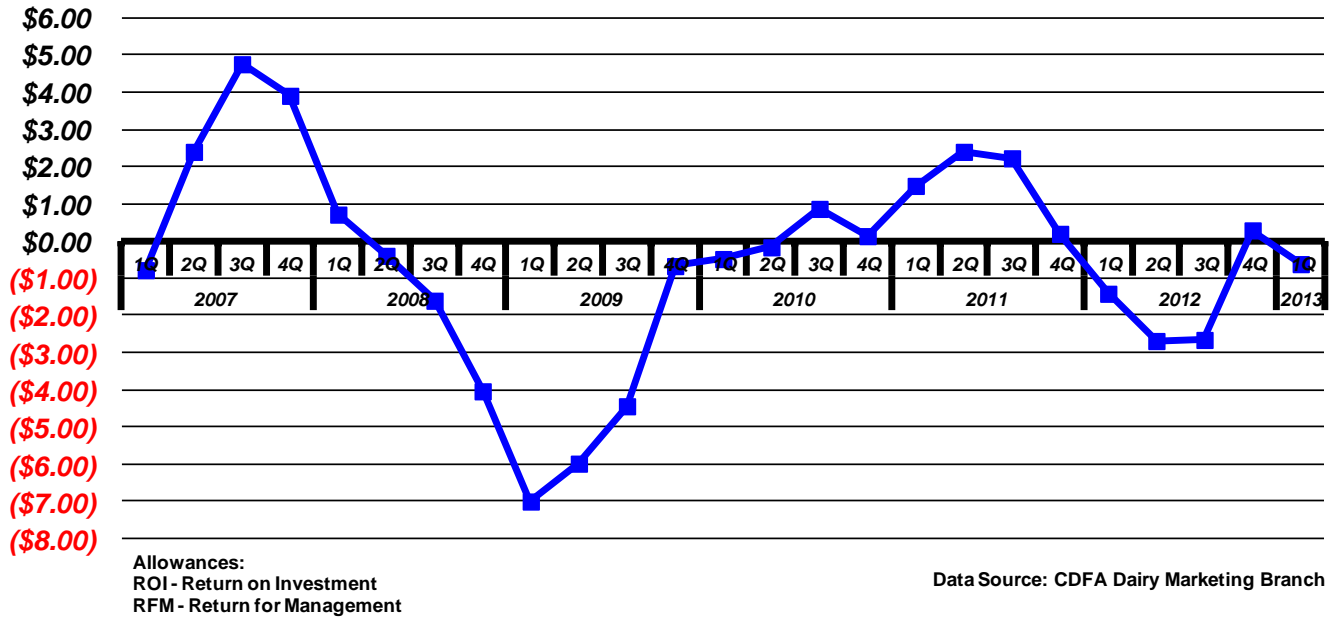
Cost of Production

The cost of milk production relative to the income or price of milk is an indicator used to assess economic conditions. The estimated average margin of California dairies participating in the Department's cost of production survey from the first quarter of 2007 to the first quarter of the current year is depicted in Figure 1. This figure shows the estimated spread between the mailbox milk price and the total cost of production, including allowances for return on investment and return for management. The mailbox milk price is a more transparent price in regards to income received by producers as it accounts for premiums received and deducts marketing costs and assessments. This price includes quality payments, component and yield premiums, bonuses, and monthly distribution of cooperative earnings, but nets out haul charges, cooperative dues, assessments, and fees. These marketing costs and assessments are included in the Department's estimated cost of production.

As shown in Figure 1, the estimated average margins were slightly negative in the first quarter of 2013. Although feed costs and total production costs with return on investment and management declined when compared to the fourth quarter of 2012, so did mailbox milk prices, resulting in costs slightly exceeding price. When compared to prior years (2008, 2009, and 2012), overall average margins on the dairy have improved and appear to be on an upward trend. For the first quarter of 2013, when allowances for the return on investment and management are not accounted for, the mailbox milk price was greater than the average total cost of production and resulted in a positive average margin.

Witnesses did not provide any current data on California producer margins on the dairy that extended beyond the first quarter of 2013. Preliminary indications from the Department's second quarter 2013 cost of production survey suggest both feed and total costs should decline in the second quarter of 2013. This, coupled with higher observed mailbox milk prices in the second quarter of 2013, suggests margins on the dairy should improve.

Figure 1:
Difference Between California Mailbox Milk Price Less California Cost of Production
Based on the California Production Cost Survey, with Allowances
January 2007 through March 2013
(In Dollars per Hundredweight)



A number of witnesses testified that milk prices are forecast to be strong for the balance of 2013, supported by robust international demand for U.S. dairy products. Based on these forecasted prices, the Department's cost of production data for the first quarter of 2013, expectations for further declines in feed costs, and because the hearing record is deficient of any substantial data regarding estimated California dairy production costs beyond the first quarter of 2013, it would appear that feed costs are on a downward trend. The economic impacts of lower corn prices on feed costs would imply continued improvement in producer financial conditions as 2013 progresses into 2014.

Milk Supply

When establishing the state's minimum prices, the Department must set class prices at an appropriate level to assure there is an adequate and continuous supply of market milk in relation to the demand for milk. For January through July 2013 (the most current Department data available at the time of the hearing), California's average monthly milk production was down three percent from the same period in 2012. However, as evidenced by witness testimony from the May 20, 2013 hearing, 2011 was a more normal milk production year. Therefore, when compared to 2011 milk production, the current year was approximately one percent higher for the respective seven-month period.

Some witnesses testified that year-over-year declines in milk production between 2013 and 2012 were examples of producer financial conditions. A representative of a producer-cooperative organization, when questioned by the Panel, testified that at the time there were issues of not being able to fully supply customer orders and having to ration milk allocations as milk supplies were not at the level expected. The witness did not state whether or not this issue would continue for the remainder of 2013. Other witnesses testified that milk supplies in general, with respect to the state's plant capacity, were in relative balance and milk

processing capacity had not been stressed this year as seen in 2012. Further testimony stated year-over-year declines in the state's milk production have brought the milk supply into better balance with the state's processing capacity or demand for market milk. The Panel believes there to be a sufficient supply of milk in relation to the state's demand and indications of a potential over-supply or under-supply of milk does not appear to be a current issue.

Other Economic Factors

Markets are dynamic and there are a variety of other economic factors which could influence trends in milk prices, milk production, costs of production, and dairy product markets. Factors which can influence demand and therefore prices for dairy products include, but are not limited to, consumer income levels, availability of substitute goods, current economic conditions, global milk supplies, and exchange rates. Cost of production can vary depending on prices and availability of feeds such as corn, global and domestic weather conditions such as drought, environmental regulations, water availability, and interest rates. There is some concern by market analysts that lower feed costs could result in increases in milk production and result in lower milk prices, while other market analysts suggest export demand could continue to support milk prices into 2014. Many of these economic factors are unpredictable and often times volatile, with the impacts on demand and milk supply being unknown at this time. The uncertainty surrounding these economic factors and the potential impacts on the industry do not indicate temporary price adjustments are warranted.

Panel Recommendation

After reviewing the information included in the hearing record, the Panel does not find that current economic conditions warrant adjusting the temporary prices established as a result of the May 20, 2013 hearing. The most current data suggests feed costs are declining and estimated margins are improving. Conditions at the time of the hearing strongly indicate a record corn crop and lower corn prices ahead, which may result in further improvement in producer margins. Testimony and Department milk production data imply that the state's milk supply appears to be in balance with respect to the demand for milk and there have not been any major concerns presented regarding that balance in 2013. The Panel believes that these economic conditions indicate satisfactory, stable, and orderly marketing conditions currently in the state that do not require adjustments to the minimum class prices. For these reasons, the Panel does not recommend making any modifications to the current temporary price adjustments resulting from the May 20, 2013 hearing.

The Panel recommends no changes to the current Class 1, 2, 3, 4a, and 4b temporary prices established as a result of the May 20, 2013 hearing.

WHEY VALUATION IN THE CLASS 4b PRICING FORMULA

Issue

When the Department first developed a Class 4b pricing formula in the late 1980s, the intended foundation of the value established by this formula was cheese. Since the formula was designed to establish a milk price paid by cheese manufacturers, the vast majority of the value of the Class 4b pricing formula was derived from the commodity price and the manufacturing process of Cheddar cheese, with the current value established by the Class 4b pricing formula continuing to be primarily based on cheese. (See Appendix A for further discussion regarding the construct of the Class 4b pricing formula and the current issues affecting the portion of the formula based on cheese.)

Since the addition of a whey factor in the Class 4b pricing formula in early 2003, the whey factor has proven difficult for the Department to administer and update. Since 2003, there have been eight separate hearings held to consider either temporary or permanent adjustments to the whey factor in the Class 4b pricing formula. The outcomes of these hearings have resulted in various modifications to the manner in which whey is valued in the pricing formula and also highlighted the concerns the Department has had with servicing the whey factor and establishing an appropriate whey value in the Class 4b pricing formula. During this time, the Department has endeavored to utilize the best objective information and data available to connect whey valuation with the relevant economic factors and conditions specific to the industry; however, certain issues related to whey valuation have consistently created difficulties and presently continue to create challenges in valuing whey. Based on the records of the current hearing and previous hearings, the Panel is concerned with modifying the whey factor because of issues associated with the lack of: transparent, California-specific data related to the product prices, yields and manufacturing costs of whey products; data directly relatable to the actual manufacturing and marketing conditions of California's diverse cheese manufacturers; and data that cannot be published due to confidentiality.

California-Specific Product Price, Yield, and Manufacturing Cost Data

When the whey factor was first implemented in 2003, it followed the typical end-product pricing construct consisting of: a product price minus a manufacturing cost allowance times a yield factor. This still is the standard methodology that serves as the foundation for all the California class pricing formulas. The servicing of this end-product pricing construction relies on the annual manufacturing cost studies performed by the Department on California manufacturing plants. These manufacturing cost studies detail the most current data available regarding the actual manufacturing costs and yields observed in California plants that manufacture the dairy products (butter, nonfat dry milk, Cheddar cheese, and dry whey) which are key to determining the milk price established by the class pricing formulas.

The Department performed audited manufacturing cost studies on dry whey and publicly released such studies annually from 2004 to 2007. These studies provided the California-specific data needed to adjust the whey factor during these years based on the actual manufacturing cost and yield data observed in these plants during this time period. These manufacturing cost studies for dry whey allowed the Department to objectively modify the whey factor using the long established process the Department employed to amend its pricing formulas prior to 2003 and the advent of the whey factor.

However, by 2007, the number of California plants manufacturing dry whey decreased from four to one plant that consistently manufactured dry whey and a second plant that intermittently manufactured dry whey. Because of the reduced number of plants producing dry whey, the Department was unable to continue this manufacturing cost study because of confidentiality rules regarding the public release of proprietary data. As a result of the lack of accurate California-specific data representative of California plants (and the lack of data relatable to actual California manufacturing and marketing conditions discussed below), the whey factor was modified to a fixed factor at the end of 2007. Since 2007, there has been no California-specific manufacturing cost data or transparent, publically available sources of such data available to the Department to serve as the needed basis for the objective servicing of the whey factor in the Class 4b pricing formula.

The hearing record shows that the Department has been historically concerned with the lack of transparent, California-specific manufacturing cost data necessary to service not only the whey factor in the Class 4b pricing formula, but other portions of the pricing formulas as well. Some witnesses stated that there was no new California-specific data available. The current hearing record is void of any data source available to provide applicable California-specific information for use in whey valuation. The absence of California-specific data interjects subjectivity into the pricing of California milk that could have adverse consequences for the competitive position of the California dairy industry. Lack of such data also creates difficulties in adhering to the legal mandate found in the Code that directs the Secretary to take into consideration the product yields and manufacturing costs associated with Class 4b products, such as whey products, when establishing minimum prices.

Data Related to California Manufacturing and Marketing Conditions

The intent of California's pricing formulas is to relate each component or factor of the pricing formulas to the actual manufacturing processes which occur in processing plants and the marketing conditions of finished dairy products facing California manufacturers. For example, the commodity prices used in the pricing formulas should correspond to the same commodity products made in the state's plants and the explicit or implicit manufacturing cost allowance and yield factors should be reflective of the actual costs and yields observed in the plants. By relating the pricing formulas to the actual conditions observed in California plants, the resulting milk prices should commensurate with the dairy products made from that milk and allow California manufacturers the opportunity to compete in statewide, national, and international markets. An examination of previous hearing records shows that the Department has expressed concern about the efficacy of the whey factor to relate to the actual manufacturing and marketing conditions of California cheese and whey products. The Panel continues to be concerned by how the whey factor relates to California manufacturing and marketing conditions.

Since its inclusion in the Class 4b pricing formula in 2003, the whey factor has used dry whey as the basic commodity or the basis for setting the whey valuation for milk purchased by all cheese plants in California. However, since dry whey is produced by only two out of approximately 60 cheese plants, whey valuation based on dry whey does not appear to accurately represent the manufacturing conditions of California cheese plants.

First, the majority of California cheese plants do not recover a value-added, dry form of their whey stream. As a result, some cheese plants pay a cost to dispose of their whey steam without receiving any revenue in return. Other cheese plants are able to sell their wet whey stream for the purpose of animal feed, which provides some minimal revenue stream for the

cheese plant but not in the same magnitude of the value established by the whey factor based on the value-added product, dry whey. In both of these cases, the cheese plant is financially stressed because the assumed whey value in the Class 4b pricing formula does not relate well to the actual manufacturing experience of these plants.

Second, the manufacturing and marketing conditions of the California cheese plants manufacturing value-added dried whey products other than dry whey appear not to correlate adequately with dry whey. There are currently seven California plants that receive a revenue stream from manufacturing the other value-added whey products, whey protein concentrates (WPC) and whey protein isolates (isolates). These products require additional manufacturing steps of filtration, separation, and drying, which imply additional equipment investment and manufacturing costs compared to those associated with dry whey. In addition, the protein content of WPC and isolates range from 34 percent to over 90 percent compared to the protein content of dry whey at approximately 13 percent. Mathematically, the quantity of WPC or isolates yielded from the whey stream would be less than the quantity of dry whey yielded from the same whey stream. Because of the differing manufacturing processes and product yields of WPC and isolates compared to dry whey, there is a concern that dry whey manufacturing costs and yields are not representative of the actual manufacturing conditions of California plants that produce whey protein products that are not dry whey.

Third, it is unclear that the marketing conditions of other whey products manufactured by California cheese plants relate well to those of dry whey. As mentioned previously, dry whey is not universally produced by those California cheese plants that do manufacture value-added whey products. In order for the whey valuation in the Class 4b pricing formula to function well, dry whey must be an appropriate surrogate for the actual whey products manufactured by the state's plants. If the price of dry whey does not move at the same time or in the same direction as the prices of the whey products that are actually made by California cheese plants, then the link between the whey values that would be incorporated in the Class 4b formula may not correspond well with the actual experience of California plants. This has been an issue since whey valuation was first implemented into the Class 4b formula and was emphasized as a continuing issue when the current sliding whey value scale was first introduced into the formula in 2011.

A review of the prices of dry whey and WPC quoted from USDA's Dairy Market News since 2007 show the two price series tend to trend up and down together; however, there are occurrences when the two price series will move in opposite directions or when one price series will be relatively constant while the other is moving upward. This provides evidence that the factors influencing the markets for each commodity differ. Additionally, the hearing record shows that the price of WPC (34 percent protein), when adjusted to equate its protein content with that of dry whey, may not relate well with dry whey. A comparison of the per pound of protein price of WPC with that of dry whey since 2007 shows occurrences when the protein value of dry whey greatly exceeds the protein value of WPC, which provides evidence that the market movements or values of dry whey are not always directly comparable with those of WPC.

There are observable differences in the marketing conditions of the differing whey products. Whey valuation based on dry whey is not relatable to California cheese plants because of both the variety of methods used to handle the whey stream and variety of products manufactured from the whey stream.

Confidential Data Issues

Over the course of many years the California dairy industry has been consolidating in both dairy farms and dairy manufacturing facilities. The number of dairy farms and dairy manufacturing facilities has been decreasing, while the size of the farms and manufacturing facilities has been increasing. One consequence of this industry consolidation is that statistical data on milk production and manufactured dairy products that were historically published for public use, in many instances, now must be held confidential, similar to USDA confidentiality rules.

In the case of manufacturing facilities, the statistical data regarding the quantity of dairy products manufactured and manufacturing costs of certain dairy products can no longer be published because there are too few plants manufacturing certain dairy products, or there are dominant manufacturers whose output represents a significant percentage of the total output for the whole state. In either case, the data is considered proprietary to the California manufacturer in question and is not released publicly. This data is held confidential so that competing manufacturers are not able to obtain a competitive advantage against the California manufacturer by leveraging the confidential data in the pricing or marketing of competing dairy products.

The issue with confidentiality applies to the other whey products manufactured by California plants. Similar to dry whey, isolates are manufactured by only two plants in California, which makes production and manufacturing cost data confidential. WPC is categorized in two groups by protein content, with WPC Low (protein content 34 to 49.9 percent) and WPC High (protein content 50 to 89.9 percent). WPC Low data is confidential due to one dominant manufacturer and WPC High data is confidential for the same reason in certain months depending on the variable monthly production of the other plants making WPC High. Therefore, there is not one whey product manufactured in California that could serve as the basis for whey valuation in the Class 4b pricing formula because the data for all the whey products are confidential and preclude the Department from utilizing them to service a whey factor.

In addition, because of the wide range of protein content of the various whey products (12 percent to over 90 percent) manufactured in California; average product prices, manufacturing costs, and yields calculated from all the different whey products would mathematically yield a result which is different from the actual conditions of individual plants that produce a product on the very low end or the very high end of the protein content spectrum. Ultimately, it would be difficult to implement whey valuation in the Class 4b pricing formula that would overcome the issue of data confidentiality.

Panel Recommendation

Whey valuation has been challenging to administer since its inclusion in the Class 4b pricing formula in 2003 and continues to be so. Determining an objective whey valuation methodology is difficult because of the lack of California-specific data, the whey factor not directly relating to the actual manufacturing and marketing conditions of most California plants, and the confidential nature of the limited data that is available. The hearing record does not contain sufficient evidence to overcome these issues. However, the whey factor appears to be adequate because the current economic conditions indicate satisfactory, stable, and orderly marketing conditions in the state.

The Panel recommends no changes to the current whey factor.

EVIDENTIARY SUPPORT

Witnesses for both producer and processor interests asserted there was economic justification and existing legal authority to, respectively, support or oppose the proposal. A review of the evidentiary support found in the hearing record shows that witnesses reiterated the same arguments in a manner consistent with the arguments presented at previous hearings. (See Appendix B for a brief discussion of these arguments.) However, there was a new legal analysis presented by a witness challenging the continuation of the whey factor used in the calculation of the Class 4b pricing formula, based on the following reasons: lack of transparent, quantifiable data needed to adjust the whey factor; lack of evidentiary support in the hearing record that must serve as the only basis for pricing decisions; and lack of California-specific data relatable to California whey product manufacturing in the hearing record. Except for this legal analysis, the hearing record does not appear to contain further new evidentiary support regarding the valuation of the whey factor or temporary price adjustments that have not been addressed in prior hearings.

PANEL RECOMMENDATION

The economic conditions currently observed in the state do not warrant any temporary or permanent changes to the class pricing formulas. The Panel believes that long-term, structural changes in the state's pricing regulations are needed and best addressed outside the hearing process. Numerous meetings with the Dairy Advisory Committee, industry stakeholders, and the Dairy Future Task Force since 2011 have addressed Class 4b formula pricing challenges and other issues associated with the current California milk pricing system. The Panel believes the best solution moving forward with regards to Class 4b pricing is for industry stakeholders and the Department to focus their efforts to develop changes to the current milk pricing system which would allow for objective milk pricing methodology and also provide the opportunity for dairy farmers and manufacturers to achieve long-term success.

The Panel Recommends:

- No changes to the current Class 1, 2, 3, 4a, and 4b temporary prices established as a result of the May 20, 2013 hearing.
- No changes to the current whey factor.
- Seeking long-term solutions to California pricing through the Dairy Future Task Force.

This Hearing Panel Report has been prepared and submitted by:

Original Signed by

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Candace Gates, Branch Chief

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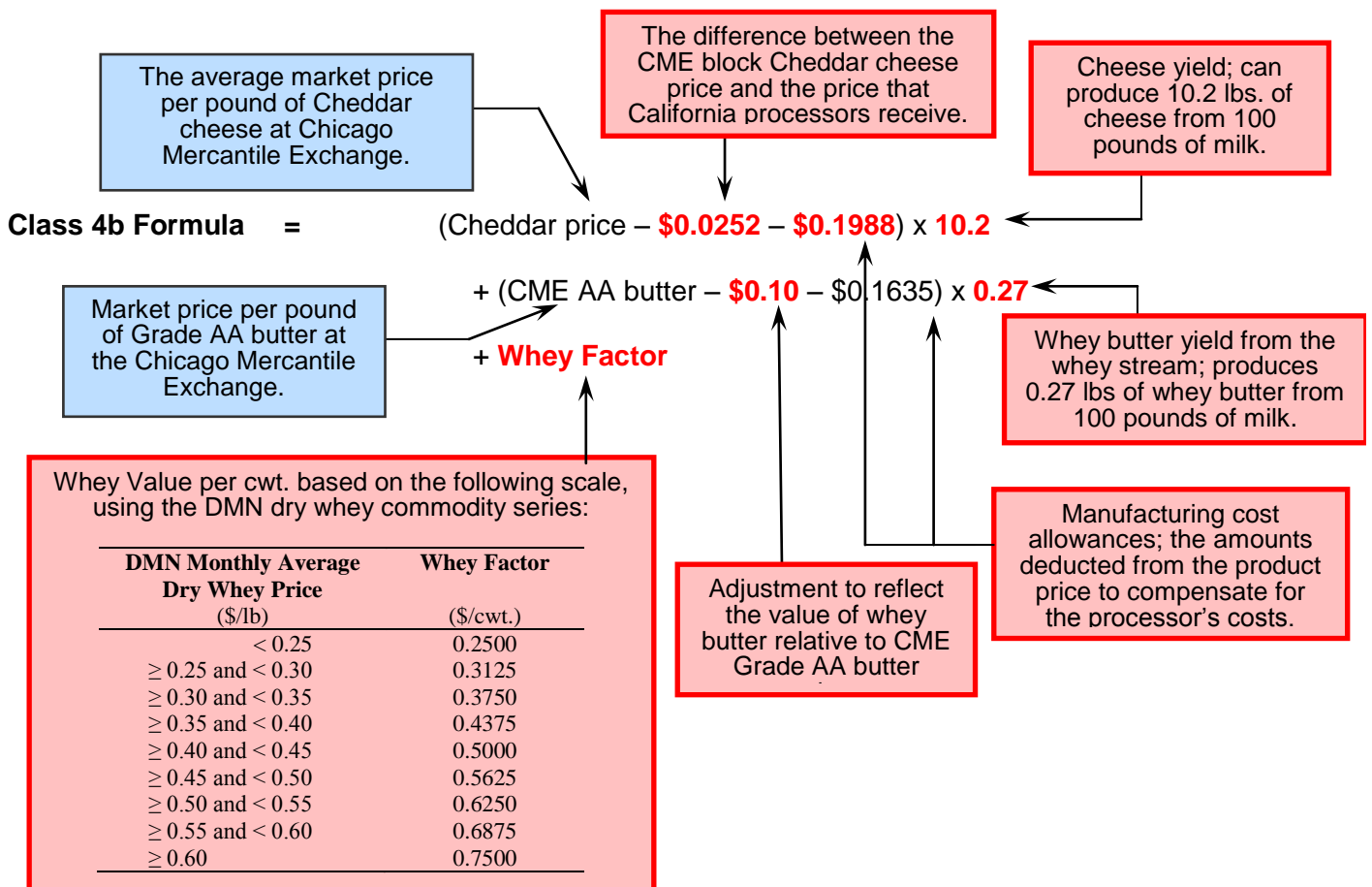
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Kevin Masuhara, Division Director

CALIFORNIA CLASS 4b FORMULA FOR CHEESE

The California Class 4b pricing formula for cheese includes a number of components to determine the value of milk used for cheese making. As shown in the diagram below, the whey factor is only one minor portion of the Class 4b pricing formula and contributes a relatively small value when compared to the other components included in the pricing formula. The manufacturing cost data for dry whey became confidential by the end of 2007 (due to an insufficient number of plants manufacturing dry whey) and resulted in the loss of California-specific data necessary to service the whey factor in the Class 4b pricing formula. Since the end of 2011, the manufacturing cost, product sales data, and yield portions of the formula related to Cheddar cheese also became confidential due to consolidation in the industry and are also parts of the Class 4b formula that are no longer serviceable. This has resulted in additional difficulties in servicing the entire Class 4b pricing formula. Since 2011, numerous meetings with the Dairy Advisory Committee, industry stakeholders, and the Dairy Future Task Force have focused on these pricing issues with the Class 4b pricing formula as well as other issues associated with the current California milk pricing system.

Red indicates those portions of the Class 4b pricing formula that are no longer serviceable because of the lack of data or data confidentiality issues.



EVIDENTIARY SUPPORT

The hearing record shows that various witnesses representing both dairy producer and processor interests provided testimony that respectively supported or opposed the petitioners' proposal by asserting that there was economic justification and existing legal authority given to the Secretary to implement or not implement the proposal. In general, witnesses for both producer and processor interests cited various Code sections that have been cited in previous hearings, which provided similar if not the same assertions that have been presented in previous hearings. These citations from the Code reference the broad authority given to the Secretary to establish minimum prices for milk and reference various mandates that give the Secretary direction to, among other things; promote the orderly marketing of milk, maintain stability and prosperity in the production of milk, and consider relevant economic factors that witnesses stated must be taken into consideration when establishing minimum prices for milk. Some of these relevant economic factors debated by industry stakeholders include:

- The difference between the California Class 4b price and the federal Class III price;
- The different minimum pricing and pooling regulations found in the California and Federal Order marketing laws and regulations;
- Which classes of milk should be affected by temporary price increases;
- How the level of California milk prices should relate to milk prices in other areas of the U.S.; and
- How California conditions relating to milk production, dairy product manufacturing, and finished dairy product marketing do relate or should relate to those in other areas of the U.S.

When reviewing the information and assertions presented, the Panel found that hearing witnesses interpreted the Code in the same manner as previous hearings while the discussion surrounding these relevant economic factors followed the same patterns and reached the same conclusions when compared to previous hearings. There does not appear to be any new economic arguments or legal evidence regarding the above listed factors found in the current hearing record that extends beyond what has been presented at previous hearings. In light of no new arguments and since the Panel has specifically addressed the cited Code sections and the above listed economic factors in previous Panel Reports, redundant discussion of these topics is not contained herein. The Panel's analysis of the Code and these economic factors remain the same as discussed in the Panel Reports from the May 31 and June 1, 2012 and the December 21, 2012 hearings.

CALIFORNIA'S DAIRY LANDSCAPE

The following background statistics reflect the dairy landscape in California with the most current data available at the time of the hearing.

Cost of Producing Milk

- For 2012, 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 \$17.57 per hundredweight (cwt.) (up \$1.40/cwt. from 2011). When including return on investment and management, the cost of producing milk in 2012 was \$19.03/cwt. (up \$1.25/cwt. compared to 2011).
- For the first quarter of 2013, the statewide average cost of producing milk was \$17.69/cwt., up \$1.06 from the same period in 2012.

Mailbox Milk Prices

- California mailbox milk prices for 2012 averaged \$16.29/cwt., a decrease of \$1.84/cwt. compared to the average 2011 mailbox price of \$18.13/cwt.
- For the first five months of 2013, the California mailbox milk prices averaged \$17.64/cwt., an increase of \$2.83/cwt. compared to the average mailbox milk price for the same time period in 2012 of \$14.81/cwt.

California Milk Production

- California's annual milk production has increased at an average annual rate of 1.8 percent over the last 10 years, compared to the 10-year U.S. average annual rate of 1.7 percent.
- For January-July 2013, California milk production has shown a 3.0 percent decrease over the same time period ending July 2012, while U.S. total milk production has shown an increase of 0.1 percent when comparing the same time period.

Milk Cows

- Annual California cow numbers have increased at an average rate of 0.8 percent over the last 10 years – while U.S. cow numbers have increased 0.1 percent over the last 10 years.

Class 1 Sales

- For 2012, 13.1 percent of California's total pooled milk production was used to produce packaged fluid milk.
- For August 2012-July 2013, total Class 1 sales showed a decrease of 1.4 percent when compared to August 2011-July 2012.
- For January-July 2013, total Class 1 sales have shown a decline of 1.5 percent compared to the same time period in 2012.

Class 4b Products:

- For 2012, California cheese production closely resembled 2011 totals, at 2.25 billion pounds.
- In 2012, 43.5 percent of California's total milk production was used to produce Class 4b products.

- For January-July 2013, total cheese production was up 0.2 percent when compared to January-July 2012.

Class 4a Products:

- In 2012, 35.2 percent of California's total milk production was used to produce Class 4a products.
- For 2012 compared to 2011, California NFDM (for human consumption) production showed a 9.3 percent increase to 830.8 million pounds; Other Dry Milk Products (dry whole milk, dry buttermilk, skim milk powder and blends, milk protein concentrate dry, milk protein isolate dry 90% protein, casein dry, caseinates dry, NFDM animal feed, and other dry milk products) showed a decrease of 11.6 percent to 290.8 million pounds; Butter production showed a 5.1 percent increase to 654.2 million pounds; and Condensed and Evaporated Milk showed a 1.3 percent decrease to 1.04 billion pounds.
- For January-July 2013 (when compared to January-July 2012): total NFDM (for human consumption) production was down 33.8 percent; total butter production was down 6.2 percent; total Other Dry Milk Products production was up 123.5 percent; and Condensed and Evaporated Milk production was up 4.7 percent.

Class 2 and 3 Products:

- For 2012, 8.3 percent of California's total milk production was used to produce Class 2 and 3 products.
- For 2012 compared to 2011, frozen dairy product production showed a decrease of 4.2 percent to 167.5 million gallons, total cottage cheese production increased 6.0 percent to 107.1 million pounds, and yogurt production decreased 6.3 percent to 587.3 million pounds.
- For January-July 2013 (when compared to January-July 2012): total frozen dairy product production was up 4.1 percent; total cottage cheese production was down 12.8 percent; and yogurt production was down 0.7 percent.

Resources: CDFA Dairy Information Bulletin, CDFA Dairy Statistics 2012 Data Annual, CDFA California Cost of Production 2012 Data Annual and CDFA Cost Comparison

SUMMARY OF TESTIMONY

CALIFORNIA DAIRIES INC., Eric Erba**Testimony**

- Supports the milk pricing proposal.
- Concern about the manner in which whey is valued by the California milk pricing system.
- Proposal is meant to address the issue of fair compensation to dairy producers.
- The decision from the June 30, 2011 hearing replaced the \$0.25 per cwt. fixed factor in the Class 4b formula to a sliding scale, but it did not provide the pricing equity and pricing level that was sought by producers.
- An acceptable level of price difference between California milk prices and federal order milk prices exists for all classes except Class 4b.
- California milk price for Class 4b has trailed the federal Class III price by almost \$2.00/cwt. over the past two years.
- Struggled to find appropriate supporting data.
- Over 400 dairies have exited the California dairy industry since 2007.
- In the last twelve months, CDI has lost 35 dairies that were producing a combined 2.5 million lbs. of milk per day.
- The regions of the state where the dairy industry has flourished have been the leading areas of unemployment.
- Factors are three-fold: disparity between federal prices and state prices, a cost of production issue, and survivability index on dairy farms.
- Milk-Feed ratio has been low for years.
- CDI is four percent down in year-over-year milk production when you don't include the new dairies brought on in January.
- Having more difficulty getting the milk to the customers in quantities that they are ordering. We do not do additional premiums for sales under contract.
- Table 1: Unemployment rates for select California counties, July 2013.
- Quantitative Measures:
 - Figure 1: California Class 4b Price Less Federal Class III price relative to market price for dry whey, 2007 to present
 - Figure 2: Cost of Production for California Dairy Producers, 2007 to Present
 - Figure 3: Milk-Feed Ratio, Jan. 2007 to July 2013

MILK PRODUCERS COUNCIL, John Moffatt**Testimony**

- Supports the milk pricing proposal.
- Components of the bill are necessary to deal with short- and long-term issues facing industry.
- Entered into the record a document entitled: Save the California Dairy Farms.
 - Supports the milk pricing proposal.
 - Map: California Dairies Lost 2007-2012
 - 387 dairies lost since 2007; 105 dairies lost in 2012 alone.
 - Chart: The Demise of California Family Dairies
 - Graph: Milk production – Year-over-year change
 - Proposal is believed to have achieved middle ground which required concessions from both sides.

SAVE THE CALIFORNIA DAIRY FARMS, Submitted to the Record without Testimony Document

- Supports the milk pricing proposal.
- Map: California Dairies Lost 2007-2012
- 387 dairies lost since 2007; 105 dairies lost in 2012 alone.
- Chart: The Demise of California Family Dairies
- Graph: Milk production – Year-over-year change
- Proposal is believed to have achieved middle ground which required concessions from both sides.
- Statements from various industry leaders and members of the legislature that enumerates their support for the milk pricing proposal.
- Attachments: flyers from sales/dairy dispersal auctions.

CALIFORNIA DAIRY CAMPAIGN, Lynne McBride Testimony

- Supports the milk pricing proposal.
- Considers the increase to be a compromise position as it represents a fraction of the equivalent federal Class III value.
- Dairy producers in our state are paid significantly less than dairy producers in the Federal Milk Marketing Order System.
- California dairy farmers experienced a net loss in income.
- Attachment: Average California Dairy – shows the accumulated losses for a typical dairy farm in our state over the last 10 years.
- The state has lost more than 400 dairy farms over the last five years.
- Our state system pays dairy producers on average \$1.00/cwt. less than dairy farmers in the Federal Milk Marketing Order System.
- Greatest disparity exists between Class 4b price and the equivalent federal Class III price, amounting to \$2.11/cwt. difference in June of 2013.
- Latest cost of production data from the Department is the first quarter of 2013 which indicated a 5.9 percent increase compared to the first quarter of 2012.
- California mailbox prices are some of the lowest of any regulated state in the nation.
- Current Class 4b price formula fails to reflect the current value of whey in the marketplace.
- Due to the consolidation and concentration that exists and the lack of competition in the marketplace, the minimum prices established by the Department are more critical than during any other time in our state's history.
- Alignment with the federal order is the only way to end the inequity in our state pricing system.
- Believes an agreement was reached between dairy producers and processors.
- Believe proposal is a compromise position and a step forward but don't think it will close the gap between California prices and federal prices.

WESTERN UNITED DAIRYMEN, Tom Barcellos Testimony

- Supports the milk pricing proposal.
- Costs of production on the dairy have increased significantly.

- Dairy producers are facing tough economic times.
- Table 1: California Dairy Production Margins.
- According to the Department data, 105 dairies went out of business in 2012, and 16 additional dairy sell outs have occurred since the beginning of 2013.
- Feed costs represent nearly 67 percent of the total cost of production.
- Figure 2: shows the dramatic increase in feed costs experienced at the dairy.
- Milk production in California has been declining for over a year.
- Figure 4: California Milk Production Year-Over-Year Change.
- Figure 5: Milk production, California vs. Wisconsin, year-over-year change
- The temporary increase proposed for Class 4b is to get a more fair Pool value from cheese making revenues.
- Believes the whey factor should more closely reflect the whey value generated by the current federal Class III formula and the market price for cheese.
- Proposed changes were agreed upon by the processor side of the industry as being reasonable.
- Since April 2007, over 80 percent of the difference between Class 4b and Class III was attributed to the whey value.
- By not including a fair whey value in the Class 4b formula, Class 4b plants are not sharing into the Pool like other classes are.
- In 2013, the overbase price has been higher than the Class 4b price every single month.
- Adjusting the whey factor to allow fluctuation with market prices would better enable California dairymen to utilize risk management tools.
- Believes an agreement was reached between dairy producers and processors.
- Appendix A: Proposed Changes to Article III, Section 300.0 (E) of the Stabilization and Marketing Plans for Northern California and Southern California.
- Appendix B: Letter from Joe Lang, representing the Dairy Institute of California.

T-BAR DAIRY, Tom Barcellos

Testimony

- Supports the milk pricing proposal.
- Excerpts taken from the petition submitted August 14, 2007 by F&A Cheese to then Secretary Kawamura.
- The viability of the dairy producer began to unravel following the determination in 2009 due to extremely low milk prices.
- Dairy equity no longer exists today causing the collapse over the last several years and continues today.
- The Department Cost Survey data and hearing record testimony provided significant evidence that amendments are necessary to the Class 4 formulas.
- In an analysis from a highly respected economist, a calculation would conclude that the dairy producer gave up \$304.80 per cow in the whey factor alone from 2009 through June 30, 2013.
- Cites additional conclusions from the 2007 Determination.
- Whey is no longer a salvage product. Current uses include sports nutrition drinks, protein shakes, and many dietary supplements.
- Graph: Number of dairies lost yearly (CDFA data)
- Attachments: Flyers from sales / dairy dispersal auctions
- Secretary has broad discretion and it has been proven that Secretary has also made decisions outside of hearing record.

- Believe it is Secretary's responsibility to made decisions with data that is not publishable or apparent to the industry as a whole.

UNIVERSITY OF CALIFORNIA AT DAVIS, Dr. Richard Sexton

Testimony

- Testimony was a PowerPoint slide presentation.
- Change to formula in 2011 to replace fixed whey value by sliding scale did not solve the problem.
- Low prices and high operating costs in California due to run up in feed and shipping costs have caused negative margins.
- Approximately 15,000 jobs mostly in areas of high unemployment have been lost from exit of farms and reduction of herd size since 2008.
- Presented graphs showing uniform price and Class III price; Whey value, Class 4b vs. Class III; Operating Margins by state, 2012; Dairies in California; Milk Production Year-Over-Year Percentage Change; Employment Created by California Dairies; Unemployment Rates in Major Dairy Counties.
- Adjustment proposed by California dairies does not realign Class 4b price with market, but represents a step in the right direction and marked improvement over current whey pricing formula.
- Implementing recommended changes will reduce losses incurred by California dairies.
- California cheese plants will not be disadvantaged relative to competitors in state.

Post-Hearing Brief

- Washington and California are both subject to high feed costs given their distance from major hay and grain producing regions.
- Both states rely heavily on purchased feed.
- Attached a hard copy of slide presentation shown as testimony at the hearing.

SAPUTO CHEESE USA INC., Greg Dryer

Testimony

- Does not support the milk pricing proposal.
- California mailbox prices for the first two months of 2013 were reported to be \$2.41/cwt. higher than the previous year, and data through May 2013 reveals \$2.62/cwt. over the same period in 2012.
- Production costs according to Department Cost of Production Survey for Q1 2013 are \$1.06/cwt. higher than Q1 last year, but declined by \$0.86/cwt. from Q4 of 2012.
- Alterations to the Class 4b whey factor cannot be justified given the scarcity of relevant California data.
- Whey processing requires huge scale to be economic and enormous capital is required. Relatively few industry participants are in a position to make that investment and take risk.
- Many cheese plants in California receive no value or incur a cost to dispose of their whey.
- California farms continue to grow, and average cow numbers per farm were up 5.8 percent from 2011 to 2012.
- The real source of producer economic challenges is the result of skyrocketing feed prices that challenged dairy producers all over the world.
- California prices have not fallen relative to USDA prices; instead USDA prices have risen relative to California because of recent high dry whey commodity prices.
- 2013 milk production through July is the second highest of the past six years.

- Chart: California Milk Production January through July.
- California's average mailbox price is \$0.14/cwt. higher than that of New Mexico – a far western state with a significant large herd industry and enjoys a much higher Class 1 utilization percentage than California.
- Over the last ten and one half years, Class 4b has contributed 17.5 cents more per cwt. to the Pool than Class 4a.
- After the fixed whey value of \$0.25/cwt. was introduced, it resulted in a higher price for farmers than the previous factor for 17 of its first 19 months of existence.
- End-product pricing is no longer viable in California.
- Many of the cheese manufacturers in the state do not enjoy large in-state customers and are forced to export the majority of their production.

Post-Hearing Brief

- In 2012, California fell from fourth to ninth as measured by value of production less total costs.
- Submitted charts displaying Value of Production Less Total Costs for 2010, 2011, and 2012 and Value of Production Less Operating Costs for 2010, 2011, and 2012.

Lantz Adams Testimony

- Supports the milk pricing proposal.
- Dairywomen are going out of business due to low milk prices.
- Losing dairies leads to a loss of many jobs.
- Dairies going out of business cause a negative impact on society, and negatively affect allied industries.
- If less dairy products are getting produced, prices may go up, and this could result in a less healthy diet.

Rick Adams Testimony

- Supports the milk pricing proposal.
- We are a small dairy milking 65 cows, produce all our own forages with family labor doing many of the milking, feeding, and farming operations.
- Asking to raise milk price to reflect the full whey value.
- Frustrating that Department is not balancing the needs of the producers, processors, and public.

Post-Hearing Brief

- Submitted written testimony given at the hearing.

KRAFT FOODS, Renee Peets Testimony

- Does not support the milk pricing proposal.
- This year's crops are reported to be in much better condition, and are predicted to be available in much larger quantities.
- Improved grain harvest conditions and reduced price pressures related to feed.

- Feed cost data published by the Department paints a compelling picture of improving conditions in California.
- Late 2013 and early 2014 corn futures suggest that corn prices are predicted to be below \$5.00/bushel through September 2014 – should result in average total feed costs that are comparable or even less than those of the 2011 crop year.
- Class 4b prices through August 2013 are \$1.70/cwt. higher than 2012.
- Chart: California Cost of Production Total Feed Costs (source: CDFA).
- Declining feed costs should provide additional income to farmers.
- Supportive of the Dairy Future Task Force.
- The duration of the current temporary price relief of Class 4b should allow time for the Secretary’s Dairy Future Task Force to create a pricing system in California that is viable for the long-term.
- Efficient whey processing requires the manufacturer to have enough scale to justify making a large investment in the asset base required to further process whey into a commodity dry whey product.
- Many California cheese makers can’t afford to buy and outfit a drying operation, or they don’t have the floor space in their facilities to support drying operation, or they simply do not generate enough whey to process.
- Cheese processor margins are small, as retail cheese is a commodity business.
- The cost of manufacturing, storage, transportation, sales, and marketing are inflationary.
- Only one place that additional costs like temporary price relief and adjustments to the whey factor in the Class 4b formula can come from: the margin.
- Milk production is improving, grain prices have fallen, and on-farm economics are improving, therefore additional increases to milk prices are not required for farmers to thrive and be profitable.
- When our input costs go up, it comes out of the margin.
- Processing whey, particularly just dry whey powder and not some of the more value-added whey protein concentrates and isolates, is very challenging, assets are super-expensive and food grade versus feed grade sells for very different price.

JOSEPH GALLO FARMS, Joe E. Paris

Testimony

- Does not support the milk pricing proposal.
- California cheese plants compete with unregulated plants in Idaho, Utah, and West Texas – New Mexico area. New Mexico mailbox prices run very close to California prices.
- Having only one class of milk (4b) pay for a temporary price relief to California dairymen is arbitrary, capricious, and patently unfair.
- Supports the continuation of the temporary prices as currently outlined in the Milk Stabilization and Marketing plans until the California Dairy Futures Task has completed its work and published a plan to change dairy pricing.

LOS ALTOS FOOD PRODUCTS INC., Adolfo Sanchez

Testimony

- Does not support the milk pricing proposal.
- There is no statutory requirement that California’s whey factor equal whey market prices or that California’s milk prices equal federal order prices.
- Proposal would unnecessarily increase production costs for manufacturers following recent, significant increases that have benefited milk producers.

- We don't have the capacity or volume to process dry whey or to buy expensive equipment that is required.
- Constructed new facility in 2010 and this investment is placed at risk with increases in whey factor and temporary price increases to Class 4b milk prices.
- Costs about \$288,000 a year to ship whey out of the plant for disposal.

DAIRY PRODUCER, Antoinette Duarte

Testimony

- Supports the milk pricing proposal.
- Asking if men and women who visit the dairies that participate in the Cost Analysis Program ask them how they are doing.
- Inadequate milk income on California dairies in three and one half years has cost us millions of dollars in equity.
- Cost of getting corn silage chopped and put in the pit is rising due to fuel costs.
- Loan officer says 80 percent of dairies that they financially carry are feeding their cows month-to-month, nobody is stocking hay this fall.
- Our dairy is feeding 560 cows and ships to DFA.

FARMDALE CREAMERY, INC., Scott Hofferber

Testimony

- Does not support the milk pricing proposal.
- Current and future corn prices to under \$5.00 per bushel.
- Removal of Paragraph H is appropriate.
- Increase in raw product costs will cripple ability to meet the covenants under the financing arrangements developed to facilitate creation of WPC-80 powder plant.
- Annual results of Farmdale's animal feed popcorn whey processing over the last three years has gone from break-even to a loss of nearly a half-million dollars; almost entirely resulting from the ever-increasing cost of whey in cheese milk.

HILMAR CHEESE COMPANY, INC., David Ahlem

Testimony

- Does not support the milk pricing proposal.
- California milk supply and demand appear to be in balance.
- High feed costs have accelerated the rate of consolidation across the nation.
- Crippling high feed costs are on the decline, as indicated by corn's current and futures market trends.
- Department data shows California income over feed margins trending upwards.
- Nothing prevents milk buyers from increasing their pay price when supplies tighten.
- Price corrections through market-driven premiums are more effective than regulated price increase because they are supported by market demand and are sustainable.
- Not all dairy producers benefit when the minimum price is increased as their premiums are redistributed through the Pool.
- Class 4b and Class III are not the same, and comparing them is like comparing apples to oranges:
 - California market conditions are different.
 - California processors' costs are greater and must move product further to market.

- Paying the regulated minimum price is optional for cheese makers in the Federal Milk Marketing Orders.
- The use of value-added products should not be attempted in minimum pricing formulas.
- End-product pricing formulas discourage processors from producing new products by introducing considerable risk.
- End-product prices are unable to keep up with our ever-changing global marketplace.
- End-product formulas lead to contentious debates over value sharing that do not contribute to sustainable increases in the value of milk.
- Pooling subsidizes the purchase of milk for low value dairy products and does not force all market participants to compete for milk.
- Supports the California Dairy Task Force as they collaborate toward long-term, sustainable solutions.
- Appendix A Graph 1: CME Corn Price Settlements
- Appendix A Graph 2: Income Over Feed
- Appendix A Graph 3: California Milk Production and Estimated Plant Capacity
- Appendix B: California Milk Production in Pounds
- Appendix C: Article: Wisconsin State Farmer; “Dairy farm numbers drop in state”
- Appendix D: Article: “Tulare Co. cheese plant closing, 144 layoffs”
- Appendix E: Article: Cheese Reporter
- Appendix F: Article: “The other solids price crush” by John Umhoefer
- Appendix G: Dairy & Food Market Analysis
- Appendix H: Article: “Situation Analysis”

DAIRY INSTITUTE OF CALIFORNIA., William Schiek
Testimony

- Does not support the milk pricing proposal.
- Prices of feeds are beginning to decline from levels seen last year and earlier in 2013, and are expected to continue in the coming months.
- State’s milk supply is in fairly good balance relative to demand.
- Orderly marketing is in the public interest.
- Pricing decisions by the Secretary, that seek to discourage disorderly marketing are reasonable even if they result in prices for milk used in manufactured products that appear to be out of sync with regulated prices that exists in other parts of the country.
- Milk prices established by the state are minimum prices – handlers are not prohibited from paying above the established prices under the State’s orders.
- Regulated prices must be set low enough to ensure that markets clear in order to maintain orderly marketing for milk.
- Additional price increases are not warranted by economic conditions.
- Cost of corn is decreasing and CME futures prices point to further reductions.
- Dairy farm margins have improved during the most recent two quarters for which data are available.
- California milk prices are now increasing again as the typically strong fourth quarter demand begins to assert itself.
- Milk supply and demand in the state are in balance.
- Dairy consolidation in California seems to be a symptom of higher feed costs rather than low milk prices.
- Milk for making cheese has an inherent lower economic value in California than milk in other areas.

- To ensure orderly marketing, California regulated price for manufactured milk must be set at levels that clear the market.
- All Grade A milk must be paid the state minimum prices, in federal milk market orders milk that is not pooled is not subject to minimum pricing.
- Majority of cheese plants in the state do not have the ability to process their whey into revenue generating products.
- One California cheese maker notes that it has over 150 whey protein formulations available for customers – capturing the value of whey in a formula practically impossible.
- Valuation of whey in a regulated milk pricing formula runs the risk of overvaluing milk in the market and leading to disorderly marketing conditions.
- Department does not have a California-based whey pricing series.
- DI believes that work of the Dairy Future Task Force is crucial.
- Attachments to testimony:

Appendix A: Statutory Directives, Legislative intent, and the Paramount Importance of Orderly Marketing

- Code sections listed for the production and marketing of milk.
- Regulated prices must be set low enough to ensure markets clear to maintain orderly marketing for milk.

Appendix B: Additional Net Price Increases are Not Warranted by Economic Conditions

- Proposal would result in net increase in Pool prices from levels generated by current formulas.
- Economic conditions do not support additional price increase at this time.
- Narrative and charts cover spot feed prices, cost comparison summary pie chart, California Milk Income and Production Costs, California Dairy Farm Income over Feed Cost, California Class 4a and 4b prices Calculated based on CME Futures Prices for Dairy Commodities, CME Futures Prices for Dairy Commodities, Number of Licensed Dairy Herds as a Percentage of 2003 Herds, U.S. and Selected States, Cost of Production and Feed Cost for Conventional Farms in CDFA Cost of Production Feedback Sample.

Appendix C: Redirecting Temporary Price Relief Solely to Class 4b is Without Economic Justification

- Narrative and charts cover Population Density in U.S., Annual Milk Production, Price Comparisons: Federal Class III, Current California 4b and AB 31, Milk Production Costs, Top States: Overall Rankings,.

Appendix D: Additional Changes to the Whey Scale are Not Supportable

- Narrative and Charts cover Dry Whey-WPC 34 Price Inversion, Western Dry Whey Mostly Price and Central/West WPC-34 Protein-Equivalent Price, Pounds of Milk Processed Into Cheese, Citing Dry Whey's Impact on Milk Prices, Penn Cheese Closes, Is Up For Auction.

Appendix E: Letter from Joseph L. Lang to the Honorable Richard Pan, MD and copy of Assembly Bill 1038

Post-Hearing Brief

- The fact that plants are unwilling to pay more to secure additional supplies suggests that milk is not short.
- Milk supply and demand are in balance.
- Has been a consolidation trend in both California dairy manufacturing and in U.S. cheese making.
- California rate of consolidation has been slower in percentage terms than U.S. as a whole and slower than next largest dairy states, Wisconsin and Idaho.

- Chart included on Number of U.S. Cheese Plants and California Dairy Manufacturing Plants, 1970-2012.
- Federal orders do not place any pricing requirements on milk that is not pooled and processors can pay below class for milk not pooled.
- In terms of industry structure, California resembles New Mexico much more than Wisconsin or New York or Florida where prices are higher.
- Chart included Mailbox Milk Price Comparisons – What Dairy Farmers Receive in California, New Mexico, and the Average for all Federal Order Markets, by Year.
- No evidence was submitted with respect to manufacturing costs, yields, or prices applicable to California cheese plants that manufacture dry whey.
- Entire whey factor is without legal foundation.

THE DAIRY INSTITUTE OF CALIFORNIA, John Lemmon
Testimony

- Does not support the milk pricing proposal.
- The adoption of a Class 4b price based only on the federal order Class III price is irrational owing to several key differences between California market conditions and out-of-state market conditions.
- Whey factor in California cannot be transparently calculated.
- The Secretary’s decision must be supported by evidence specifically related to California handlers.
- The only data regarding the whey factor available for introduction in this hearing relates to pricing, cost, and yield information related to out-of-state handlers.
- There is no reasonable basis on which the Secretary may adjust or even continue the whey factor as an element of Class 4b milk pricing.
- Code Section 62062 does not permit the Secretary to use FMMO Class III prices as a substitute for California-specific data.
- In the absence of evidence in the record, the Secretary is obligated under the law to reject any proposal regarding the whey factor.
- Most handlers purchasing Class 4b milk have not made the capital outlay necessary to convert whey from a cost center to a profit center in their production processes.

Post-Hearing Brief

- The proponents of the Petition failed to provide testimony at the hearing addressing issues noted in the call of the hearing.
- No witnesses addressed the sufficiency of the whey factor by referring to quantifiable economic data and methodologies.
- No witnesses presented testimony resolving issues and concerns presented by the lack of readily available transparent data as well as concerns about matters that cannot be published due to confidentiality.
- The use or application of any whey factor without evidence in the administrative record showing the prices, costs and yields of California handlers would exceed the Secretary’s authority under the Food and Agricultural Code.

LAND O’ LAKES, INC., Pete Garbani
Testimony

- Supports the milk pricing proposal.
- Agree with the petitioners that the Class 4b price remains the primary issue.

- Concerned about the persistent gap between the California Class 4b and the federal Class III prices.
- Class 4b has averaged \$1.60/cwt. lower than the Class III price for the seven-month period February through August 2013.
- Analysts project that whey prices will remain at levels exceeding 50 cents for the rest of 2013 and 2014 which will ensure that the large California cheese plants will return significant margins on their processed whey operations.
- Without changes to the whey factor in the Class 4b formula and the temporary increase in Class 4b price, dairy farmers will feel the full force of a decrease in cheese prices while receiving only a portion of the benefits of a strong whey market.
- The proposal would have the potential to add revenue to California's dairy farmers' accounts over a 12-month period.
- California dairy farmers absorbed a loss of \$0.70/cwt. in the 1st quarter of 2012, \$2.22/cwt. in the 2nd quarter of 2012, and \$1.97/cwt. in the 3rd quarter of 2012.
- Fixed whey factor hinders a California dairy farmer's ability to make effective use of dairy futures to hedge their milk and take advantage of the projected corn prices to lock in their margins.
- Over the past twenty months, 55 dairy farmer members of LOL have discontinued milking – 43 dairy farmers in 2012 and eleven in 2013.

DAIRY PRODUCER/CONSUMER, Rob Vandenneuvel

Testimony

- Supports the milk pricing proposal.
- From October 2012 – December 2012 average mailbox price was \$19.20/cwt. - \$0.88 below the reported cost of production.
- First quarter of 2013 the average statewide cost of production was \$19.16/cwt. compared to the average mailbox milk price of \$17.45/cwt., that is an estimated loss of \$1.71/cwt.
- Lack of available data is beginning to impact the Cheddar cheese component of the Class 4b formula.
- Our formulas as well as the formulas used by the FMMO system use basic commodity dairy products to drive the end-product pricing formulas.
- Forty-pound blocks of Cheddar cheese are not the most prominently produced cheese in the state, but yet it is used to establish our regulated milk price.
- The modified sliding scale is certainly just as transparent as the current sliding scale, with a clear and defined relationship between the market value of dry whey and the impact on the Class 4b minimum price.
- If dairy product prices escalate or fall during temporary relief, a plant's relative position in the marketplace remains the same, as the prices paid by all plants are rising and falling as well.
- Appendix A(1): Statewide Cost Comparison Summary (Production Cost 4th Quarter 2012)
- Appendix A(2): Statewide Cost Comparison Summary (Production Cost 1st Quarter 2013)
- Appendix A(3): Comparison of Mailbox Milk Price vs. Cost of Production
- Attachments: 20 Ads for dairy dispersal auctions

LEPRINO FOODS COMPANY, Sue Taylor

Testimony

- Does not support the milk pricing proposal.

- Economic conditions have improved and lower corn prices will result in an improved competitive position for California dairy producers.
- Current whey factor cannot be substantiated by California-specific data given the inability of cheese plants below a certain size to extract full whey value.
- Difficult to construct a sound whey factor in the minimum milk price formula that extracts greater value than that attainable from the sale of liquid whey.
- Graph: USDA / AMS Corn Price Estimate for Stockton – Modesto – Oakdale - Turlock
- Milk prices are rising but are expected to soften modestly over the next 12 months as the result of greater milk supplies generated by greater farm level profitability nationally.
- Prices derived from the supply and demand balance for dairy commodities nationally will generate a level of dairy farm profitability sufficient to generate the needed supply to satisfy demand nationally.
- Current whey factor cannot be substantiated by California-specific data given the inability of smaller cheese plants to extract full whey value, even under best management practices.
- Whey processing is highly capital extensive, and the high capital costs create a barrier to entry for smaller cheese plants.
- No common whey product produced within California, and this makes it nearly impossible to identify a whey product that will accurately reflect market clearing returns generated by the whey complex on an ongoing basis.
- 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.
- The marketplace is the better venue for such price relief.
- An elevated emergency price simply diverts money that we are already paying into the Pool and can reduce the milk price to our suppliers.

Special 3-Minute Testimony from California Legislators

Senator Anthony Cannella

Testimony

- Asking Department to find more equitable pricing formula.
- Thought agreement was reached for the whey pricing formula.

Senator Tom Berryhill

Testimony

- Need to resolve issue and get Task Force going.

Assembly Member Adam Gray

Testimony

- Challenges the dairy industry has faced has been devastating to Merced, Stanislaus counties and small family businesses.
- Have been active participant in legislative process trying to both establish task force and get some price relief.

Assembly Member Kristin Olsen

Testimony

- Financial crisis for California family dairy farms.

- Unmanageable feed costs for dairies and am trying to do something about that in Assembly Joint Resolution 21.
- Producers want a fair price for the milk they produce.
- Need short-term solution and then task force to work hard to come up with long-term solution.

Senator Edward Hernandez

Testimony

- Agreement made is a starting point for a long-term solution.

Assembly Member Richard Pan, MD

Testimony

- Economic condition of dairies warrants Legislature and Secretary working together to guarantee short-term relief.
- Answer includes Dairy Future Task Force, which will hold mandated workshops and solicit timely input to make recommendations to the Legislature.
- Doing nothing is not an option.

Senator Cathleen Galgiani

Testimony

- The agreement was a short-term deal and an element for the task force to keep working.
- Task Force to come up with recommendations for the Legislature.
- Purpose of the hearing and the purpose of the legislation was to codify the fact that a deal had been reached.