STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

CONSOLIDATED PUBLIC HEARING TO CONSIDER AMENDMENTS TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK FOR THE NORTHERN AND SOUTHERN CALIFORNIA MARKETING AREAS

CALIFORNIA DEPARTMENT OF FOOD & AGRICULTURE

DEPARTMENT AUDITORIUM

1220 N STREET

SACRAMENTO, CALIFORNIA

MAY 31, 2012

9:00 A.M.

ACCELERATED BUSINESS GROUP

(916) 851-5976

A P P E A R A N C E S

CDFA Panel

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Emergency Management Coordinator, Dairy Marketing Branch

Candace Gates, Branch Chief
Dairy Marketing Branch

Hyrum Eastman, Dairy Economic Advisor
Division of Marketing Services

Amber Rankin, Associate Agricultural Economist
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Michael Marsh
Annie AcMoody
Western United Dairymen

Donna Melby, Attorney
Paul Hastings
representing The Coalition

Eric Erba, PhD
California Dairies, Inc.

Thomas Wegner
Land O'Lakes

Rob Vandenheuvel
Milk Producers Council

Alternative Proposals

Scott Hofferber
Farmdale Creamery, Inc.

Also Testifying

Barry Murphy
BESTWHEY, LLC

Jose T. Maldonado
David Villanueva
Marquez Brothers International, Inc.

Lynne McBride
California Dairy Campaign

Gilbert de Cardenas
Cacique, Inc.

Cornell Kasbergen
Rancho Teresita Dairy

Joey Airoso
Airoso Dairy

Art Van Beek
El Monte Dairy

Tom Barcellos
T-Bar Dairy

John Gailey
Milky Way Dairy

John Moons
Dairymen

Kevin Ornellas
Ornellas Dairy

Jeff Wilbur
Rio Blanco Dairy

Tony Machado
Couco Creek Dairy

Also Testifying

Jonathan Kennedy
Farm Credit West

William Schiek, PhD
Rachel Kaldor
Dairy Institute of California

David Ahlem
Hilmar Cheese Company, Inc.

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P R O C E E D I N G S

9:00 a.m.

HEARING OFFICER ROWDEN: This hearing will now come to order. The California Department of Food and Agriculture has called this public hearing at the Department's Auditorium, 1220 N Street, Sacramento, California, on this day, Thursday, May 31st, 2012, beginning at 9:00 a.m.

My name is John Rowden. I am the Emergency Management Coordinator for the Department. I have been designated as the Hearing Officer for today's proceedings. I have no personal interest in the outcome of the hearing and I will not be personally involved in any decision that may result from this hearing.

On May 2nd, 2012 the Department received two separate petitions requesting a public hearing to consider amendments to the Class 4b pricing formula of the stabilization of marketing plans for market milk for the Northern and Southern California marketing areas.

The petitions were received from Western United Dairymen and a group of producer organizations which includes California Dairies, Inc., Dairy Farmers of America, Western Area Council, Land O'Lakes, Inc., Security Milk Producers Association, Milk Producers Council, California Dairy Campaign and Alliance of Western Milk Producers.

Collectively this group is called The Coalition.

The Department announced the call of a hearing on March 16th, 2012 to consider the petitioners' proposed changes to the whey factor of the current Class 4b pricing formula.

Further, this hearing will consider the proposed changes that were raised by the alternative proposal received from Farmdale Creamery on May 1st, 2012.

This hearing will also consider the factual basis evidence and legal authority upon which to make any and or all of the proposed amendments to the plans.

Testimony will begin with a representative of the Department who will introduce the Department's Exhibits. The audience may ask questions of the Department representative only as it relates to the Exhibits. This is the only witness that may be questioned by those other than the panel members.

Next the two petitioners will each have 45 minutes, or a combined total of 90 minutes, to submit testimony and related material to support their proposals, which will be followed by any questions from the panel.

The parties submitting an alternative proposal will have 30 minutes to give testimony and evidence followed by questions from the panel.

Anyone else wishing to testify must sign in at the

hearing witness roster located at the back of the room and will be allowed 20 minutes to give testimony and evidence.

Special provisions have been made to allow witnesses presenting testimony of three minutes or less to be called upon to provide their testimony today, the first day of the hearing. There is a separate sign-up sheet in the back of the room for those witnesses.

Witnesses will be called in the order that they sign up. The time clock on my right has been established to assist you in testifying.

If you testify under oath during the conduct of this hearing you may request a post-hearing brief period to amplify, explain or withdraw or testimony. Only those individuals who have testified under oath during the conduct may request a post-hearing brief period. And only those individuals who request a post-hearing brief period may file a post-hearing brief with the Department.

As a courtesy to the panel, the Department staff and the public please speak directly to the issues presented by the petitions and avoid personalizing disagreements. Such conduct does not assist the panel and will not be permitted.

Questioning of witnesses other than the Department representative by anyone other than the members of the panel is not permitted.

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses and make recommendations to the Secretary. The panel is composed of members of the Department's Division of Marketing Services and Dairy Marketing Branch and includes Candace Gates, the Branch Chief, Hyrum Eastman, Dairy Economic Advisor, and Amber Rankin, Agricultural Economist. Again, I am not a member of the panel and will not be taking part in any of the discussions relative to the hearing.

The hearing is being recorded by Ramona Cota of the firm Accelerated Business Group located in Sacramento. A transcript of today's hearing will be available for review at the Marketing Branch Headquarters located in Sacramento at 2800 Gateway Oaks Drive after the Department makes its final decision.

Testimony and evidence pertinent to the call of the hearing will now be received. At this time Mr. Francesconi, Supervising Auditor of the Dairy Marketing Branch, will introduce the Department's exhibits. The audience may ask questions of Mr. Francesconi only as it relates to the exhibits.

Mr. Francesconi, will you please state your full name and spell your last name for the record.

MR. FRANCESCONI: Yes, Mr. Hearing Officer. My name is Mike Francesconi. It is spelled M-I-K-E, the last

name is spelled F-R-A-N-C-E-S-C-O-N-I.

Whereupon,

MIKE FRANCESCONI

Was duly sworn.

HEARING OFFICER ROWDEN: You may proceed.

MR. FRANCESCONI: Okay. My purpose here this morning is to introduce the Composite Hearing Exhibits numbered 1 through 39. Relative to these exhibits, previous issues of Exhibits 8 through 39 are also hereby entered by reference.

The exhibits entered here today have been available for review at the offices of the Dairy Marketing Branch since the close of business on May 24th, 2012.

An abridged copy of the exhibits is available for inspection at the back of the room. A copy of the exhibit is also available at the back of the room.

I ask at this time that the Composite Exhibits be received.

HEARING OFFICER ROWDEN: Yes. The Department's Exhibits are now entered in the record. They will be stamped 1 through 39.

(Exhibits 1 through 39 were received into evidence.)

MR. FRANCESCONI: Okay.

HEARING OFFICER ROWDEN: Thank you very much.

MR. FRANCESCONI: Additionally I am entering a letter received from Imperial Valley Cheese dated May 29th, 2012 and signed by Dolores Gossner Wheeler as Exhibit 40.

I have another letter I'd like to enter from Security Milk Producers Association dated May 30th, 2012; it was signed by Ed Haringa.

And I would also like to enter a letter received from Sierra Nevada Cheese Company dated May 30th, 2012 and signed by Ben Gregersen.

I believe I missed the Rumiano -- did I miss the Rumiano one?

MS. GATES: Yes.

MR. FRANCESCONI: Yes. And I would also like to enter a letter from Rumiano Cheese dated May 30th, 2012, signed by Baird Rumiano. And those will be Exhibits 40 through 43.

HEARING OFFICER ROWDEN: So entered into the record are Exhibits 40 through 43 as Mr. Francesconi has stated.

(Exhibits 40 through 43 were received into evidence.)

HEARING OFFICER ROWDEN: Any questions from the panel?

Any questions from the audience?

All right, thank you, Mr. Francesconi.

MR. FRANCESCONI: I do have one additional thing. I would also like to request the opportunity to provide a post-hearing brief, Mr. Hearing Officer. And this concludes my testimony.

HEARING OFFICER ROWDEN: All right, your request is granted. Thank you.

At this time I would like to call the first petitioner, a representative from Western United Dairymen. You will have a total of 45 minutes to submit your testimony. Please state your name and spell your last name, please.

MS. AcMOODY: My name is Annie AcMoody, the last name is spelled A-C, capital M-O-O-D-Y.

Whereupon,

ANNIE AcMOODY

Was duly sworn.

HEARING OFFICER ROWDEN: And this is your exhibit, which is testimony, your testimony, correct?

MS. AcMOODY: Correct.

HEARING OFFICER ROWDEN: And this will be Exhibit number 44.

(Exhibit 44 was received into evidence.)

HEARING OFFICER ROWDEN: Sir, are you going to be testifying also?

MR. MARSH: Yes.

HEARING OFFICER ROWDEN: Okay, please state your full name and spell your last name.

MR. MARSH: Michael Marsh, M-A-R-S-H.

Whereupon,

MICHAEL MARSH

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MR. MARSH: Mr. Hearing Officer and members of the hearing panel: My name is Michael Marsh, I am the Chief Executive Officer of Western United Dairymen. Joining me today is Annie AcMoody, our Director of Economic Analysis. Our association is the largest dairy producer trade association in California, representing approximately 900 of the state's dairy families. We are a grassroots organization headquartered in Modesto, California. An elected board of directors governs our policy. The board of directors approved the position I will present here today at a special meeting on February 24, 2012.

We would like to thank Secretary Ross for the call of this hearing on our petition. We would also like to thank Governor Brown for his oft-expressed support and recognition of California agriculture, and dairy in particular, as being a driver intrinsic to California's economic recovery. We appreciate the Governor's and the Secretary's attention and receptiveness to hearing our plea

for relief.

Arriving at this position was a lengthy process that did not begin with this petition. With the fixed whey factor implemented on December 1, 2007, it was only a matter of time before prices would fall significantly out of alignment with federal order pricing. This issue became particularly apparent n 2011 as the value of dry whey started to rise. The producer community, concerned with the inequity, overwhelmingly supported some changes. Land O'Lakes submitted a petition on May 24, 2011.

Agreeing that the issue should be revisited, the Department called for a hearing on June 30th of 2011. Support from dairy producer organizations and cooperatives was unparalleled. All sought changes that would bring the California 4b price in closer alignment with federal order prices. Western United Dairymen specifically submitted an alternative proposal requesting changes that would have allowed the whey value in California to track every closely to the whey value generated by the federal Class III formula. As a result of the hearing, the Department decided to implement changes, eliminating the fixed whey factor and replacing it with a sliding scale.

The changes resulting from the June 30, 2011 hearing and implemented on September 1, 2011 were an improvement for producers; the whey value was now allowed to

fluctuate. However, while Western United Dairymen appreciated the modification, we believed it still fell short of a fair method to determine the value of whey in the Class 4b formula. Hence, Western United submitted a petition to the Department on December 2, 2011. In the petition, Western United Dairymen proposed modifying the current sliding scale n the Class 4b formula to allow the whey factor to more closely reflect the whey value generated by the current Class III formula. At the time, the difference between California's whey value and federal orders since the new sliding scale's implementation averaged a staggering $1.75 per hundredweight. California dairy families clearly needed a better way to capture the whey value. Unfortunately, the Department decided not to act on the matter and denied the hearing request.

After the Department's denial, the issue remained and producer discontent intensified. Our board discussed asking for reconsideration or immediately filing another petition. We held a number of meetings with the Secretary and her team, sharing data and information which we hoped to be persuasive when we next asked for relief. We very much appreciate the open dialogue with the Secretary, the Undersecretary and her staff.

We stressed the imperative of resolving this issue sooner rather than later and impressed upon the Secretary

that waiting until after cost studies were completed in September 2012 would not work. We needed a hearing sooner rather than later. Our Board was not going to give up on lost producer revenue and decided to petition again. Industrywide support on the producer side was evident. Lengthy discussions took place and each organization agreed on the requested changes that we are arguing in favor of today.

MS. AcMOODY: So I will talk to you on the Relationship to Federal Order.

The California Food and Agricultural Code states that "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," Section 62062. According to CDFA analysis that was presented at the workshop, with the current formula the Class 4b price would have averaged $1.05 per hundredweight less than the Federal Order Class III price for the period of April 2007 through March 2012. That difference is even more striking when looking at the last 12 months of data, where federal Class III was an average $2.18 per hundredweight higher than the Class 4b.

The deviation between Class III and 4b prices was caused by several factors. Notably, formula differences such as different price series, CME versus NASS, make

allowances, yield and formula construct contribute to the divergence. But the whey value is what creates the most variance between the two class prices and this is a significant concern to the members of Western United. According to our analysis, since April 2007, 74 percent of the difference between Class 4b and Class III was attributable to the whey value.

More specifically, assuming current formulas had been in place since April 2007, the average difference between Class III and Class 4b would have been $1.05 per hundredweight. Of that amount, 27 cents per hundredweight would be due to formula differences other than the whey factor. The remaining 78 cents per hundredweight is due to the difference in the whey value. With whey values that follow market movements in Class III and a sliding scale value in Class 4b capped at 65 cents per hundredweight in California, such a discrepancy was not unlikely to occur. As the price of whey fluctuates, so will the variance between the two classes if California retains a limited sliding scale. Clearly, the current scale violates the mandates outlined in Section 62062 of the Code.

Our proposal would achieve a much closer relationship between Class 4b and Class III by removing the potential for unbearable discrepancies in the whey portion of Class 4b that can occur if we do not more closely tie our

whey value to the end product pricing formula used in federal orders. As outlined in our petition, we propose the following whey value in Class 4b. And attached on page four you can see the beautiful sliding scale that is presented here.

The next figure illustrates the impact of our proposal on the whey value. And this is in black and white but the lower line is the whey value that was in place at the time in California and the line that generates a higher value represents our proposal.

Since the current whey Class 4b was implemented in September 2011, revenues to producers from the whey value compared to our proposed whey value were $212 million lower. This is a significant amount.

The narrow range of the sliding scale used in the current formula is at the root of the problem. With a ceiling capping the whey value at 65 cents, there is tremendous potential for discrepancies between the Class 4b and Class III, as was just illustrated in the chart above. Similarly, a floor of 25 cents also creates the potential for discrepancies. The scale proposed in our petition removes the potential for these large discrepancies.

As the panel stated in 2005 before recommending the removal of price floors from the 4a and 4b formulae: "price floors create an artificial price within a market at

a level that may be higher than the naturally-occurring market price." The same is true of ceilings, creating an artificial price that may be lower than the naturally-occurring market price. In this case it has prevented producers from benefitting from that value.

The 2005 panel added: "Federal milk order pricing formulas do not incorporate federal support purchase price as price floors. If the federal order pricing program is not revised on a comparable basis, then over the long term the continued use of the federal support purchase price as price floors in California pricing formulas could place California manufacturing plants at a competitive disadvantage in commercial markets nationwide." Looking at the producer side of the equation then, if price ceilings are not used in federal order formulas and the pricing program is not revised on a comparable basis, then the continued use of a price ceiling in the California formula will and has placed California producers at a competitive disadvantage. Not only is a cap at 65 cents inequitable for producers in California, preventing them from getting a comparable share of the whey value like their counterparts in federal orders, it also exacerbates the issue of risk management. We will discuss that issue in more detail in a later section.

in the past it has been argued that a cap is

necessary for small cheese processors who do not process whey. When has had a value for years. Many have found ways to make it profitable by investing in whey processing facilities. Others dispose of it by selling it to dairymen so they can mix it into their feed ration for the cows. Many dairymen sell their hospital milk to calf raisers because it makes more sense than throwing it away. Cheese plants have had plenty of time to maximize opportunities to recover value or make whey products profitable, just like dairymen found value in hospital milk. Operation sizes have never been a focus in the milk pricing formulas in California. All dairy families get the same volatile price, regardless of the size of their operation. Cheese processors across the country have adapted to that reality and have adapted well and California dairy operations of all sizes have been facing dairy price volatility for years. Therefore, there is no place for a cap on the sliding scale on the grounds that some small cheese processors cannot afford whey price volatility.

As far as which data to use, we propose using Dairy Market News, the Dry Whey West mostly series average data as the source of dry whey prices instead of NASS to avoid lag issues. NASS dry whey prices are typically released later. When comparing NASS and Dairy Market News dry whey data sets on a weekly basis from April of '07 to

prices for the week ending March 31st, 2012, the difference amounts to less than a penny. Dairy Market News is timlier than NASS. The difference between NASS and Dairy Market News is very small and the Department has favored using Dairy Market News in the past. Therefore, we believe that Dairy Market News dry whey west mostly series remains the appropriate one to use.

Economic Plight of the producers. Given current conditions in the industry, the years ahead will undeniably be more challenging for California dairy families. Economic and regulatory pressures are escalating in the state. Current and proposed environmental regulations have led and will continue to lead to added costs, something farmers in no other states have to deal with. Aside from this regulatory burden, costs of production on the dairy have increased significantly. This was the case at the hearing last summer and remains ever more so the case today.

As everyone well remembers, producer milk prices fell significantly through most of 2009, posting an overbase price of only $9.60 per hundredweight in July 2009, compared to $17.35 per hundredweight the prior July. For the second half of 2009, prices slowly increased to $14.47 per hundredweight by the end of the year. However, prices dropped again to the $12 to $13 per hundredweight range for the first part of 2010. With a statewide average cost of

production of $15.02 per hundredweight for the first quarter of 2010, the financial situation for dairy producers was unbearable. After prices softened through the first half of the year they showed signs of improvement by the end of the summer when the August 2010 overbase price reached $14.84 per hundredweight. The overbase price made it all the way to $15.94 per hundredweight in October. With the statewide average cost of product at $15.13 per hundredweight for the third quarter of 2020, some producers were likely experiencing positive margins again, but the equity hole dug by the economic duration will take years of prosperity to fill.

While prices were overall improving, the cost of production was also increasing. Improving dairy prices is good news, but it will take a prolonged period of improved margins for dairy producers to recover the immense losses and eroded equity that arose from the economic disaster of 2008 to 2010. Revenues per cow in 2010 did not come close to the losses per cow incurred in 2008-2009. 2011 was an improvement but 2012 has proved to be financially challenging for a lot of dairymen. After all the aforementioned losses another downturn may prove unbearable for some.

A comparison of California overbase prices to the average cost of production in California since 2011 (sic)

reveals the challenge faced by producers. Production costs were on a steady, upward trend until the beginning of 2009. At the same time prices were not only volatile, but far below costs in many months. The difference between the cost of production and overbase price in 2009 is striking evidence of the catastrophe that occurred for California dairy families. And you can see those numbers in the table below. The difference in 2011 is evidence that it will take time to recover those losses.

A minimal softening in feed costs had been a notable mover in the reduction in cost of production observed from the first quarter of 2009 to early 2010. According to CDFA data, feed costs rose just over 51 percent of the total cost of production in 2003 to a staggering 60 percent of total costs by the third quarter of 2008. Feed costs dropped to an average of 57 percent of the cost of production for the second quarter of 2010, lower but still significantly, historically high. The slow decline in feed costs was short lived. Since fall 2010 feed prices have skyrocketed.

In 2011, estimates from USDA reported the corn ending stocks-to-use ratio at its lowest level since 1995/96. This outlook led to dramatic increases in feed prices, further eroding an already tight margin. CDFA data indicates that feed costs reached an all time high of 61

percent of total cost of production for the first quarter of 2011. The issue remained throughout the year as feed costs represented an ever-increasing share of total cost of production; 64 percent, 65 percent and 65 percent for the second, third and fourth quarter, respectively. While 2012 cost of production data is not yet available, the significant declines in overbase prices combined with fairly steady feed prices will likely show ever more deteriorating margins for California dairy families. With current feed prices and a projected overbase under $14 per hundredweight in May of this year, the financial picture for producers is somber.

Due to all those increased costs, California dairymen have lost much of their competitive position relative to the rest of the nation. Failing to capture the value of whey, which has turned out to be a very marketable product, is hurting their competitiveness further. In addition to the inequality, the whey in Class 4b is causing, compounding the issue of already low milk prices, we reviewed the cost of production information because the Department must take it into account. "In establishing the prices, the director shall take into consideration any relevant economic factors, including but not limited to, the following: the reasonableness and economic soundness of market milk for all classes, giving consideration to the

combined income from those class price, in relation to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. In determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment."

While it may be tempting for the panel to interpret the current milk production trends in the state as a sign that producers are doing okay, we strongly disagree. Milk production patterns respond to a variety of factors. Notably this spring, weather has been fantastic for cow comfort and production increased significantly, without producers necessarily making production decisions to increase volume. As outlined above, producers are still recovering from the losses incurred a few years ago. With decent prices in late 2011 and milk per cow at good levels, dairymen were in recovery mode and incentives to reduce cow numbers would have been limited. Still, in 2012 good beef prices combined with the current high feed costs have pushed many to trim their herds. When this happens, dairymen get rid of lower end cows, keeping the higher producing ones, thus increasing the herd's milk per cow average. The resulting increased milk per cow is clearly not due to higher milk prices.

While production is increasing and plant capacity

has been mentioned as an issue in the past, base programs have been put in place in the state to take care of that issue. Keeping a lower milk price in our state would only contribute to the financial plight of dairy producers, not to bring supply more in line with capacity. Producers are the ones bearing the cost of a lack of capacity and they can respond to it by either building capacity or reducing production via their plant supply management program. The current whey issue is one of fairness with prices observed in the rest of the country, not one pertaining to plant capacity.

MR. MARSH: On the issue of risk management: Feed prices are showing no reprieve and margins are very fragile. The memory of the 2009 dairy crisis is still fresh in producers' minds. Waiting for good times does not suffice. Volatility has been a buzzword in the last few years for a reason: it is here to stay. As you know, dairymen have no way of passing along added costs. To avoid a repeat of that economic catastrophe many producers have turned to risk management tools to protect their operations. More specifically, hedging has become an increasing part of dairy operation management.

Hedging allows parties to secure prices months in advance. But it's not as simple as that. The effectiveness of hedging relies on many things but especially on the

relationship between futures prices and cash prices.

The futures contract most commonly used by California dairymen is tied to federal Class III. The difference between futures and cash prices is called "basis." A hedge will never be perfect due to changes in the basis, which can be negative or positive. But over time, with similar formulas, dairymen can assess their basis risk much more effectively. As illustrated earlier, the spread between Class III and our milk price has gotten much larger due to higher whey values being reflected in Class III but not in the California milk price. Effectively, the issue of lower milk prices in California is exacerbated by the fact that the fixed whey factor in the California formula makes Class III futures contracts a less-effective hedge than it otherwise would be. As a result, the very insurance that dairymen attempt to buy to insure some operating margin, does not perform as they expected nor intended.

The unpredictability of the spread due to the completely structure of the whey value ironically makes it riskier for dairymen to hedge by preventing them from being able to determine their basis effectively. For example, let's look at the month of March. Three years ago the whey value in federal orders generated 44 cents less than in California. Last year it generated $1.27 more and this year

it generates $1.86 more than the current sliding scale. Looking back at historical relationships between prices received at the dairy and federal Class III, which is how one can determine the basis, is certainly not a good predictor of basis because of this disparity.

If the crisis is fresh in dairymen's minds, it is not very far from lenders' minds either. At the Dairy Advisory Committee Industry meeting hosted by the Secretary on March 30th, 2012, dairy producers sitting on lending institutions' boards made clear that dairy loans were increasingly undesirable, making it harder for dairymen to get funding when needed. Risk management tools could be very useful for dairymen to show strong business plans to their bankers, reassuring them of less volatile margins. Lending standards have tightened and banks like to know where their borrower's bottom line will be. At a dairy financing conference in Visalia on February 22nd, 2011, speakers stressed that "borrowers will need to have a prudent business strategy and a clear objective." Again, this has encouraged many dairymen to turn to risk management tools. And unfortunately, it is becoming less and less of an option.

Even processors recognize the importance of those tools and what producers to be able to use them effectively. Adjusting the whey factor to allow fluctuation with market

prices will better enable California dairymen to utilize these risk management tools.

With regard to whey markets: Whether whey has a value or not is not the main question anymore. It is widely recognized that the whey stream has generated considerable revenues for the cheese processing industry. Various sources continually point to the increasing use of high-value whey products, domestically and abroad. According to the latest US Dairy Export Council data, the United States exported 46 percent of the dry sweet whey it produced in March 2012. USDEC adds that whey exports improved in March and "China remains the major customer, with first quarter purchases up 5 percent versus the prior year. In addition, exports to Mexico were up 43 percent." While specific California trade data is not available, with its proximity to Asia and its major shipping ports, as well as our shared border with Mexico, California is well positioned to participate in those markets.

The number of whey applications that have emerged in recent years is amazing. America's dairy farmers understand the importance of developing higher valued products and have contributed to this process over the years. The DMI, Dairy Management Incorporated, website says: "Research can play a critical role in turning product concepts into product successes. Whey protein research at

Dairy Management Incorporated has led to an entire new industry developed around whey protein-enhanced foods and beverages, because of their many benefits." DMI is funded through dairy check-off dollars. We realize a wide range of whey products are produced from the whey stream and California producers need a fair share of the basic raw commodity, just like with cheddar cheese and nonfat dry milk. Producers and processors should both be able to benefit from higher prices in whey product markets.

While products have been developed, the most important part of the whey story is perhaps the tremendous growth potential that remains. Mark Beck, senior vice president of the US Dairy Export Council said in a Cheese Market News column dated December 9th, 2011 that: "2011 might best be remembered as the year that whey protein crossed over from an ingredient on the rise to a full-fledged, long-term global growth proposition. Trends and events of the past 12 months point to a new level of recognition of the benefits of whey product from suppliers, food and beverage manufacturers and consumers alike, and with it, a corresponding rise in demand even in the face of price hikes." If demand will expand, producers need a fair share of that value.

Mr. Beck adds that facilities around the world are going online, aiming at high-protein applications. They are

"being built not to serve some theoretical projected rise in whey protein demand. The demand is already there. Markets are short now. The world needs supply and needs it fast. Sources indicate a number of US suppliers are nonetheless contemplating new whey products and could soon pull the trigger, and none too soon. It is critical that the United States builds on its market leadership and that US efforts include a stronger position in higher end whey fractions." Producers in federal orders will benefit from higher whey value with the current Class III formula. It is only fair that producers in California also get a share of this growing market.

Furthermore, the Panel in the past has been concerned about being proactive rather than reactive. In light of this potential growth it should be an important focus. This was a concern of the Panel at the December 2006 hearing. While the report focused on Class I, the potential issue remains the same. "The Panel concurs with the concern that an increase in the Class I pricing formula may address the 'reasonable relationship' that existed in the prior year, but it does little to address potential reasonable relationship issues that may happen in the future. The Panel believes it is more important to incorporate changes in the Class I pricing formula that will be more reflective of the market factors driving prices in contiguous states

now and in the near future. It is a far more proactive approach to ensure that California Class I prices maintain a reasonable relationship with contiguous states than the approach of simply correcting prices after the fact." With the current demand projections the current valuation of whey in the Class 4b formula will fall short of the value generated in the federal Class III. The issue likely to get larger, not smaller.

One difference between California and federal orders that we cannot fail to discuss is the fact that processors in federal orders have to abide by different pooling rules. We are cognizant of this situation. As described in a Food and Agricultural Policy Research Institute and University of Wisconsin Policy Briefing Paper on the Federal Milk Marketing - Pooling: "For manufacturing plants, called pool supply plants, pooling option. But there is usually an economic incentive for doing so because they receive producer settlement fund payments to pay producers." The paper presents depooling as an issue and adds: "Some orders have been and are being amended to make it more difficult for plants to depool."

While there are some differences between the two systems, it is recognized that depooled volumes are minimal. Data presented at the workshop highlighted depooled volumes in the Upper Midwest order representing 6.1 percent of milk

production receipts in 2011, all classes combined. Some of that milk could have been pooled in other orders. Nationally, only 4.3 percent of the milk in federal orders, all classes combined, was depooled due to price. In 2010, that number was even smaller at 2.2 percent. Cooperatives operating both in California and federal orders have knowledge of the differences and can attest that plants in federal orders, despite the different pooling rules, still pay the minimum Class III price. Thus, the idea that plants in federal orders can escape the minimum price easily cannot be justification for a lower whey value in California.

In addition, the option to depool may not be the same in California, but there are options for plants to pay less than the minimum price in the state. When a producer elects to go Grade B, no minimum price applies to that producer in California. Plants, whether they are pooled or not, can agree on whichever price they want with the producer. In 2011, Grade B represented approximately 1.7 percent of total milk production in the state. In 2010 that percentage was around 5.3 percent. The picture in California is not as different from federal orders as some processors would like us to believe.

Other proposals: We oppose the alternative proposal submitted by Farmdale. Reverting to a fixed whey factor put California producers at a bigger disadvantage

with federal orders than they are with the current sliding scale. It would also further deteriorate the relationship between Class 4b and federal Class III. This was clearly illustrated in CDFA's analysis presented at the prehearing workshop. Over the past five years it would have resulted in a Class 4b price 18 cents per hundredweight lower than the current, insufficient, Class 4b formula. The difference with Federal Order Class III would have gone from $1.05 per hundredweight with the current formula to $1.23 per hundredweight with their proposal. Farmdale's proposal would put California producers in a rose place than with the current formula so we are obviously adamantly opposed to such a scenario.

We support the Coalition's petition and position as we share the same concerns and objectives.

This concludes our testimony. We would like to reserve the rest of our allowed time for later to further clarify our position if we deem it necessary. The members of Western United Dairymen thank CDFA staff for their effort in preparing for this hearing. We would be pleased to answer any questions you may have and request the option to file a post-hearing brief.

HEARING OFFICER ROWDEN: Okay, first of all, your request to file a post-hearing brief is granted.

MR. MARSH: Thank you.

HEARING OFFICER ROWDEN: Questions from the panel?

MR. EASTMAN: I have a few questions. Can you hear me? Is that on? On page five of your testimony, just in the first sentence right underneath the figure. It mentions that you calculate that revenues to producers were lower in about $212 million. How was that calculated?

MS. AcMOODY: This is a difference basically between the whey factor that was in place in -- at the time since September 2011 and the whey factor in our proposal. So it's a difference only in the whey factor, multiplied basically by the pounds of solids/not fat that were in the pool for that period.

MR. EASTMAN: And then on page six where you talk about the difference -- you mentioned the dry whey commodity price series that's released by Dairy Market News and NASS. You mentioned that one of the reasons you prefer the Dairy Market News is because of the -- that it's more timely. The fact that USDA has changed their reporting from NASS to now AMS and it's a few days quicker do you think that changes your idea that the timeliness of that price series or is it pretty much the same either way?

MS. AcMOODY: I think it's pretty much the same either way. I mean, it is a little bit timelier but not, not as much. And one of the main reasons is the Department in the past has been comfortable with Dairy Market News so

we felt we would advocate for that. But either way.

MR. EASTMAN: Okay. On page seven in Table 1 you show a comparison of the California statewide cost of production compared to the California overbase price and you calculate the margin. Was there a particular reason why you chose the overbase price instead of, say, maybe a mailbox price that would also include an increased quota price or premiums that producers may receive?

MS. AcMOODY: Well doing that would basically -- it wouldn't be representative of those producers that are getting closer to the overbase. So I wanted to show what the, you know, the bottom, the lowest, you know, possibilities would be.

MR. EASTMAN: So the worst case scenario then.

MS. AcMOODY: Right, basically.

MR. EASTMAN: Do you know whether -- do you know if your membership in general is closer to -- as a group whether they receive more of just an overbase price or do you have any sense of how your membership would --

MR. MARSH: It would be a blend.

MR. EASTMAN: Do you have any sense of which side, if you -- say if you compared mailbox to overbase prices?

MR. MARSH: No,

MR. EASTMAN: And then I have one more question. On page 11 at the very bottom paragraph you talk about the

amount of milk that may be depooled in federal orders. And so there's two figure there, the 4.3 and then 2.2. Do both of those come from the paper that you list in your second footnote on the page?

MS. AcMOODY: Yes, the paper is for 2011 and it refers to 2010 in that paper as well. So at the same link you should be able to find those numbers.

MR. EASTMAN: Okay, perfect.

MS. RANKIN: All right, I have a few questions also. Can you hear me?

MS. AcMOODY: Yes.

MS. RANKIN: On page eight of your testimony you talk a little bit about production numbers and how production is going up and you talk about that a little bit. There's a lot of data, a lot of reports out there that milk production and cow numbers are both going up and there is also data showing that there are farms going out of business. Could you speak a little bit to this. Maybe what the data is showing. What you have heard, whether it's anecdotal or anything.

MR. MARSH: The challenges that were brought by 2009, the economic downturn, is still being felt today among the producer community in the state of California. The damage to families was horrific and it still continues today. There have been a number of situations where we have

had dairy producers who have unfortunately had to file for bankruptcy. We have had a number of dairies that continue close their doors. Neighbors notice when the cattle trucks show up in the morning to pick up the cows and take their neighbor's cattle away.

We have had increased cow numbers. We also have had increased milk production per cow. Those investment determination decisions that actually resulted in some of that were made clearly in 2011. At the same time dairy producers have struggled with the higher cost of production just to keep their operations going. Fortunately we have a few that are still left in the state. And with the change in our 4b formula we are requesting, hopefully we'll be able to keep them here for a much longer term.

MS. RANKIN: Okay. The only other question I had was on page nine of your testimony you talk about hedging using the Class III price. Do you know if there are other futures contracts that farmers use or maybe not as much? Can you speak a little to that?

MR. MARSH: Yes, we can use federal Class IV price series. The market is not quite as robust as it is for federal Class III. And given the relative utilization in the state it's probably -- well, it is under-utilized at this point. Whether or not we will see additional activity in that market in the future would be speculative but

nonetheless that does exist as an option. but really what producers would like to tie their price to would be that federal Class III.

MS. AcMOODY: And I believe the Coalition will actually testify to some of those numbers as well later.

MS. RANKIN: Okay. I think that's all questions I have.

HEARING OFFICER ROWDEN: Okay. Do you wish to have any more testimony, since you have some time left at this time?

MR. MARSH: No, we would like to reserve the balance of our time to further clarify in the future or if there is some testimony from other witnesses that we would like to rebut.

HEARING OFFICER ROWDEN: Thank you very much.

MR. MARSH: Thank you.

HEARING OFFICER ROWDEN: Next I would like to call up representatives from the Coalition. And before you step up, those in the back, there are a few chairs in the front if you would like to take and -- okay. Never mind, I have been told those chairs are not available. Before we start testimony let's get everybody settled here. Okay, let's be seated please. We have seats in the front for those of you that need seats. I guess we'll be taking some testimony from the podium; is that correct?

MS. MELBY: Yes.

HEARING OFFICER ROWDEN: Does the Coalition have any exhibits they wish to submit?

MS. MELBY: Yes. We have some PowerPoints that we are going to pass around, hard copies around.

HEARING OFFICER ROWDEN: Okay.

MS. MELBY: And an outline of some testimony. But we expect to be supplementing that with a post-hearing brief.

HEARING OFFICER ROWDEN: Okay, first of all, I guess the copy of the PowerPoint will be Exhibit 45.

(Exhibit 45 was received into evidence.)

HEARING OFFICER ROWDEN: Okay, everybody is settled. Please state your full name and spell your last name.

MS. MELBY: Thank you. My name is Donna Melby, M-E-L-B-Y. I'm with the law firm of Paul Hastings.

Whereupon,

DONNA MELBY

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MS. MELBY: Thank you. I think we have three others to swear in.

HEARING OFFICER ROWDEN: Okay. Are you going to all testify at once? I just want to --

MS. MELBY: No.

HEARING OFFICER ROWDEN: What I would like to do is just to clarify just -- unless you're going to have a mixed presentation like the last presenters. Is that your plan or is it going to be individuals? Because it's just easier to kind of keep track one at a time.

MS. MELBY: It won't be a mixed presentation but members of the Coalition are here to assist with questions in the question and answer phase.

HEARING OFFICER ROWDEN: I see. Okay, then let's swear all you folks in too. Sir?

DR. ERBA: Eric Erba, E-R-B-A. I represent California Dairies, Inc.

HEARING OFFICER ROWDEN: Thank you.

Whereupon,

ERIC ERBA

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MR. WEGNER: Tom Wegner, W-E-G-N-E-R, with Land O'Lakes.

Whereupon,

TOM WEGNER

Was duly sworn.

HEARING OFFICER ROWDEN: Sir?

MR. VANDENHEUVEL: Rob Vandenheuvel with Milk

Producers Council, V-A-N-D-E-N-H-E-U-V-E-L.

Whereupon,

ROB VANDENHEUVEL

Was duly sworn.

HEARING OFFICER ROWDEN: Okay, please proceed.

MS. MELBY: Thank you. Paul Hastings is privileged to represent today the Coalition of Dairy Interests, which consists of dairy cooperatives and trade associations including California Dairies, Inc., Dairy Farmers of America, that's the Western Area Council, Land O'Lakes, Inc., Security Milk Producers Association, the Milk Producers Council, the California Dairy Campaign and the Alliance of Western Milk Producers. This Coalition represents approximately 64 percent of the state's eligible milk producers and approximately 78 percent of the state's total milk production. Page 2 of the PowerPoint that you have been handed has a graph that shows that percentage.

This is the first time, and significantly so, that all of these dairy groups have come together for one single purpose. And that is, to seek a remedy to the fundamental inequity caused by the current Class 4b milk pricing formula.

It is for that reason that on March 2, 2012 the Coalition submitted its petition requesting that the Department consider replacing the current Class 4b milk

pricing formula with a formula that results in prices that bear a reasonable and a sound economic relationship to the national value of manufactured milk products.

The petition, including the proposed amendment of the Class 4b milk pricing formula, is designed to address the undervaluation of milk produced by California dairies.

Western United Dairymen has also submitted a petition, which is in full accord with the Coalition's position.

The Coalition wishes to address several key points this morning. First, the law. The law requires that the current Class 4b milk price shall bear a reasonable and sound economic relationship with the national value of manufactured milk products. That, of course, is Food and Agricultural Code Section 62062, which can be found on Slide 5 of the PowerPoint that you have in front of you.

The language of the code is mandatory with the use of the word "shall." That is because the California Legislature understood that the very best way to achieve a reasonable amount of stability and prosperity in the production of market milk is to ensure that California has a pricing system which will bear a reasonable and a sound economic relationship with the national value of milk products. The Coalition seeks nothing more than compliance with the code, consistent with the intent of the California

Legislature.

Second, we will offer testimony today explaining the harm to the status quo, and it is great. Namely, that the current Class 4b milk pricing formula results in prices that undervalue the milk produced by California's dairies. As well as the current situation creating instability and a lack of prosperity in the production of milk by producers, including the loss of millions of dollars every day.

You will hear from many representatives from the Coalition this morning, today and tomorrow, including experts, including members of trade associations, including many of California's dairy producers.

For example, this morning you will hear from Eric Erba who is the Senior Vice President of Administrative Affairs for California Dairies, Inc. He is affiliated with CDI, as you well may know, and that CDI produces approximately 40 percent of the state's milk.

Dr. Erba has a PhD in agricultural economics from Cornell University with a specialty in dairy market policy. From 1997 until 2004, Dr. Erba served as a Senior Agricultural Economist for the Dairy Marketing Branch, during which time he performed quantitative analyses to assist the Secretary in the administration of the California Milk Marketing Program.

You will also hear from Rob Vandenheuvel, who is

the General Manager of Milk Producers Council. He was raised on a dairy farm in Chino, California and his family continues to operate that dairy. Mr. Vandenheuvel has personal knowledge, which he is here to testify about today on behalf of the Coalition and on behalf of the Milk Producers Council. The membership of the California Milk Producers Council is comprised of dairies throughout Southern and Central California.

Perhaps most importantly we will hear today from members of the dairy producing community, who we expect will testify before the panel over the course of these two days. These witnesses will testify regarding the economic hardship caused by the improper valuation of the milk that is produced by California's dairies. And specifically we expect that they will tell you that in large part this is due and can be traced to the whey solids factor and the failure of the California Class 4b formula to reflect increases in the market price for whey.

The Coalition's witnesses will also testify that the undervaluation of milk produced by dairies has had a number of negative impacts on dairy families in California. These impacts include weaker equity positions in their dairy operations, mounting debt, tightening credit lines and defaults on existing lines of credit. As well as a shortfall in producer revenue of approximately $300 million

in 2011 alone. With an equal, we might add, windfall in processor profits.

We'd like to talk thirdly about proposed solutions to the fundamental inequity that exists now and has existed for so many years and for which California dairy producers have waited a very long time for a remedy.

In view of these harms the Coalition has proposed a viable amendment to the Class 4b milk pricing formula and suggested language to amend the plan and a table. And these have all been attached to the petition, which is a part of the record. All of that said, there are a few notable highlights of the proposed amendment that we would like to just address briefly.

To begin with, the Coalition has proposed that the Department's current sliding scale be replaced with a new sliding scale. A new sliding scale that results in a whey value that tracks the market direction followed by the Federal Milk Marketing Order's Class III whey value. Put simply, the Coalition urges that the FMMO Class III is the correct benchmark for Class 4b milk pricing. Specifically with respect to the value of whey.

On this point I expect you will hear testimony from Dr. Erba as well as from Tom Wegner and Elvin Hollon. We have introduced Dr. Erba already, who you may already be familiar with.

Mr. Wegner, you may also know, is the Director of Economics and Dairy Policy for Land O'Lakes, Inc. He is responsible for, among other things, following changes in the federal and state milk marketing orders and regulations. Mr. Wegner has a master's of science degree in applied economics and agribusiness management from the University of Wisconsin at Madison. And Mr. Wegner has traveled from Minnesota in order to testify here today.

In addition, Elvin Hollon is the Director of Fluid Marketing and Economic Analyses for the Dairy Farmers of America. And in that position Mr. Hollon is familiar with milk pricing at the local and at the national levels. Mr. Hollon has traveled from Missouri to be with us today and to testify.

In its amendment the Coalition has proposed that the Department use a simple average of the Dairy Market News West price range for dry whey as part of the Class 4b milk pricing formula. It has done so because it understands that the Department has, at least in the past, preferred to use Dairy Market News price ranges in lieu of the National Agricultural Statistics Service price range.

The proposal is based on a calculation of 95 percent of the FMMO Class III dry whey factor. That's adjustment that accounts for the trend that the Dairy Market News West price range has generally been slightly higher

than the NASS price range.

The last feature of the Coalition's proposed amendment to the Class 4b pricing formula pertains to the institution of a floor and a cap, at zero hundredweight for the floor and a $4 hundredweight cap. You will hear testimony from the economic experts of the coalition who will tell you why this makes sense.

We'll conclude our presentation by addressing arguments that have been set forth by the cheese processors, which we also expect to hear today. Dr. Erba, Mr. Hollon, Mr. Wegner, Annie AcMoody, all will testify that cheese plants will not suffer undue harm if the Department adopts the coalition's proposed amendment to the Class 4b milk pricing formula, which we believe to be consistent with the intent of the legislature of California.

These witnesses will tell you that among other things not all cheese plants manufacture whey, but those which have whey manufacturing capacity currently benefit from whey values that are far below market prices. In other words, many cheese plants have obtained windfall profits at the expense of dairy producers because of the undervaluation of milk produced by California dairies.

Many small and medium sized cheese plants, in addition to not manufacturing whey, often produce specialty cheeses such as brie or gouda and they extract a premium for

their cheeses in these niche markets. You will hear more testimony about that later today.

The coalition very much appreciates the opportunity to be heard in connection with this petition. We will request at the end of our presentation the ability to please present a post-hearing brief for submission into the record.

If I might now just turn a little bit more to the legal discussion on the law as it applies to the issues that are before the panel.

First, as this panel is aware, the Food and Agricultural Code authorizes the Department to regulate the price of milk sold in California pursuant to a stabilization and marketing plan. That, of course, is California Food and Agricultural Code 61801. That is also contained in your PowerPoint.

Pursuant to its authority the Department has implemented a stabilization and marketing plan to establish prices for various classes of milk. The Department determines a value for raw milk produced by dairy producers based on the end uses of milk and, of course, that is California Food and Agricultural Code Section 62838.

The overriding legislative intent of the entire statutory regime is to enable the dairy industry, with the assistance of the state, to develop and to maintain

satisfactory marketing conditions to bring about and to maintain a reasonable amount of stability and prosperity in the production of market milk. California Food and Agricultural Code Section 61805(d). That's on page four of your PowerPoint.

As the coalition has pointed out in its petition and as many witnesses will testify over the course of the next two days, the current Class 4b pricing system has created the very conditions which the Legislature intended to avoid. It has created instability in the production of milk. Given this backdrop of instability the Department, although it does have discretion in establishing milk prices for various classes of milk, must comply with the law in setting prices in accordance with certain criteria.

Notably the law, specifically the Code, is very clear, very unequivocal and very, very specific in the use of mandatory language, for instance using the word, not once, not twice but many times, the word "shall." And that word "shall" is used with respect to the application of certain criteria to the development of a minimum price for milk.

First, the Code provides that in connection with calculating a milk price "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." That's California Food and Agricultural Section 62062, slide five in your PowerPoint.

Next, the Code also provides that in establishing milk prices the Director shall take into consideration relevant economic factors, including the dairy producers "cost of management" and whether the producers were capable of generating a "reasonable return on necessary capital investment." That's California Food and Agricultural Code 62062(a).

These are the two areas where the existing policy fails to connect with the law and with the intent of the Legislature. It's these two areas, namely whether the current Class 4b milk price bears a reasonable and sound economic relationship with the national value of manufactured milk products and whether dairy producers have been able to generate a reasonable return on their capital investment. These are the areas where there is the failure of the existing formula.

Shortly you will hear from witnesses who will testify that the current Class 4b price fails to bear that reasonable and sound economic relationship with the national value of milk products. And you will hear from those same witnesses that the pricing discrepancy has caused dairy producers to have weak equity positions in their operations

and collectively to lose that nearly $300 million that I mentioned earlier, in 2011 alone.

There can be no reasonable basis to ignore the current trend in the Class 4b pricing discrepancy. In fact, the failure to reconcile whey solids -- the whey solids component of the Class 4b milk pricing formula with the national FMMO Class III pricing formula may be arbitrary, may be capricious. At least to the extent that it would ignore the irreparable harm that dairy producers are daily experiencing or that it may ignore the Code's requirement through its mandatory language that the Class 4b price shall bear some reasonable and sound economic relationship with the national value of manufactured milk products. That law matters. The current policy is out of sync with that law.

We understand that the Department has taken a position, at least in a March 28, 2012 letter from Kevin Masuhara to CDI that its primary obligation may be to establish a price that will "clear the market or will facilitate the balancing of supply and demand for milk." We have looked but we have not been able to find any authority to support such a proclaimed mandate.

And to the extent that the Department has that position, the coalition preserves the record on the issue and asks for some clarification of this. It is clear in any event that the expressed language of the Code, the mandatory

language of the Code as provided just a few moments ago, is what should govern the Department's consideration and review of the Class 4b milk pricing formula. Fortunately, the law provides the context for that review. The coalition hopes that that is the context in which its current amendment will be reviewed.

In sum, the proposed amendment better tracks the FMMO Class III price, specifically with respect to adjustments in whey markets. That's slide seven of your PowerPoint.

We understand that the Department has 60 days upon which to act on the petitions pursuant to the Code provisions. This, however, is a time of great stress for California dairy producers. It's a time without stability, it's a time without prosperity. And the harm that is -- in light of the harm that is occurring each and every day, the millions of dollars that have been lost already, and the fact that the dairy producers have already waited for many years for an adjustment to the Class 4b milk pricing formula, it is respectfully requested that the Department move as expeditiously as it possibly can in its review and assessment of the proposed amendment.

Are there any questions?

MS. GATES: Ms. Melby, I would like to clarify for the record. On slide seven, if you go down to number A.

I'm assuming that you are referencing what was in the petition, correct?

MS. MELBY: Correct.

MS. GATES: Correct, okay. Beginning on the second sentence when it talks about the California price adjuster of two and fifty-two hundredths cents and then in parens it says one and fifty-two hundredths. I'm assuming you mean two and fifty-two hundredths. I'm assuming it's a typo but I don't want to assume that, I want clarification.

MS. MELBY: Yes, I think that is a typo.

MS. GATES: Okay. Just so we can get that on the record. Okay.

Question number two. You stated in your testimony that we will hear arguments from the cheese processors that they have suffered undue harm and your statement was they will not suffer undue harm if your proposal is put in. Could you tell me how that data was calculated or how you got to that?

MS. MELBY: The only thing that I intended to convey was that we anticipate that the cheese processors will give testimony that if the amendment is considered and/or adopted that they will suffer undue harm if that is the result. And our position is that that is not in fact what will happen.

MS. GATES: Okay. In that same context when you

were speaking you spoke that they -- "they" being the cheese processors, have incurred windfall profits. Do you have data supporting that that we could look at?

MS. MELBY: I believe that we do and that some will be presented through the coalition witnesses. Yes, we do.

MS. GATES: Okay.

MS. MELBY: But as a fundamental observation because of the losses of the dairy producers, it logically follows that there are in the same amount, i.e., $300 million. There are on the other hand the same amount of windfall profits to the processors.

MS. GATES: Okay, then we will ask the gentlemen when they testify for the data to support that then.

MS. MELBY: Yes.

MS. GATES: Okay. And then you just mentioned my next question. When you talk about the $300 million that the dairy producers have lost. We would like to know how that was calculated so we can understand that better.

MR. VANDENHEUVEL: It will be a little bit later in the testimony.

MS. GATES: Okay.

MR. VANDENHEUVEL: I have the calculations included as an attachment to mine.

MS. GATES: Perfect.

MR. VANDENHEUVEL: It's slightly different from the previous number that Ms. AcMoody mentioned because she was measuring from September 2011 to the present, whereas this is a calendar year calculation.

MS. GATES: Okay.

MR. VANDENHEUVEL: But those numbers will be --

MS. GATES: Perfect. And I think my final question is, you spoke to the instability of milk production in California due to the current sliding scale that's in effect.

MS. MELBY: Yes.

MS. GATES: What data supports the instability? I want to understand what that means.

MR. VANDENHEUVEL: The instability of the current system, you mean?

MS. GATES: No, she spoke to the instability of milk production. That milk production has been unstable.

MR. VANDENHEUVEL: I didn't have that exact language. I mean, the economics of the dairy -- of milk production has been certainly unstable. And that's well-documented in the exhibits that the staff put together comparing the statewide blend price to the cost of production and the instability.

MS. GATES: Okay, I'm sorry. When she spoke to milk production I was looking at the production of it, that

that was unstable.

MR. VANDENHEUVEL: Okay.

MS. GATES: So that's what I was trying to get a better understanding of. And you were talking to the?

MR. VANDENHEUVEL: The economics of milk production. I believe that's what the testimony was.

MS. GATES: Okay.

MS. MELBY: Yes. And thank you for the clarification. I'm glad we got that clarified.

MS. GATES: I just wanted to make sure that was clear.

MS. MELBY: Yes.

MS. GATES: Thank you.

MS. RANKIN: I also just had one clarification question.

MS. MELBY: Yes.

MS. RANKIN: You mentioned a number of code sections but they weren't -- I don't know that they were all in your slides. You have three listed in the slides. I just wanted to -- could you mention which code sections, besides the three slides you handed us, that you mentioned in your testimony?

MS. MELBY: Yes. In fact, we can -- we will submit copies of all of them.

MS. RANKIN: Okay. That's all I have.

HEARING OFFICER ROWDEN: Excuse me, is that part of the further testimony when you would be submitting copies of that or is that coming today?

MS. MELBY: We can submit them today, tomorrow or with the post-hearing brief, whichever --

HEARING OFFICER ROWDEN: The post-hearing brief, okay, all right.

MS. MELBY: And I do want to be certain that we can submit that post-hearing brief?

HEARING OFFICER ROWDEN: Yes, that's granted.

MS. MELBY: Thank you.

HEARING OFFICER ROWDEN: Okay. Do you gentlemen have an order of testimony or is it just going to be --

MS. GATES: We have other questions.

HEARING OFFICER ROWDEN: You have one more question, go ahead.

MR. EASTMAN: Well actually I guess I have two questions. I'm assuming that all three of you are going to testify later on behalf of your individual organizations and that you are not going to be providing further testimony right now, you are simply here to answer questions.

DR. ERBA: That's correct.

MR. EASTMAN: And then the other question I have is, in formulating the proposed changes to the whey scale, the sliding scale. In the testimony you mention that you

use the Class III formula as a benchmark. And one of the things you mentioned is that you purposely put in an adjuster of 95 percent to account for the differences between the dry whey commodity price series, the difference between Dairy Market News and, say, NASS.

The question I have is, had you in constructing your proposal had you come up with any other thoughts with regards to how, for example, the previous or California conditions are different than say, at a national level? And what I mean by that is, in federal orders they have a typical and product pricing-type factor with a commodity price and make allowance and a yield. And typically in our California formulas we tend to establish our formulas based on California factors, California conditions.

And so in formulating your new scale I notice that you purposely looked at and considered, say, the price series. But did you consider differences in California and across the nation with regards to, say, manufacturing cost allowances or yields or other facets of the production?

MR. WEGNER: I'll address that one, Hyrum. I think you are well aware that the history here has been that we haven't had a make allowance for whey since 2007. There have been proposals to talk about proxies for that; they have been denied by the Department. The Whey Committee just got some -- I think we are in a position where there isn't

good manufacturing cost data available for the date and that the Federal Order Class III formula is a base price, a benchmark to consider. That's why we chose that as well.

MR. EASTMAN: So in essence then really, based on lack of data -- in essence in formulating the scale there is a certain ad hoc nature to the construct in the sense that you are basing it off of the class rate price and whatever your best feeling is.

MR. WEGNER: Well, I mean, the formula and the result of the formula is laid out in the table quite succinctly. And like I said before, there is no California data to use to address issues that you raised around yield, around make allowance.

MR. EASTMAN: Perfect. Thank you.

HEARING OFFICER ROWDEN: Any other questions for the coalition? Okay, do you wish to reserve the remainder of your time?

MS. MELBY: Thank you, yes.

HEARING OFFICER ROWDEN: You have burned off 24 minutes, you have 21 minutes left. And again, you have the right to submit a brief.

MS. MELBY: Appreciate it, thank you.

HEARING OFFICER ROWDEN: Thank you.

Okay, at this time we will be calling witnesses. Excuse me.

Okay, we would like a representative from Farmdale Creamery. Is there a representative from Farmdale Creamery? Okay. Okay, please state your full name, spell your last name and state your affiliation for the record, please.

MR. HOFFERBER: My name is Scott Hofferber, H-O-F-F-E-R-B-E-R, I am the Controller for Farmdale Creamery.

Whereupon,

SCOTT HOFFERBER

Was duly sworn.

HEARING OFFICER ROWDEN: Okay. Your testimony is listed as Exhibit 46. Please.

(Exhibit 46 was received into evidence.)

MR. HOFFERBER: Good morning, Hearing Officer and members of the Hearing Panel. I am Scott Hofferber, the Controller at Farmdale Creamery, Inc. and I am here at the direction and on the authority of our Board of Directors who, in turn, are represented today by Michael Shotts. Mike is a third-generation owner and the President and General Manager of our family-owned and operated dairy processing facility in Southern California. With about 80 employees Farmdale makes sour cream and buttermilk products and also processed an average 19.8 million pounds of milk per month, that's about 360 loads a month at 55,000 pounds a load, into block jack and cheddar cheeses, during 2011. We are grateful for this opportunity to provide Farmdale's

perspective on the matters before the panel.

Relevant portions of our testimonies and post-hearing briefs from the prior five 4b formula hearings have been incorporated in this hearing record by the Department. Rather than taking time to reiterate the fundamental concepts proffered in those documents, which we completely reinforce and incorporate herein by reference, we will provide perspective and information specifically for the tenor and import of this particular hearing.

Return to Orderly Marketing. In order to save the California dairy industry from losing about 9 percent of its cheese processing capacity, and possibly 75 percent, or 43 of 57 of its cheese makers, and those are figures from Exhibit 1, the undersigned offer the following alternative proposal.

We propose the Department return the whey factor to the 25 cent per hundredweight for 4b milk and encourage the Department to recognize once and for all that the producer community and their representatives are sophisticated enough to take responsibility for sorting out what each individual cheese processor, there's only 57 of us, will pay for their 4b milk through the use of the established practice of added service charges. A service charge is an additional fee-per-hundredweight above the minimum regulated price that is not included in the cost

studies that establish make allowances. The higher valued the whey product, the more that individual processor could be willing to pay, all other market factors being equal.

Despite the producer community's belief that cheese plants are popping up all over the place, as was heard from the floor at a recent Dairy Advisory Committee, or DAC, meeting, the fact is that the number of cheese plants has dropped from 60, as reported for the May through July 2007 by the Department in Exhibit 2, to 57 currently. And total cheese-milk utilization has fallen from 1.6 billion pounds per month on average to 1.55 billion pounds per month. This during a period of alleged prosperity in the cheese processing sector due to the 25 cent per hundredweight whey factor. Something is not adding up.

One interesting side note to this discussion is reflected in the Department's revision to Exhibit 2, see Exhibit 3, wherein the month of August 2007 was added to the analysis. After that inclusion, cheese milk monthly utilization dropped to 1.4 billion pounds for the four month period reported; a direct reflection of the injurious nature of the variable whey factor in force at that time.

First and foremost, we recognize the dairy industry in California is in serious trouble. While there are tremendous opportunities for growth and prosperity domestically and abroad, disparities and inequities within

the producer community, such as quota versus no-quota, grown feed versus purchased feed, landowner versus leased land, producer-owned processes versus non-owner producers, freight allowance disparities, et cetera. These disparities abound and are fueling crippling debate and a regulatory process. The ray of hope for reform germinating within the DAC will take some time to create real and lasting change, but the DAC has certainly recognized that the system is broken.

Whey Tax. And with regard to the previous testimony we can now call it a windfall profits tax.

Each 4b hearing that included a discussion of whey valuation since 2003 has caused the system to break even further. The result of implementing the August 2011, 4b hearing decision on September 1st, 2011, caused the cheese processors in the state to shift $24.8 million, and the math follows, from the processor's bottom line to the pool in the last four months of 2011 with no corresponding increase in revenue potential to offset that cost.

Then there is a table showing Hyrum some calculations there.

For the same four-month period at the end of 2011, the petitioners' tax rate would have transferred an additional $111.1 million with no recuperative path for cheese makers. This will cause the 81 percent, 46 out of 57 cheese makers who are not processing whey into value-added

products, primarily due to the cost of capital investment required to do so coupled with the economies of scale factors, to have little or no reason or ability to continue in the cheese business.

A tax can be interpreted as a transfer of wealth through regulation. The shifting of funds described above seems too close to what is actually happening here to be dismissed in the conversation as anything other than a tax. The imposition of such a humongous transfer seems inappropriate to a regulatory scheme without proper legislative support.

And in terms of use of the term "windfall," I'll talk about that a little bit later.

Reasonableness. The petition attacks the Stabilization and Marketing Plan on the grounds that a single phrase, to wit "reasonable relationship," is not adequately addressed. We would argue that the Department has a greater charge to provide an orderly marketing environment wherein the alignment issue is a lesser included plank in that platform.

The petition argues that perfect equality in the dollar value of 4b milk with the Federal Marketing Orders, or FMOs, is what is necessary to bring order to the orderly marketing precept of the plan. We will hear testimony from other, more expert, witnesses during this hearing about the

fallacy of the petition's assertion of reasonable. Our limited understanding of the alignment issue, nonetheless, has led us to the following observations.

Whey taxation ointment is not the cure. It is a treatment for an unrelated disease, a treatment that will ultimately cause greater harm to the patient than the recommended and necessary amputation. AKA, cut the milk supply.

Acquiring milk at prices under the minimum regulated price is not available in California as it is in the FMOs.

Quota creates complexity in California not apparent in the FMOs.

Despite rhetoric to the contrary, the petition completely dis-incentivize expansion of plant capacity in the largest processing sector, Class 4b.

Pulling more money from whey will incentivize more milk production and just exacerbate the oversupply situation. Producers by their own admission to me at a recent DAC meeting used the '07-08 and '10-11 opportunities to expand production. In 2010 and early '11 the apparent last prosperous time for some producers, cows were purchased rather than debt paid down. Why, we wonder. Possibly because more is the only way to get ahead under the current pooling system for a producer and because tax incentives for

new cows helped out that year. Shame on the tax preparer who recommended that course of action when the taxpayer really needed to get out from under previous bad year and where the milk supply really didn't need expansion.

Proximity of cheese plants is not conducive to whey aggregation in California where it is an option in many FMO areas. And that's a list of observations.

In any event, we wonder about a time, like late '08-09, when the FMOs happened to present a lower relative value for cheese milk. What will we b hearing from producers in that day?

For Farmdale, what we know for certain is that under the petition we cannot continue to make cheese profitably with our existing animal feed whey program. In fact, the implementation of the current sliding scale whey factor is challenging enough for us, to the point where we are seriously considering making cheese -- discontinuing making cheese. Our best choice seemed to be to succumb to the endless pressure to make a very risky investment in a plant to produce higher valued whey products.

Dis-incentive. To this end Farmdale is, right now, attempting to expand its cheese production by ten percent. In order to accomplish this we must make changes to our whey processing capabilities. We have aggressively pursued the feasibility and development of a WPC-80 powder-

making plant. We developed detailed plans and projections, issued RFPs and RFQs and have selected a financier. One part of our evaluation including a SWOT analysis, Strengths, Weaknesses, Opportunities and Threats on the project. The two major threats identified were the long-term milk supply in Southern California and an unstable milk pricing regulatory system.

Through market-based negotiation we were able to achieve an acceptable answer and reasonable assurance regarding the milk supply issue, such that we feel reasonably sure we would see the project through the critical initial payback period. Once the project is paid for, so to speak, then the economics would change and probably afford us the ability to bring milk in from greater distances.

The second threat has manifested itself in a most aggressive way by the petition under consideration at this hearing. Should the petitioned for changes to the regulated Class 4b price enacted, our proposed project will be scrapped and we will be out of the cheese business. The expansion/improvement project will not return sufficient benefits to reward the enormous risk we would be taking to accomplish it. Further and maybe even of greater long-range importance to our industry, the mere fact that petitions can be filed and heard on such a frequent basis completely

hamstrings decision-making relative to investment in plant capacity. Investors are not interested in building on shifting sands.

Specifically to risk, an investment of approximately $8 million should be expected to return a reasonable rate of return under any competent analyst's criteria. The return on investment percentage CDFA used in the 4b cost studies for 2010 is a positive 6.038 percent. In Exhibit 6 we show our page out of our cost study where we were given that number. But we would argue that a higher return should reasonably be expected from such a risky, vertical market investment.

With the petitioned-for whey factor in the cheese milk price, our analysis of the intended whey plant project -- of our intended whey plant project, indicates the potential average next loss before tax to be a -11 percent, considering a relevant range of combinations of WPC-80 and dry whey prices. And we provided that in Exhibit 4. Exhibit 4 will probably take some digesting so we can allow some time for that and respond later.

Based on quarterly historical combinations of prices for the last 19 calendar quarters ending March 2012, the average net loss before tax is 17 percent on our project, negative 17 percent. These projected potential outcomes completely dis-incent our going forward. And if

implemented, the petitioned-for price actually puts us out of the cheese business. So rather than our desired 10 percent expansion in 4b milk utilization, we will be laying off approximately 60 percent of our employees. Under the premise that at least six other jobs are created in a community for every worker in a processing plant, and this is information taken from an article published in a Tulare newspaper -- a Visalia newspaper and that's Exhibit 5, over 300 jobs would be lost from Farmdale alone.

And to this we are going to hear testimony about dairy farms failing. And we have actually heard some things about trucks taking cattle away and neighbors noticing and things like that. And one of the realizations we have about that and where -- you know, again, this is a human tragedy. The cows don't seem to be leaving. And if you lose 37 dairy farms somewhere along the way but the cows don't disappear -- if you lose a cheese plant that capacity is gone. They don't -- we don't move it somewhere else, it just goes away.

A New End Product Formula. With respect to the petition, it is creating, through the back door, an end product formula for the whey stream. By using a floor and a cap for dry whey prices that bracket all imaginable prices, and; assigning penny increments through that range of bracketed prices, and; forcing an amount at each individual incremental input price level into the milk price that

causes all added value of the whey into the cost of the 4b milk; a processor receives nothing for its trouble at any sale price, in essence creating a new, FMO-based end product for whey superimposed on a price system that already includes a California-based end product formula for the cheese.

This new end product whey formula that the petitioners are proposing in the guise of a sliding scale is not based on any factors that are characteristic of California operations, but rather uses a high percentage of the federal make allowance and yield found in the Class III formula. Which were, in turn, based primarily on plants outside California. Adoption of such a formula would be a major departure from the principles of end-product pricing formulas that the Department has employed since their inception.

Ostensibly, dry whey is the lowest valued product, as that is how their factor is indexed. "They" being the petitioners. However, there are no published cost studies for dried whey and the petitions offers no construct for developing appropriate cost information to support such a make allowance. This flies directly in the face of all established due process for a make allowance construct in our pricing formulas.

This is unconscionable. If this is the approach

the industry is to take, it would require adding a new product class, maybe 4c, and creating all of the legislative and regulatory support systems to maintain it, only to create yet another debate arena over how to value the base product. I am not sure how we would approach that seeing as there is no whey without cheese, so far.

Oh, and on that point, we re-assert our position as to the value of whey in cheese milk. Cheese makers have always had the responsibility of dealing with the whey stream. Originally as purely a waste product and then as animal feed and then coming up with protein powders and more advanced products, the whey stream has been the problem/ opportunity of the cheese makers. All costs of R&D, plant and equipment, production, market development and maintenance have been borne by the cheese makers. So because we have been successful at that we are now looking at a windfall profits tax to move all of that value to the producer community. Meanwhile, milk has remained milk and cheese has remained cheese. The price of cheese milk was and needs only to continue to be tied to cheese, with maybe a minimal value ascribed to the skim solids in the wet whey stream; maybe 10 cents to 25 cents per hundredweight of milk.

Reality. The producers need to get more for their milk. Agreed. However, this will not be accomplished by

becoming equal to the federal orders. Currently, end-product prices are insufficient to overcome high feed costs, no argument. But why are the end product markets so low? The answer is that supply and demand are out of balance. The rhetoric notwithstanding, the steps being taken to manage supply are failing, as evidenced by the milk supply growth figures being seen in California relative to the national figures and by the continuing alleged low prices. Prices aren't the cause, they're the effect.

Market equilibrium can be achieved at any price level, depending on the willingness of the product provider to supply the market at that price. If you don't like the current price, cut the supply, create a scarcity and let buyers compete for the product, bidding up the price. Econ 101 stuff. Instead, in California, milk supply keeps growing because despite the current temporary price-cost squeeze, returns to producers have averaged values that are high enough to encourage investment and growth in the milk supply.

In Summary - A Better Approach. In order to properly incentivize our growth, we must be able to compete for milk in a way that is appropriate for our size and product mix. This is best accomplished apart from the regulated system. The setting of a minimum regulated price at a high level so as to compensate producers for a higher

valued end product puts all processors of lower valued products out of business or certainly headed that way. There are too many various end products, both in cheese and in whey, for the current one dimensional approach toward finding the value of 4b milk to remain the best practice for our industry.

The reasonable approach would be to set the minimum price based on a minimal product. As in cheese, where cheddar was considered the lowest common denominator, liquid whey should be valued in the minimum price formula as the nominal product it is. Ten cents per hundredweight of milk is arguably the appropriate minimum price. Twenty-five cents per hundredweight was an acceptable minimum price from '07-11. The producer community certainly has the ability to address the value in milk for the higher valued cheese and whey products through their own or their representatives' direct negotiations, service charges, with the various, and few, processors left in the state.

With our request for the privilege of submitting a post-hearing brief this testimony is respectfully submitted.

HEARING OFFICER ROWDEN: Thank you. Your request for a post-hearing brief is granted. Questions from the panel?

MS. GATES: On page two of your testimony you speak to a drop in the cheese production. I'm reading my

notes here, Scott, hold on.

MR. HOFFERBER: That's okay.

MS. GATES: Did production in your plant drop in correlation to what you had spoken to?

MR. HOFFERBER: Well certainly when you include August of '07 in that we would have to say no. Because during August of '07 we actually shut our plant down for a week because we were so far underwater under the sliding scale factor. So if you compare that window to current I would have to say we actually were increasing if you're looking at the absolute numbers.

If you want a general sense, we have been pretty flat. We haven't added any, any vat capacity and we have been running pretty much the same vat volume on a daily basis over that entire period. Which is why we are enthusiastic about adding ten percent capacity, you know, through adding a more efficient whey plant.

MS. GATES: When you talk about the investment, you know, in the whey plant that you are looking to, what type of time frame are you looking for, for payback, for return on that investment?

MR. HOFFERBER: In discussing it with the financiers, they're asking for something like five years. We might -- think we might be able to do better than that. But in terms of qualifying it for the financing --

MS. GATES: Five years.

MR. HOFFERBER: We were looking at a five year window.

MS. GATES: On page seven of your testimony --

(Background conversations in audience.)

HEARING OFFICER ROWDEN: Please keep it quiet. If you have any conversations take them outside. Thank you.

MR. HOFFERBER: Did you say seven?

MS. GATES: Yes, page seven. It starts with -- I guess you'd call it the first full paragraph there. The new end product whey formula for the petitioners.

MR. HOFFERBER: Yeah.

MS. GATES: In that one. And you speak to there are characteristics of California operations. How are they -- could you explain a little bit about the differences between California and the federal order that you were speaking to in this -- in this piece here.

MR. HOFFERBER: Well, the list of bullet points kind of addresses our anecdotal observations about that. I think we're going to hear a whole lot more technical analysis about that kind of thing. Since we only operate in California it would be hard for us to draw a technical comparison.

MS. GATES: Okay. Okay. Thank you.

MR. EASTMAN: All right, I have a couple of

questions. You might as well walk me through a little bit a couple of your tables here to make sure we understand it before you leave.

MR. HOFFERBER: Yes.

MR. EASTMAN: So the first table on page three then where you talk about, I guess, the whey tax increases.

MR. HOFFERBER: Right.

MR. EASTMAN: So the first column is just monthly Dairy Market News monthly dry whey prices as announced by --

MR. HOFFERBER: Per your publication, right.

MR. EASTMAN: And then the second column, are you referring to just the hundredweight price of the whey contribution to the formula each one of those months?

MR. HOFFERBER: That's correct.

MR. EASTMAN: And so then the third column is you're just taking the 1.55 billion pounds of milk on average and coming up with --

MR. HOFFERBER: Doing the math.

MR. EASTMAN: Okay. And so the question I have is, I guess you could argue -- you look at the first column that has the dry whey price. In California there are cheese makers, there's cheese plants that do a variety of whey products. So in theory for them, wouldn't the revenues from their products reduce these numbers here on the table?

MR. HOFFERBER: I would imagine theoretically we

could argue just about anything. We'd have to specifically determine what their costs of operations were.

MR. EASTMAN: Okay.

MR. HOFFERBER: But this is just going just directly off the change in the formulas and developing the dollars as a result of the changes in the formulas.

MR. EASTMAN: So is this --

MR. HOFFERBER: Whether those dollars would actually be present in those operations, I don't know. I know they're not in ours.

MR. EASTMAN: Okay. So the table, the purpose of the table is more just to show the difference of the change and --

MR. HOFFERBER: The impact on the change.

MR. EASTMAN: In the previous fixed dry whey factor and then the new scale that was implemented last summer.

MR. HOFFERBER: Correct.

MR. EASTMAN: So just highlighting the differences between those two.

MR. HOFFERBER: Right.

MR. EASTMAN: And the second question I had was when you go to Exhibit 4 where you show the big table with projected, it looks like returns there.

MR. HOFFERBER: Right.

MR. EASTMAN: So is that based on the current -- is that based on milk prices, the current formula, or the proposed changes by the co-petitioners?

MR. HOFFERBER: The way I developed this table is in the development of our proposed plant, the new plant, we have a model that we were using to justify the financing and to justify doing the project to ourselves. How we think the thing would operate economically. And we took combinations of dry whey prices and what the petitioner's formula would generate at various levels of WPC-80 market prices and ran them through the formula individually to come up with this net income before tax answer in a percentage number. And these are all of those answers.

MR. EASTMAN: Okay, so that is based off of the petitioner's proposed change.

MR. HOFFERBER: That's correct. And then the darker boxed numbers are taken from data that was developed through the course of our analysis in terms of actual combinations of quarterly average 80 prices compared to dry whey prices. And taking those combinations and highlighting them on this table. Because we were interested to see, you know, where this splits between profitability and not profitability.

Where the real history kind of lay on that chart. And whether or not, you know, with the petition in play,

those combinations of prices would even make this thing profitable. Which is where I get back to my -- in the body of the testimony, those negative numbers.

If you take a ten-key to this thing you'll come to those numbers. I can actually -- I don't know if I can send you the actual Excel spreadsheet but it might your analysis, if you want to dig into that, a little better. I could probably submit that. I'm not really thrilled about making that part of the public record.

MR. EASTMAN: Okay. Well you can judge how you want to do that. Whether or not you want to include that in your post-hearing brief or not, I'll leave that up to you. So just to clarify what you just said or restate it. So the highlighted boxes then are based on the actual dry whey and WPC-80 prices --

MR. HOFFERBER: Combinations.

MR. EASTMAN: -- that occurred on an average, sort of a quarterly average basis. So those are things that typically if history were to repeat itself those could be possible outcomes.

MR. HOFFERBER: To give us an idea of what history would have resulted had all of these things been in place. Or what we were facing going forward under the condition the petition is accepted.

MR. EASTMAN: And then another question I had was

when you mentioned -- on page five of the testimony you started talking about the work you had done when you were trying to project the strengths and weakness and being able to obtain financing for a proposed operation. You mentioned that you were able to come to, I guess, a reasonable negotiation in terms of a milk supply. Do you currently have problems obtaining milk?

MR. HOFFERBER: Not this week.

MR. EASTMAN: In the past year or in the past four months? We know that based on --

MR. HOFFERBER: Not in the past --

MR. EASTMAN: -- data, California milk production has been -- we're going through what would be the spring flush where normally the milk, we're producing the most milk.

MR. HOFFERBER: Outside of flushes I would say we have been successful in acquiring sufficient milk to supply our sales market without too much trouble. During the flush, though, we have actually had to now push back because we can't move the product. We're swimming in finished goods right now.

MR. EASTMAN: And that's just based on the market for finished goods. But if the market for finished goods was going like nuts and you had tons of sales to customers, et cetera.

MR. HOFFERBER: Under the current supply system we would be running at capacity. We actually have run seven day capacity during the last three months.

MR. EASTMAN: Okay.

MR. HOFFERBER: Off and on. Not most recently because we're out of storage capability on the -- on the finished goods.

MR. EASTMAN: So right now I guess you would say you don't have excess capacity, so to speak.

MR. HOFFERBER: No.

MS. GATES: In your analysis when you were looking at going forward and obtaining the milk supply. Was there any calculation in there for service charges or was that just done at minimum?

MR. HOFFERBER: We have -- we have done the calculation for service charges and created -- I kind of allude to that when I make the comment that once we get to the payback period we can afford to bring product from a longer distance. Whether that gets sucked up in a service charge or whether that gets sucked up in a freight charge or something like that.

MS. GATES: So that calculation is in there.

MR. HOFFERBER: That's right.

MS. GATES: Okay.

MR. HOFFERBER: But we can't do the -- we can't

get into it at all under the petition. There is nowhere near any kind of room for -- if we can't get below the minimum regulated price there would be no removing a service charge enough to make this thing work for us, I guess is kind of another way of looking at it.

MS. GATES: All right, thanks.

MS. RANKIN: I guess I wanted to clarify one of the questions that Hyrum asked. In the SWOT analysis you listed that one of the threats was the long-term milk supply. Meaning that there wouldn't be enough supply?

MR. HOFFERBER: Meaning that we are afraid that as soon as the real estate market comes back in Southern California, which we think is between five and ten years out, that we will start seeing the continuation of the disappearance of the Chino Dairy Preserve. And that we will be faced with the situation of having to bring cheese milk down from the Central Valley.

So we want to get on this plant now so that we can get through the payback period during the time when the cows are staying put. And that's, you know. That's a lot of words to talk about a gigantic economic thing that may or may not happen, I don't know. Those are the sorts of things we have to deal with as a processor looking to make an investment. We have to kind of put on our crystal ball and imagine what could be happening.

MS. RANKIN: Okay.

MR. HOFFERBER: But that's how we see the economic factors in our little micro-market down there for us to accomplish this.

MS. RANKIN: Okay. And then I also had a couple of questions on your Exhibit 4.

MR. HOFFERBER: Yes.

MS. RANKIN: So you said you did these calculations based on actual dry whey and WPC-80 prices.

MR. HOFFERBER: Well no, those are theoretical prices.

MS. RANKIN: Right.

MR. HOFFERBER: But actually running them through the model that we built for the plant that we are going to build.

MS. RANKIN: Right.

MR. HOFFERBER: Or want to build.

MS. RANKIN: So Four, the boxes that you have are actual market occurrences, correct?

MR. HOFFERBER: Historical market occurrences, yes.

MS. RANKIN: And those are Dairy Market News prices or --

MR. HOFFERBER: The dry whey price and -- there is also a 34 price in the table that we used. Those are, of

course, published prices.

The 80 prices were provided to us through a proprietary agreement in developing the plant themselves. We did get permission, though, to at least present them in this format rather than any other way. But I think, I think anyone who wanted to go research them would come to a number that would be plus or minus a fairly small percentage to that. They still serve the presentation, whether they are spot on or whether they are plus or minus five percent.

MS. RANKIN: Okay. And then I'm assuming you also did this same calculation given the current whey factor structure?

MR. HOFFERBER: We didn't really feel a need to because under the current sliding scale factor this model worked. Under the current sliding scale factor, however, our animal feed doesn't work. Once that September 1 sliding scale was put into place we went full blast toward this path believing -- you know, knowing now that we are so challenged on the animal feed side that we are probably -- I mean, we are very challenged to the point where we are considering stopping cheese. I mean, if we stay at the 65 cent level, we transferred -- I better check with the boss. Am I disclosing that number?

The windfall profits tax impacted us -- impacts us fairly dramatically under the sliding scale. To where we

needed to move off of animal feed toward 80. But that is such a risky investment for us considering all these other factors. They the petition hit the wall and so here we are.

MS. RANKIN: So just one last clarifying question.

MR. HOFFERBER: Sure.

MS. RANKIN: On page five of your testimony you do mention the fact that the new factor makes it challenging, to the point where you are considering discontinuing making cheese. So is that -- is that the leap into the investment in the WPC?

MR. HOFFERBER: That's correct. That's the impetus for now looking at having to do an 80 plant just to stay in the game.

MS. RANKIN: Okay, thank you.

MR. HOFFERBER: Yeah.

MS. GATES: One last question for the record. If you discontinue producing cheese, how much are you producing a year that that would impact the state?

MR. HOFFERBER: Uh.

MS. GATES: I can go look it up. But for the record I just --

MR. HOFFERBER: Yeah. Well, you know, you got a yield factor on 19.8 million pounds of milk a month.

MS. GATES: Okay, thank you.

MR. HOFFERBER: Without doing the math in my head

and making that mistake.

MS. GATES: Not a problem.

HEARING OFFICER ROWDEN: All right, thank you very much. You still have about nine minutes left on your time.

MR. HOFFERBER: No, I think I only had 30.

HEARING OFFICER ROWDEN: Yes.

MR. HOFFERBER: Oh, you mean --

HEARING OFFICER ROWDEN: She never stopped it. But I paid attention to when you stopped so --

MR. HOFFERBER: Yeah, I will reserve that for later.

HEARING OFFICER ROWDEN: All right. Thank you very much.

MR. HOFFERBER: Thank you.

HEARING OFFICER ROWDEN: Okay, now we can start with the other witnesses. The first witness is Eric Erba.

Mr. Erba, do you have anything that you would like to submit as an exhibit?

DR. ERBA: I do. I'll bring these up shortly.

HEARING OFFICER ROWDEN: All right, thank you.

Mr. Erba is already -- is sworn in. And his Exhibit is number 47, is his testimony.

(Exhibit 47 was received into evidence.)

HEARING OFFICER ROWDEN: Okay, please proceed.

DR. ERBA: Mr. Hearing Officer and Members of the

Panel, good morning. My name is Eric Erba and I hold the position of Senior Vice President of Administrative Affairs for California Dairies, whom I am representing here today. California Dairies is a full service milk processing cooperative owned by 420 producer members located throughout the state of California, collectively producing about 17 billion pounds of milk per year, about 43 percent of the milk produced in California. Our producer members have invested over $500 million in large processing plants at six locations, which are projected to produce about 400 million pounds of butter and 800 million pounds of powdered milk products in 2012. On February 28, 2012, the Board of Directors for California Dairies voted unanimously to participate in the producer coalition in search of an upward adjustment in the whey portion of the Class 4b formula. California Dairies fully supports the position articulated by the producer coalition that testified earlier today. As a member of the coalition I will be offering some supporting comments.

As other witnesses have already done, we too wish to thank the Department for calling this hearing and allowing us the opportunity to voice our concern about the manner in which whey is valued by the California milk pricing system. The disparity between whey valuation in federal milk marketing orders and in California is simply

too large to ignore and has far too great of an impact on our member-owners' milk price. It must be addressed and it must be corrected.

A background on the history of whey valuation. Participants from the 2007 hearing understood that when the Department adopted the fixed factor of 25 cents per hundredweight to represent the value of whey in the Class 4b pricing formula, it was meant to be a placeholder until the dairy industry could agree on a more appropriate mechanism to value whey. A series of industry workshops was held to find an appropriate and widely supported substitute, but none was found. Consequently, the 25 cents per hundredweight fixed factor was maintained for a period of years, rather than a few months, as originally conceived.

The decision from the June 30, 2011 hearing provided a better solution but it was one that did not go far enough. Even though the new approach adjusted the whey contribution to the Class 4b price according to market conditions, it was immediately maxed out upon implementation in September 2011. Furthermore, at only the very lowest market prices of dry whey does the contribution to the Class 4b formula resemble that of the Federal Order Class III formula. As the dry whey price increases, there is a greater and greater disparity in the contribution of the value of whey toward the two cheese milk prices.

Fortunately, the difference between the California and federal order formulas is identifiable, measurable and reparable. It is precisely this valuation disparity that California producers see as an egregious inequity in milk pricing. The issue of proper whey valuation has galvanized California dairy producers like very few other issues have, and that is why we have unprecedented cooperation and agreement among producer groups for this hearing.

California dairy producers have been patient through the decade-long process of getting the industry to accept the concept of whey being a part of the regulated pricing formula. We recognize that all cheese processors would be impacted by the proposal advanced by the producer coalition, whether or not an individual cheese plant further processes whey. Our support of a previous effort to provide a whey credit for all cheese plants was rebuffed by the Department in 2007. The disagreement stems from the different interpretations of the California Food and Agricultural Code as to the authority bestowed upon the Department. That is to say, does the Department have the authority to establish a whey credit system for cheese plants without specific authorizing language or not? It is unfortunate that no resolution to this general disagreement on Departmental authority has surfaced, and therefore, dairy producer representatives are limited in trying to identify a

solution. Basically, an appropriate mechanism to value whey must apply to either all cheese plants or none of them. Dairy producer groups are not trying to put cheese plants out of business. However, the issue of the whey contribution to the Class 4b pricing formula and the subsequent value to producers as a whole cannot be ignored any longer. Therefore, California Dairies supports the adoption of the producer coalition's revised sliding scale to adjust the whey contribution as contained in the Class 4b formula.

The pricing formula change is quantitatively justified. You may have heard on what a -- you have heard already testimony on what a reasonable relationship means in the context of milk pricing and I will not dwell on the Food and Agricultural Code any further. There is something to learn, however, about milk pricing equity and I will devote some time to this issue.

I am going to display Figure 1, which the panel sees already and the audience can now see what I'm talking about. Figure 1 shows the monthly difference between the announced California Class 4b price and the Federal Order Class III price. The graph shows that there are pricing differences even when dry whey prices are relatively low as seen in 2008 and 2009. As prices for dry whey surged in 2010 and beyond, the differences between the two formulas

became much larger.

A simple statistical analysis reveals that almost 80 percent of the change in the difference in the two milk price series is explained by the change in the value of dry whey. The meaning of the result is clear enough. The additional value of dry whey that is being captured by the Federal Order Class III formula is not, for the most part, getting captured in the Class 4b formula. This phenomenon is a function of the pricing formula construct and can be remedied easily by adopting the changes set forth in the producer coalition's petition and testimony. Doing so would improve the cheese milk price equity among producers in federal milk marketing orders and producers in California that is now absent.

The reality of higher milk production costs. While the revised Class 4b whey factor table contained in the producer coalition's petition is rooted in an argument for greater milk price equity I would be remiss not to mention the extraordinary increases in milk production costs that have hit California dairy producers. These costs should not come as a surprise to the Department. The data that I will be citing has been collected and distributed by the Department. It is a well-known fact, particularly within the Dairy Marketing Branch, which collects the cost of production data, that California dairy producers are

extremely vulnerable to feed cost increases, as most dairy producers must purchase a high percentage of their feed.

Figure 2, which I will again show for the audience and is already being presented to the panel in the handout, shows two measures of the cost of producing milk in California obtained from the Department. The most recent data release shows that the current cost of producing milk is about 25 to 30 percent higher than either of the two lowest points shown on the chart. That will be the first quarter of 2007 and the first quarter of 2010. Again with reference to the data made available by the Department, the driving factor of this result is elevated feed costs. The cost of milk cow hay is 68 percent higher and the cost of milk cow grain mix is 50 percent higher than their respective low points over the last five years.

Survivability has replaced profitability. By virtually any measure the situation facing dairy producers today, especially in California, is dire. USDA's milk-feed ratio is a widely recognized barometer of the health of the production side of the dairy industry. At one time a milk-feed ratio of 3.0 was considered to be favorable for dairy producers. Figure 3, which I am showing on the screen before you, shows a stark trend away from the dashed line which highlights what would be considered a favorable ratio.

From the perspective of California Dairies, the

cooperative, we are concerned about the health and the survivability of our member-owners. One of the easiest measures that we have direct access to is number of members in the cooperative. Most analysts would agree that milk prices in 2011 were at least good, perhaps even very good. However, they were not good enough to keep 32 of our members from resigning from our membership. Nearly all of these resignations were from financial pressures and these former members are not permanently out of the production side of the dairy business.

The continuation of the Class 4b and Class III pricing differences is not defensible. Part of the benefit to having close relationships with the dairy industry is that each group has a good idea of the statements that will be made by the other groups. Just as the cheese processors have anticipated what the producer representatives will say at today's hearing, we too have anticipated what may be submitted into the hearing record by cheese processors. We suggest that our statements and responses effectively parry any opposition to the producer coalition's proposed changes to the Class 4b formula.

You may have heard or will hear that cheese makers need more time to adjust to whey pricing changes. We remind the Department that the issue of regulated milk pricing as applied to whey has been debated for more than a decade.

During that time, the producer point of view has not wavered. Producers are seeking to extract more money from the milk that goes into cheese because of the value that whey adds. Cheese maker have had ample time to make their own operational changes such that more value can be achieved from a unit of milk and a higher price can be paid to dairy producers.

You may have heard or will hear that higher whey prices as a part of the regulated milk price will devastate the California cheese industry. But cheese plants outside of California have been paying, on average, a higher price for milk for decades. More recently they have had to pay a higher price for cheese milk as a direct result of the higher price for dry whey. Somehow, cheese plants in other states have found an answer for continuing to operate while paying a higher price for the milk used to make their product. We only ask that California cheese plants be as resourceful as cheese plants in other parts of the US and pay an equitable price for the milk they are buying to make cheese and other products.

Furthermore, we suggest that low regulated whey prices have not attracted cheese processing capacity to California. And conversely, higher regulated whey prices have not discouraged cheese plants from being built outside of California. A simple enumeration of cheese plants built

in the US over the last few years verifies this statement. The obvious conclusion is that there are factors other than the price of whey that are affecting the decisions by companies on where to locate a cheese plant. It is not logical to suggest that keeping the whey component of the Class 4b milk pricing formula low can help to attract more processing capacity to the state. Dairy producers have endured undervalued whey for many years and have no additional cheese plants to show for their patience. The whey valuation inequity must be corrected.

And finally, you may have heard or will hear that milk production is already too high and establishing a higher minimum price for increasing -- by increasing the whey component will only make matters worse. It does not take much of an analyst or historian to conclude that managing the state's milk supply by adjusting minimum price formulas once every 18 to 24 months is effective or efficient. It's not, it's ineffective and inefficient. All of the major cooperatives and some of the proprietary plants arrived at that same conclusion years ago and adopted supply management plans that are actively managed and can adjust to market conditions. As far as I know, the cost of oversupply of milk is borne entirely by the producers, not by any other entity. And this statement applies to any of the supply management programs that exist in California today.

There is a matter of timing that should be touched as well, specifically the timing of this hearing and the timing of the cyclical nature of milk production. There are only a few months out of any year that potentially put a strain on plant processing capacity. Had this hearing been scheduled at a different time, say in February or in July, there would be few, if any, arguments suggesting that higher prices will lead to more milk being produced that cannot be processed in-state. Likewise, it seems counter-intuitive to use conditions faced during a two month period to establish minimum prices that may persist for the next 18 to 24 months. Achieving efficiency means maximizing the use of assets at both the farm and at the plant. Short-term oversupply may be the result of needing to keep plants at a more optimal level of capacity in the remaining months of the year.

My concluding remarks: California Dairies has offered testimony today on behalf of its 420 member-owners to voice our collective concern about the manner in which whey is valued by the California pricing system. At a time when so many California dairy farmers are struggling to survive the widely advertised disparity between whey valuation and federal milk marketing orders and in California is difficult to understand and even more difficult to accept.

We appreciate the changes that the Department made to the Class 4b pricing formula last year to begin to close the gap between California's Class 4b price and the Federal Order Class III price. However, the pricing data show that there is still considerably more work to be done to get the two minimum pricing series in closer alignment. The revised sliding scale for whey valuation as proposed by the producer coalition's petition is the next step in what would be a lengthy process to establish milk pricing equity. We urge the Department to adopt the revised sliding scale for whey valuation as presented earlier today.

Thank you for your attention. I am happy to answer any questions you have and request the opportunity to file a post-hearing brief.

HEARING OFFICER ROWDEN: First of all, your request is granted. Questions from the panel?

MS. GATES: Dr. Erba, on page four of your testimony you state that while you have lost -- that you have lost 32 members from re-signing back.

DR. ERBA: That's correct.

MS. GATES: Did you have any drop in your production or capacity, the amount of milk coming into the facility?

DR. ERBA: You know, that's kind of difficult to answer because they drop out on a continuous basis. And our

cyclical nature of milk production hasn't changed at all, it still follows the same pattern. We are lowest in August, September, sometimes October, and highest in the spring, March, April and sometimes May.

MS. GATES: What about if we look at it on an average daily basis?

DR. ERBA: Average daily basis, I still don't think you'd see much of a drop. The producers that we lost were dropped -- you know, we lose two, three a month and they're not large enough individually to offset the kind of milk production we see at our cooperative with the 420 members that we have.

MS. GATES: Is the co-op operating at capacity currently?

DR. ERBA: At capacity? Well, I think we're probably doing as much as we possibly can to get all the milk picked up and processed in a timely manner. We have had the good fortune of having good planning early last fall as we set ourselves up for not having issues or as many issues as we would in the spring had we not done any planning at all. And we haven't had any issues about leaving milk behind, dumping milk on the ground, any of those kinds of things. But as tim

MS. GATES: Are your base plans currently in place?

DR. ERBA: Our base plan has always been in place since April of 2008. It's never been out of place.

MS. GATES: Is there milk leaving the state? Are you having to move milk out of state?

DR. ERBA: We have milk leaving the state even when we have low milk production. We have customers all over the US so that's, for us, not a very good measure. We don't have distressed milk sales, if that's what you're getting at.

MS. GATES: That's what I'm getting at.

DR. ERBA: We don't have that.

MS. GATES: So nothing is going out at a minimum or anything like that at this point?

DR. ERBA: I don't believe so. But like I said, we've got customers all over the US and we routinely send milk and milk products out of state, even when we have low milk production.

MS. GATES: Thank you.

MS. RANKIN: I have a question, Dr. Erba. You mentioned the dairies that you're aware that have been going out of business. Do you -- have you heard anything in other states or national about how that kind of compares to the experience that is in California?

DR. ERBA: Numerically, no. Anecdotally, qualitatively, yes. There's difficulties being faced

everywhere. Although I don't have the numbers of backing this up I know that producers all across the United States are struggling with our current downtrend on prices.

MR. EASTMAN: Do you have a sense of whether or not the number of dairies that are going out of business now, has that been -- under the current trend is it different than what's happened in the past? If you look at historically over the last number of decades we know that the number of dairies are definitely decreasing and dairy sizes are increasing. So there's been this trend towards some point that has been going on for awhile. Do you have a sense of what is happening currently? Are we above that trend? Is it different than what's happened?

DR. ERBA: Yeah. I think the answer, Hyrum, is yes. It's different and it's been different ever since 2009 when we had the incredibly devastating financial year for dairy producers. Like I said, even though last year's prices were quite good by many measures it didn't prevent over 30 of our members resigning. And that trend continues even in 2012. We are tending to lose in the order of two to three members every single month. And that's an accelerated trend from what we were seeing, say, prior to 2009.

MR. EASTMAN: And then the other question I have is based on what you have seen over the last couple of months. Do you think we are past the spring flush? Have we

hit the peak in terms of production? Accounting for the fact that your base program is in place and we know other organizations in the state have their programs in place. Do you think that now causes the peak to have been reached based on what has happened, say, in the month of May?

DR. ERBA: I will only speak for our cooperative, I don't really know what is going on with the other cooperatives or other businesses. But from our point of view we are past the peak but barely past the peak. We're down less than a million pounds a day from where we hit the peak and that was just in March so we are still very heavy in milk production. And pretty much what it did for our cooperative is hit the peak, drop off a little bit and then level off. So we are still working our plants very hard to keep up with the supply of milk.

MR. EASTMAN: And so do you anticipate going into the month of June that it will be a heavy month?

DR. ERBA: So far it's been heavy every single, every single week. And generally in May we start to see a downturn; we haven't seen that just quite yet. I expect when we get our first couple of days of warm weather back to back we'll see that down-tick that we expect. I don't expect that we're going to have a, what I consider to be a very heavy June. That just doesn't happen at our cooperative. Most of the dairies we have are located in the

Central Valley, they get affected by the heat pretty dramatically when June rolls around.

MR. EASTMAN: And then I had one more question about your base program. Obviously it's -- as you mentioned, it's been in place for a few years now. Have you been assessing your members surcharges for any milk or has that just not happened yet?

DR. ERBA: We haven't had to do any of that until just recently for April. We made an announcement to our members that there would be an overbase charge to the members. But it's not based on our usual factors of milk being shipped out of state or sold to a calf ranch just to accommodate. It's based on an entirely different set of matters and it has to do with operations and finance. More of an opportunity cost than anything else.

MR. EASTMAN: So some of those assessments have been occurring then for certain people that exceeded their base then?

DR. ERBA: Right. And it only applies to the milk that's produced above their assigned production.

MR. EASTMAN: And then in terms of -- this is more of an administrative question. When it's time to determine whether or not that assessments or surcharges will have to be assessed how long of a process is that? How fast can CDI react to what they see coming and implement that or announce

it to their membership? Is there a certain time period? Is there any kind of procedures or bylaws or understandings?

DR. ERBA: Yes, there is a procedure. And it is not contained in the bylaws, it's actually done by a board decision. And it's reviewed every month by the board and they'll make a decision at that meeting. For example, at the May meeting they decided on the April charges, whether there would be any or not. And we'll do the same thing in June. The June meeting will decide if there are any charges for May or not. So just because there is a charge one month doesn't mean there is going to be a charge the next month. It's decided by the Board at each of the board meetings.

MR. EASTMAN: So on a month to month basis. For example, next year, depending on --

DR. ERBA: That's correct.

MR. EASTMAN: -- how the circumstances fall out. Within a month's period you feel that you can implement your program and get it announced and get it going, so to speak.

DR. ERBA: Right. A decision by the board is made based on basically the policy that's established. Whether or not we charge will be the board's decision. And if they say "yes" as it was last time, the announcement goes out within a week of the board meeting to let the members know what the charge was.

MR. EASTMAN: So it appears that it's implemented

fairly rapidly then.

DR. ERBA: I would say so.

MS. RANKIN: I just have one last question. With all the reports showing milk production up and cow numbers up and you spoke to the dairies going out of business. Can you comment on what you think the story is there. I mean, you mentioned that the farms may have been smaller in terms of milk production. I don't know if cows stay in the state or maybe there's large replacement numbers. Just any comments you have on that.

DR. ERBA: When our members have resigned, typically those, at least a portion if not a large portion of those cows end up going to the auction and they don't remain in our production system. Some cows will remain behind, picked up by other members of CDI. Maybe picked up by other members that are not CDI members. But there is a fair number of cows that end up going to the auction yard.

MS. RANKIN: That's all I have, thanks.

HEARING OFFICER ROWDEN: All right, thank you very much.

DR. ERBA: Thank you.

HEARING OFFICER ROWDEN: Rob Vandenheuvel, please. Mr. Vandenheuvel has already been sworn in. Please proceed. And your exhibit is Exhibit 48. That's his testimony.

(Exhibit 48 was received into evidence.)

HEARING OFFICER ROWDEN: Please proceed.

MR. VANDENHEUVEL: Thank you. Mr. Hearing Officer and Members of the Panel, my name is Rob Vandenheuvel, I am the General Manager of Milk Producers Council. MPC is a nonprofit trade association with office locations in Ontario, Bakersfield and Turlock, California. We represent a voluntary membership of dairy families throughout Southern and Central California. My testimony today is based on positions adopted by the MPC Board of Directors.

The last several years have been extremely challenging for the California dairy producers. CDFA's own numbers tell a sobering story about the financial state of the producers. As we can see from the figures in CDFA's exhibits that were entered into the record this morning, the average cost-of-production from 2007 to 2011 was $16.77 per hundredweight. Compare that to the average price paid for milk during that time period of $15.96 per hundredweight. To put that in perspective, a California dairyman working hard for the past five years to run an average-sized 1,000 cow dairy here in California and provide for his family can reasonably expect, according to CDFA's own analysis, to realize a net loss of over $850,000 during that extended time frame. And I note that that time frame included both periods of higher prices and lower relative prices so it's a longer period.

While today's hearing focuses specifically on the structure of the Class 4b formula and achieving equity with the national prices paid for comparable milk, it is important to recognize that the decisions made by the Secretary in this area have a direct impact on the overall economics of the California dairy families. Forty percent of the milk produced and sold in California is going to cheese manufacturers and the regulated minimum prices that must be paid for that milk have a direct impact on the ability or inability of our State's dairies to generate a reasonable return on their investment.

Producer Petitions. Before us today are two producer-sponsored proposals for modifying the Class 4b formula, one from a coalition of dairy producer organizations and cooperatives and another from Western United Dairymen. As previous testimony has already shown, these two proposals are identical. Milk Producers Council was involved in the development of the proposed changes to the Class 4b formula and strongly supports them as the only proposed changes being made today that would result in a California Class 4b price that more reasonably tracks with the national value of milk being sold to cheese manufacturers.

While CDFA staff has included analysis in its hearing exhibit about the impact of this proposal on a per-

hundredweight basis, I have included in Attachment A of this testimony a breakdown of the actual financial impact this proposal would have on California's pooled revenues. And Attachment A, we can discuss this if there's questions about it but it's on page six and seven of the written submission. As you will see in the attachment, the difference between the proposal being made today, which brings our formula in closer alignment with the national value of milk being sold to cheese plants around the country, and the actual Class 4b formula we have had the past several years, is absolutely astounding. Since December of 2007 when the Class 4b formula was changed from having a variable dry whey factor to having a static 25 cent per hundredweight dry whey factor, the difference between the proposal today and the actual formula equates to more than $582 million. In just the past eight months since the last time the Class 4b formula was modified the difference equates to more than $212 million.

While these numbers alone tell a sobering story, it should also be noted how the proposed changes would have impacted the relationship between the California Class 4b price and the announced Federal Order Class III price. Which as I will discuss in a few minutes, is the optimal benchmark price for the milk being sold to cheese manufacturers around the country. Looking at that same

period from December 2007 to the present, the proposed changes would have resulted in an average Class 4b price of $15.13 per hundredweight. That's under the proposed changes today. That's a 74 cent per hundredweight increase over the actual 4b prices that we realized that were announced during that time. And that was $14.39 per hundredweight. During that same period the average announced Federal Order Class III price was $15.55.

I reason I point this out is to demonstrate that while producers are proposing a revised Class 4b formula that will more fairly capture the value of whey solids, and those numbers are quite large as I said just a couple of minutes ago. It's worth noting that over the past five years even our proposed Class 4b formula would have resulted in a minimum price that is 42 cents per hundredweight below the Federal Order Class III price. That difference is primarily tied to the differences in how the two formulas account for the value of cheddar, i.e., CME versus NASS, differences in the make allowances and our California FOB adjuster. I point this out not to endorse this difference but to recognize that even under the producer proposal our state's cheese manufacturers would have enjoyed a regulated minimum price that is on average 42 cents per hundredweight below the Federal Order Class III benchmark price for milk sold to cheese manufacturers around the country.

California Food and Ag Code. CDFA is bound by law to implement minimum prices for each of the five classes of milk per the legislative instructions included in Section 62061 through 62079 of the California Food and Ag Code. While these sections collectively include numerous things the Secretary must consider when establishing minimum prices, Section 62062 lays out the most direct mandate to the Secretary in determining the minimum price for each class. While the section provides broad latitude in how the Secretary ultimately establishes the price, for example, it can be directly designated in the stabilization plan or methods or formulas can be established to result in prices, the statute is clear that in the case of using methods or formulas, "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." So regardless of the methods or formulas that are used, the ultimate Class 4b minimum price that is announced is what shall be in that reasonable relationship.

Other testimony in this hearing, particularly from coalition partners Land O'Lakes and Dairy Farmers of America, who operate in both California and Federal Order areas, will likely be devoting more time to explaining why

the Federal Order Class III is an appropriate benchmark for establishing the national value of manufactured milk products. I understand there is also written material that will later be submitted into the hearing record by a dairy processing company that operates in Idaho, a market that is not part of the state or federally regulated system. Collectively, that additional testimony will make it abundantly clear that in the case of determining the national value of milk being sold to cheese manufacturers, the Federal Order Class III price is by far the best benchmark to use.

The next question is how do we define a reasonable and sound economic relationship. In conducting research for this hearing I came across a letter CDFA wrote to John Rossi, Chairman of the California Floor Price Committee, on August 25, 2010. In that correspondence CDFA cited Section 62062, which I noted above, as a justification for denying that hearing request. As background, the California Floor Price Committee petitioned CDFA to hold a hearing to consider establishing a floor price of $14.50 per hundredweight for milk produced and sold in California. In CDFA's letter denying this hearing request, which is attached as attachment B to this testimony, Kevin Masuhara, Director of CDFA's Division of Marketing Services, stated that "Establishing a floor price for a two year period would

result in prices that are not in a reasonable and sound economic relationship with the national value of manufactured milk products as required by Section 62062 of the Food and Agricultural Code."

The clear message in the letter was that limiting the ability of California raw milk prices to move with the market, while no such limitation exists in other areas of the country, would violate the legislative mandate outlined in Section 62062 of the Code. I submit to the hearing panel that this characterization can be equally applied to our current Class 4b formula, which includes provisions that narrowly limit the range or possible dry whey factors between 25 cents and 65 cents per hundredweight. It's clear that our current Class 4b formula must be changed in order to allow the monthly announced price to consistently be in a reasonable and sound economic relationship with the national value of manufactured milk products as required by Section 62062.

Importance of Maintaining a Reasonable Relationship. Must of the raw milk sold in the US is priced using formulas that utilize the market value of dairy products. This includes not only California and Federal Order pricing systems but also some of the contracts that are entered into in unregulated areas like Idaho. That type of formula allows supply/demand signals to be sent to dairy

farmers through changes in the market value of products such as cheddar cheese, butter, nonfat dry milk and dry whey.

With that amount of market value flexibility already built into the pricing structure, there is no logical reason to further discount California's regulated price significantly below national values for comparable milk. We have seen ample evidence, some of which will be included in testimony at this hearing, that the discounted regulated prices in California have not attracted significant additional investment in processing capacity in the state, particularly cheese processing capacity. At the same time news reports indicate that proprietary dairy processing companies are choosing to make some investments in other areas of the country where the expected cost of the milk supply is higher than California. The logical reason is that the business climate, whether you're a dairy farmer or a dairy processor, is very hostile in California. The dairy producer side of our industry simply cannot afford to continue discounting our milk price in some misguided attempt to overcome the red tape that exists in California and use the milk price to attract additional processing investment. That issue is larger than simply the milk price.

Reasonable expectation that CDFA will follow the law. Sellers of raw milk in California, whether that is an

independent dairy farmer or a producer-owned cooperative, rely on a belief that the government will follow the law. And because of that have established long-term contractual relationships for milk based on state-announced minimum prices. That is a reasonable position to take when looking at the California Food and Ag Code which states that:

One: A goal of the regulations is to enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions and bring about and maintain a reasonable amount of stability and prosperity in the production of market milk. It's an excerpt from Section 61805(d).

I have already talked about Section 62062 and the Code section for reasonable relationship.

Three: CDFA shall take into consideration that the reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those classes in relation to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. And that in determining the cost the Director shall consider the cost of management and a return on -- and a reasonable return on necessary capital investment. That's from Section 62062(b).

Dairies and their cooperatives rely on CDFA to follow these sections of the Food and Ag Code when they

establish contracts to sell their milk to manufacturers. They rely on the fact that prices must be competitive with what milk is worth in other parts of the country. They rely on the fact that CDFA must consider producers' cost of production, including a reasonable return on investment and a cost of management, when establishing prices.

Why would sellers of raw milk in California agree to long-term contractual relationships fundamentally based on CDFA-announced minimum prices if they thought those prices would be systematically discounted below the national prices for milk sold to comparable processing facilities? Why would sellers of raw milk agree to contracts that can't reasonably be expected over the long term to cover dairy producers' costs? It's simple, they wouldn't.

Managing supply is a best role played by the industry. In a March 28 letter written to California Dairies, Inc. with regard to this hearing. It was mentioned before that Director Masuhara wrote that "The Department has the responsibility and mandate to establish minimum prices that will encourage California's milk production to be marketed in an orderly fashion. The Class 4a and Class 4b prices must be set at a level that will clear the market or will facilitate the balancing of the supply and demand for milk." The full letter is attached to the testimony as Attachment C.

While this hearing structure does not allow for a dialogue with CDFA counsel, MPC would challenge the assertion that any such mandate exists. Where in the California Food and Ag Code is it stated that our manufacturing classes must be set at market clearing prices? It is true that references in the Code list orderly marketing as something that the Secretary must consider when establishing prices. No different than the requirement that CDFA considers producers cost of production and return on investment and return on management and the ability of those milk prices to cover costs. But the only fundamental mandate that exists in the relevant sections of the Code is the mandate that the prices resulting from our classified pricing formulas be in a reasonable and sound economic relationship with the national value of manufactured milk products.

It's unrealistic to expect broad policies outlined by CDFA to be responsive enough to address specific supply/demand issues within the state. The ultimate responsibility for aligning our state's milk production with demand for that milk falls on the dairy producer sector, whether that's individual dairies that have contracts with their buyers or producer-owned cooperatives. It's also worth noting that any financial cost that arises from a milk supply that exceeds local demand is borne directly by producers. The

recent implementation of base plans by the state's major cooperatives is clear evidence that the dairy producer sector of our industry is the only one that truly has effective tools to affect the regional supply/demand balance.

Basic structure of the 4b formula. A common theme in previous hearings on this issue has been that not all cheese makers are created equal. Our state boasts a diverse collection of cheese manufacturers, from large-scale international companies to smaller-scale specialty manufacturers and everything in-between. These plants have all made individual business decisions about how to operate their plants.

The role of CDFA is to establish a minimum price for the milk these plants must purchase to run their operations. To accomplish this task CDFA has established a 4b formula that's driven by the prices reported for commodity-grade cheddar cheese being sold on the CME in high-volume quantities, 40,000 pound loads of cheddar cheese blocks, and basic dried whey powder as reported by the US Department of Agriculture. That's not to say that most of the cheese manufactured in California is cheddar cheese sold in high-volume quantities on the CME. In fact, significantly more mozzarella cheese is being produced in California than cheddar cheese. But CDFA has chosen these basic commodity

dairy products to serve as a surrogate for the purpose of establishing minimum prices for Class 4b milk.

Each individual manufacturing plant in California makes a business decision as to whether they can secure a milk supply at a price that allows them to process that milk into a product that can garner a profitable price in the marketplace. It is not different than the considerations that must be made by cheese manufacturers around the country, including those that operate in Federal Order areas and pay prices at or above Class III minimum prices.

And I'd note that there was some interesting testimony by the witness from Farmdale Creamery about some of the decisions that they started making or considerations they started making after the modest increase in Class 4b price last fall and looking at some of the additional ways to capture market revenue. We have seen that anecdotally in other areas of the country, arrangements to pool waste streams from multiple plants. Areas that where they have to pay a higher milk price they have to come up with ways to extract more money from the marketplace. So necessity is the mother of invention.

The point is that the minimum price formulas established in California have not been designed to reflect the exact processes followed by each manufacturer, nor should they be. They were simply a tool used each month to

establish a regulated minimum price for the various classes of milk sold to manufacturers, with the mandated standard that those prices must be in a reasonable and sound economic relationship with what prices are paid for comparable milk around the country.

In conclusion, for all the reasons stated above as well as the reasons outlined by previous and upcoming testimony given by fellow producer organizations and cooperatives, MPC is strongly supporting the identical petitions submitted by the Coalition and Western United Dairymen. That proposal is truly the only one being made today that will achieve the mandated standard of bringing our California 4b price into a reasonable and sound economic relationship with the national value of manufactured milk products. We strongly urge the Secretary to act quickly to implement this much needed change to our Class 4b formula.

And that concludes my testimony. I'd like to request an opportunity to submit a post-hearing brief.

HEARING OFFICER ROWDEN: That request is granted. Questions?

MR. EASTMAN: So I have a couple of questions for you. On page one of your testimony in the first paragraph under Economics of the California Dairy Industry you mention an average pay price of $15.96. Is that -- which number was --

MR. VANDENHEUVEL: That was the whey price as outlined in the Department's exhibit. I believe it was the statewide blend price that was used in that exhibit.

MR. EASTMAN: The blend, okay. And then I guess my second question is a question that was originally asked during the testimony given by the Coalition. And that was, we wanted to know how you came up with the calculations for the revenue losses that's in the first sentence or two on page two.

MR. VANDENHEUVEL: Absolutely.

MR. EASTMAN: Can you just walk me through the methodology there.

MR. VANDENHEUVEL: Yeah. Page six is the table there.

MR. EASTMAN: Okay, perfect.

MR. VANDENHEUVEL: I'll just give you a second to go over there. So moving across the line. We'll just take the first one there, December 2007, as an example. You've got the Dairy Market News Dry Whey Value. That's the average, the Westerns mostly. The Actual 4b Dry Whey Factor, that's 25 cents. The Proposed 4b Dry Whey Factor is pulled directly from the table. So given that dry whey value, what the dry whey factor would be under this proposal. You can see the difference there of $1.1199.

MR. EASTMAN: Um-hmm.

MR. VANDENHEUVEL: The Pounds of Solid Not Fat for that month. And this is taken from the Dairy Information Bulletin. So in December of 2007 it was 139,705,000 pounds of solid not fat in the pool for 4b.

MR. EASTMAN: Um-hmm.

MR. VANDENHEUVEL: And so you multiply -- you multiply those things. And the way you calculate it for pounds of solid not fat is each penny per hundredweight difference in the dry whey factor represents that calculation in the conversion there on the top of the page, one penny over 8.8. There is that feature of the 4b formula. So that's how you convert it to solid not fat. so you can see the financial impact in December of 2007 was a difference of $17,779,049. And if you go all the way down you can see a bold line there between -- just above September 2011 on the next page. That's where the formula was changed last fall. And then on the bottom line there is the comprehensive numbers. First since the California Class 4b formula was changed in '07. All these combined differences equal $582,689,780. And since September of 2011, $212,603,958, which was the number I believe we saw this morning in the testimony.

MR. EASTMAN: Okay. So in essence then that's showing the difference over -- well we have two time periods there.

MR. VANDENHEUVEL: That's right.

MR. EASTMAN: So showing the difference between what -- the dry whey value that was actually -- what was actually contributed each one of those months and the 4b formula compared to the proposed changes by the Coalition or Western United, right? So just comparing those two things for the two time periods.

MR. VANDENHEUVEL: That's right. Using specific solid not fat pounds out of the Dairy Information Bulletin.

MR. EASTMAN: Perfect.

MR. VANDENHEUVEL: The last columns there take the dry whey factor and plug it into the 4b price and have the actual 4b price, the proposed 4b price which is adjusted, and how that compares to the Federal Class III price.

MR. EASTMAN: Based on what the Coalition and Western United -- the Coalition has proposed?

MR. VANDENHEUVEL: That's right, that's right.

HEARING OFFICER ROWDEN: All right, thank you very much.

Okay, I've got 11:52. We'll stop the hearing for right now and we will reconvene at one o'clock. And we'll be starting off with Barry Murphy who will be our first witness at one o'clock. Thank you.

(Off the record at 11:52 a.m.)

A F T E R N O O N S E S S I O N

HEARING OFFICER ROWDEN: Okay, the hearing is now reconvened. For those of you that have asked to submit a brief, the brief may be emailed to dairy@cdfa.ca.gov or submit it to the Department's branch office located at 2800 Gateway Oaks Drive, Sacramento, California, 95833. The brief also may be faxed to area code 916-900-5341. All briefs need to be in to our Department by June 8th by four o'clock.

Okay, our next witness is Barry Murphy. Mr. Murphy. Okay, Mr. Murphy, please state your full name, spell your last name and state your affiliation for the record, please.

MR. MURPHY: My name is Barry Murphy, the last name M-U-R-P-H-Y. I'm an independent industry consultant for -- I'm an independent whey consultant for whey and cheese processing in the cheese industry here in California.

Whereupon,

BARRY MURPHY

Was duly sworn.

HEARING OFFICER ROWDEN: And your written testimony will be noted as Exhibit 49.

(Exhibit 49 was received into evidence.)

HEARING OFFICER ROWDEN: Are you testifying on behalf of an organization or just yourself?

MR. MURPHY: I am testifying on behalf of BESTWHEY, LLC, a consultancy.

HEARING OFFICER ROWDEN: All right, please proceed.

MR. MURPHY: Mr. Hearing Officer and Members of the Hearing Panel. My name is Barry Murphy and I have spent 25 years in the cheese and whey processing business. Initially in management capacities and for the past 12 years as a consultant for entities with a desire to invest in cheese and whey plants in California and throughout the United States.

The petitions for 4b milk price adjustments submitted by the Coalition and the Western United Dairymen on March 2nd, 2012, are not valid petitions since they claim that the current California Class 4b milk pricing violates the law because "it results in prices that have no reasonable or sound economic relationship with the national value of manufactured milk products." This is a false claim since the Federal Milk Marketing Order, FMMO, Class III formula is out of touch with the realities of milk pricing and cheese milk buyers outside of California can buy milk, by law, below the minimum pricing. The intent of the milk marketing orders is to provide for minimum prices paid for milk only and milk premiums paid for quality, and the supply and demand relationship are in addition to this. The key

milk marketing problems in California are related to over-production of milk and cooperative control of milk marketing. More than 85 percent of milk marketed in California is controlled by the cooperatives and these co-ops are focused on milk clearing rather than milk marketing and simply want annual agreements for milk purchasing and their milk marketing strategies ignore the potential in milk premiums. Dairies selling their milk through the cooperative system rarely see this milk premium and yet all cheese manufacturers pay a premium over the minimum price.

Under the current California 4b pricing formula where milk solids and fat are tied to the butter and cheese markets, while including a make allowance, the return on investment for a large commodity cheese plant without whey processing is almost zero and would not attract investment for further growth of the California cheese industry. The last major investment in California's cheese industry was over ten years ago by Land O'Lakes in Tulare and resulted in several years of financial losses and the eventual sale of the entire plant because it was not profitable. Shortly after the '07, the 2007 milk price hearings, F&A Cheese sold out after a few years of financial losses as a direct result of the 4b whey factor, which at the time was similar to the Federal Milk Marketing Order. Today, I am aware of three cheese plants which will likely exit the California cheese

industry should a Federal Milk Marketing Order Class III-type milk formula be adopted here. By leaving the current California 4b milk pricing mechanism untouched, or by eliminating the 4b whey factor, there is hope that based on moderate returns there would be additional cheese capacity investment in the state. Based on a five or ten year history of the whey price, of the published whey prices, the return on investment is still below 10 percent while the risk is moderate. And by that I mean, if you're looking at a full-blown commodity cheese plant in California with whey processing the return on investment would still be below ten percent.

For smaller cheese plants there is less hope. Most small cheese plants cannot process their whey since they do not have the economies of scale or the capital to make the minimal investment of $10-30 million to process their whey. A cheese plant needs at least one million pounds of whey per day to invest in a small protein drying operation. And even then about 90 percent of the whey solids are lost as permeate to animal feed. Even if a cheese plant has one million pounds of whey per day the investment in a whey protein plant, based on whey pricing over the past five years, would be considered moderate to high risk. Smaller cheese plants pay $150 to $400 a load to dispose of whey, the equivalent of $6 to $16 per

hundredweight. And they pay for the whey factor up to 65 cents per hundredweight also.

If milk producers want to better understand the cheese and whey business and its economies and risk then they should direct their cooperatives to invest in cheese and whey plants rather than powder and butter plants. Strategically if the dairies believe that they can get more from their milk in the cheese and whey business then this should be a clear directive for cooperatives. California Gold Cooperative Creamery in Petaluma had three cheese plants in 1999 and yet merged with Dairy Farmers of America because it was not profitable. Dairy Farmers of America closed the Corona cheese plant a few years back and Land O'Lakes recently shut down its Tulare cheese plant. Sorry. Land O'Lakes recently shut down its Tulare cheese plant and stated clearly at the most recent milk hearings that they were getting out of cheese. So the big cooperatives have been in the cheese and whey business and have left.

Most of the solids from whey, about 90 percent of solids in whey -- whey represents about 50 percent of the solids in milk. Most of the solids in whey, about 90 percent, end up as a low or no value permeate for animal feed. From about the 8.5 percent solids-not-fat in milk, about 5 percent of these solids are permeate solids or 60 percent of all the SNF in milk. Another whey opportunity

for dairymen and cooperatives would be to collect all the waste whey permeate and de-lactose permeate in the state and process this at a single plant. This, however, would be a $100-200 million proposition at a very high risk.

The recent and temporary spikes in the whey powder values in 2011 and 2007 should not be drivers for dairies to request that the California Department of Food and Agriculture adjust milk pricing formulas. Nowhere in California is raw whey sold from one plant and shipped in its raw form to another. So nowhere in the whole state is raw whey, unprocessed, shipped from one plant to another. Raw unprocessed whey is shipped from cheese plants in Wisconsin to whey processing facilities because of proximity. The lowest prices paid in Wisconsin are zero $0.00 per hundredweight FOB plant and the buyer pays for the freight, period. Or up to ten percent of the whey powder value, FOB plant. In the recent peak for whey powder pricing this would represent about 45 cents per hundredweight for whey. So the average fair market value for whey in its raw unprocessed form is roughly 22.5 cents per hundredweight and this is below the current California 4b whey factor value minimum of 25 cents.

California dairy producers' current over-production of milk has resulted in shipments of many milk loads to local calf ranches and shipments to Idaho, Texas

and Wisconsin at drastically reduced pricing. High feed prices combined with low milk pricing has resulted in more production, not less. And this is the responsibility of the producers, not the processors. No new significant cheese plant capacity has been built in California for almost ten years and any further meddling with the 4b whey factor will eliminate any future investment potential, especially now that it is so badly needed. Cooperatives should use milk premiums over minimum pricing as a way to improve producers' income based on the supply and demand of milk in a working market.

Presently I am consulting with three private entities in California with a desire to building new cheese and whey projects and all three parties are holding their position on investments of over $100 million awaiting the outcome of these hearings. Even if these hearings provide for 4b milk price stabilization, the notion that the California Department of Food and Agriculture would entertain a 4b whey factor hearing within one year of the last resolution is troubling and has created a high degree of uncertainty for the future of and the investment in California's cheese industry.

In conclusion and in the interest of preserving California's cheese industry while providing an incentive for future investment the California Department of Food and

Agriculture must maintain a whey component factor in the 4b milk price formula of 25 cents per hundredweight of milk and there should be no further hearings on this issue for at least five years. This is fair for both the small and large cheese processors and the milk price premium can be set based on market conditions.

That's the end of my testimony and I would like to request a post-hearing brief, please.

HEARING OFFICER ROWDEN: That request is granted. Questions from the panel?

MR. EASTMAN: I have a question. On the second page of your testimony in the second full paragraph in the middle you mentioned the circumstances of raw unprocessed whey that is shipped from cheese plants in Wisconsin to a facility for processing. So just to clarify what you were saying. So in essence the cheese plant that is producing that raw unprocessed whey and shipping it somewhere else, they receive nothing in terms of an income or revenue, is that correct? It's just strictly them paying some cost to ship it somewhere. So in essence their cost-minimizing strategy is to ship it and that's pretty much it, there is no revenue income side. Is that what you're stating?

MR. MURPHY: Wisconsin is a different dynamic. We have maybe -- there's about five plants in Wisconsin that are built solely to attract cheese whey from -- there's 157

cheese plants in Wisconsin or -- there's a lot more than California where -- 123 I think the number is. So there's three plants up there, three to five plants that can actually handle raw unprocessed whey. Because the proximities are pretty close.

So the base price on that whey -- the incentive for a whey producer, let's say a small cheese company. The incentive is to just get the whey out of the plant so they don't have to deal with the environmental or sewer issues. The BOD and the waste -- the waste problems with whey are enormous. This is what the industry grappled with for the last 50 years. So the base price --

I'm involved in a plant in Wisconsin that does just this. So I built a plant up there called Wisconsin Specialty Protein in Reedsburg, Wisconsin. What we do is 100 percent of the whey into that plant comes from surrounding small cheese plants. Part of the motivation for that, I should clarify, was based on organic whey and goat whey. But still the bulk of the capacity at that plant is just regular whey, regular hormone-free whey.

And some of it comes in at zero cents FOB the plant per hundredweight and some of it comes in for, like I said, up to about ten percent of the whey value. So there is some incentive there as whey markets climb that we would pay them up to ten percent of the dry whey powder market and

factor that back in per hundredweight. As I stated here, that's worth about 45 cents a hundredweight FOB the plant.

And then the freight. Freight is a big issue with whey. Even in a -- so in a load of whey that's, you know, 500 hundredweights and you're looking at a $500 haul, that's $1 a hundredweight. So, you know, you're looking at -- if you back that into the cost per pound of whey powder or whey protein these costs are significant.

MR. EASTMAN: So as a follow-up question to that. You mentioned that you're involved in the construction of that plant. Do you have an ownership interest in it?

MR. MURPHY: No.

MR. EASTMAN: Do you play a role in managing the plant?

MR. MURPHY: No, I am strictly a consultant.

MR. EASTMAN: And so the data in terms of what this plant is paying or not paying for the raw unprocessed whey, is that just anecdotal? Do you have access to the data information?

MR. MURPHY: No, I'm involved in making the deals, yeah.

MR. EASTMAN: Okay.

MS. RANKIN: I have a question. You mentioned that the cost to dispose of whey for the small cheese plants is between $6-16 per hundredweight, which seems like a

really large range. Is that transportation distance or?

MR. MURPHY: Yeah, that's proximity, proximity to either -- I think most of the whey that I'm aware of in -- I'm working on a project right now in California and the disposal -- we are looking at $150 cost disposal.

But my concern long-term with that is where are we going to dispose of it? Who is going to take it? Where is it going to end up? The municipalities don't want this stuff, from a wastewater perspective.

And the dairies are -- you know, there's only so many dairies can handle this type of feed because the solids are so low. We're looking at 6 percent solids and the dairies typically want something 20 percent or above.

And the $400 figure, yeah, that would be kind of a high-end number for a plant that's out of the way. And it's all freight, 100 percent freight, yes.

MS. RANKIN: And then on the first page of your testimony you mentioned that there were three cheese plants you were talking to that were considering exiting the business.

MR. MURPHY: Yes.

MS. RANKIN: Can you speak to maybe are they small specialty cheese makers or --

MR. MURPHY: I think I can name two of them because I think it's -- one of them is in the testimony that

hasn't been read aloud yet, it's one of the first presenters here this morning. Imperial Valley Cheese I think will exit the state. And I think we heard the testimony from Farmdale Cheese. And there is another company that I don't have permission to disclose who they are.

MS. RANKIN: All right, that's all I have.

HEARING OFFICER ROWDEN: All right, thank you very much.

MR. MURPHY: Thank you.

HEARING OFFICER ROWDEN: Jose Maldonado. Okay, please state your full name and spell your last name and state your affiliation for the record, please.

MR. MALDONADO: Yes, my name is Jose Maldonado and I'm with Marquez Brothers International, the Controller.

HEARING OFFICER ROWDEN: Spell your last name, please, for the record.

MR. MALDONADO: M-A-L-D-O-N-A-D-O.

Whereupon,

JOSE MALDONADO

Was duly sworn.

HEARING OFFICER ROWDEN: Do you have any -- and you have your written statement. That is going to be noted as Exhibit 50.

(Exhibit 50 was received into evidence.)

HEARING OFFICER ROWDEN: And is the gentleman next

to you going to be also --

MR. MALDONADO: He is here to answer any questions if there are any for him.

HEARING OFFICER ROWDEN: Okay, let's have you sworn in too, please.

MR. VILLANUEVA: Okay.

HEARING OFFICER ROWDEN: Could you state your name for the record.

MR. VILLANUEVA: Sure. My name is David Villanueva, V-I-L-L-A-N-U-E-V-A, and I am the CFO for Marquez Brothers International.

HEARING OFFICER ROWDEN: Okay. Could you make sure your mic is on there.

MR. VILLANUEVA: Okay, thank you.

HEARING OFFICER ROWDEN: Okay, please.

MR. MALDONADO: Okay. Mr. Hearing Officer and Members of the Hearing Panel, good afternoon. My name is Jose Maldonado, I represent Marquez Brothers International, Inc. based in Hanford, California. I am here at the direction of the Board of Directors of Marquez Brothers International and David Villanueva is the CFO representing the Board. I have been working for Marquez Brothers for the last 15 years in various positions and currently as Controller.

Marquez Brothers International, Inc. is

disappointed that a hearing has been called so soon on the whey factor of the 4b price. The frequency of these hearings are causing us great concern and hindering our ability to plan for growth. Marquez Brothers' position is to revert back to the 4b why factor at 25 per hundredweight. We respectfully oppose the petitions set forth by the Western United Dairymen and the Coalition. We fully support the alternative proposal made by Farmdale Creamery, of returning to the .25 per hundredweight whey factor in the Class 4b formula as was in place back on August 31st, 2011.

Marquez Brothers International, Inc.'s primary business focus is in the manufacturing and distribution of Hispanic cheese products. Since the foundation of Marquez Brothers in 1981 we have grown our business as demand for our cheese products has expanded. Our particular cheese market demand is highly price sensitive and very competitive. We are in the business of manufacturing Hispanic-style products such as Queso Fresco, Panela cheese, creams and drinkable yogurts. The manufacturing of these products are highly labor-intensive.

Back maybe ten years ago -- some folks have made a comment that the specialty cheese business, they have a windfall of profits and great margins. And I'm here to tell you as the Controller, and the CFO can also assert to this, is that that is not truly the case. Perhaps that may have

been the case years ago but that is not the case now. Our cheeses are very competitive out there, there is a lot of competition, and that has brought the prices down to almost commodity. It's been basically commoditized.

Marquez Brothers reluctantly invested in a whey processing plant in 2004 in order to reduce the cost of disposing of the whey. The investment cost was more than any other investment Marquez Brothers has ever made in the history of the company. The investment decision was driven primarily by the rising environmental concerns with whey disposal and the cost of whey disposal, not the projected financial return. Furthermore, Marquez Brothers is primarily in the cheese business and investing in a whey plant was a necessary but unwanted investment decision outside of the core competencies.

You know, imagine you're running a business where you have, you know, 20 truckloads of milk coming in and you've got to figure out how to dispose of 18 truckloads of whey going out. That was a logistics nightmare for us to do that and so this was a decision that we made to alleviate that -- that problem we had.

With respect to making whey-processing investments within the industry, it is generally acknowledged that a plant must produce at least 1 million to 1.2 million pounds of whey per day in order to reach the economics of scale

necessary for a whey plant investment to break even. We heard that from Barry Murphy's testimony.

Adoption of the Western United Dairymen and the Coalition petitions will result in not only small/medium size cheese manufacturers not able to recoup their investment but the extinction of the California small and medium size cheese manufacturers. According to the milk pooling data table prepared in the workshops titled "Pounds of Milk Processed into Cheese" which is Exhibit A.

Thirty-three plants represented approximately -- about 58 percent of the total plants producing cheese in California are processing less that 664,000 pounds of liquid whey per day, assuming 17.7 million pounds/average milk pounds per month. These cheese factories are too small to dry whey or process whey to get the whey proteins. they lose money every month on this portion of the Class 4b price.

Six plants representing approximately ten percent of the 57 total plants producing cheese in California are processing less than 1.2 million pounds of liquid whey per day on average. That's assuming 31.7 million pounds per month and taking 90 percent of the yield off that, considering that as whey, on a 24 day per month operation.

So if you go to the table here quickly on Exhibit A. I'm referring to the six plants categorized there on

Group 7. And the six plants, they're averaging about 31.7 million pounds. That's where I got the data from.

Going back to page two of my testimony, Item 3.

In other words, 49 plants in all, representing approximately 86 percent of the 57 total plants producing cheese in California are processing less than 1.19 million pounds of liquid whey per day.

Although all 57 plants would be severely financially impacted by the increase in the milk price as proposed by the Western United Dairymen and the Coalition, 33 cheese processing plants will never recover their investment and six other plants will break even, taking them decades to recover or see a return if they were to build a whey plant. These plants are financially burdened when the whey market price increases dramatically or reaches certain thresholds.

I fact, only four plants of the 49 plants mentioned above in points one and two are processing whey, per Exhibit A.

Even for companies likes ours that have some whey processing capabilities, growth in cheese manufacturing and distribution will be severely restricted should we experience further losses in our whey business. Our experience has been that during the first three to four years of whey operation we did not see any profits.

Now, financial impact of the whey component to our company. Cheese whey disposal has always been a burden and an environmental problem, costing Marquez Brothers $1.5 million per year to dispose of with zero revenue value and no milk allowance for the 4b price to cover whey disposal costs over the years. I repeat, there was no real recognition for our whey disposal cost losses in the milk price formula.

Historically, whey powder values compared with whey protein concentrate values were similar when calculated on a price per pound of protein basis. This led to a decision in 2004 to finance a whey protein plant only. This decision was driven by two factors:

The environmental problems associated with the whey disposal will be alleviated by Marquez Brothers International so that we can focus on growing its cheese distribution business.

Number two. The pricing history in 2003 indicated that the revenue stream from a WPC-80 only would be similar to a whole whey powder plant and therefore justified us building a WPC-80 only plant, while disposing of the concentrated permeate as animal feed.

Now, should the Western United Dairymen and the Coalition petitions be adopted, we will be in serious trouble because we do not dry the permeate fraction and

don't have the ability to fund a $35 million permeate drying facility. So we will be unable to capture revenues to keep up with the rising milk cost proposed in the 4b whey component formula. In time when additional plant capacity is needed, the state's regulated milk pricing formula applicable to cheese plants will discourage investment in new cheese plants and whey protein plants and will make it difficult for some plants to continue operations.

As I mentioned earlier, Marquez Brothers International, Inc.'s primary focus is on cheese manufacturing and distribution. I want to just take a side note. We are not experts in whey manufacturing, that's not our business. We just -- our primary business and what started the business is cheese, making cheese, and that's what we do. This is just to alleviate, as I mentioned. To alleviate our problem and environmental problem. How do you, how do you get rid of whey.

Prior to construction of the whey plant our cost to dispose of the whey component for the years 2000 to 2005 was approximately $7.5 million or $1.5 million per year. The whey protein plant was completed in August 2005 for an investment amount of approximately $20 million. Despite our multimillion dollar investment to alleviate an environmental problem associated with the whey we have not seen a return on the investment. Our total loss incurred from August 2005

to August 2007 mainly due to the whey component is approximately $7 million. To date we have not yet recovered from these losses and we are years away, perhaps decades, from getting our ROI. Why? We simply do not have enough volume.

As a result of having a whey plant we have seen an increase in our hydraulic BOD and EC loads. This has led us to make another multimillion dollar investment in a wastewater pre-treatment plant with an operating cost of approximately $200,000 a month.

I want to take a side note on that as well. When we built the whey plant we had no idea the consequences that it would bring us of disposing the water to the city. We had no idea of the impact or that we were going to build a $6 million wastewater pre-treatment plant. That's something that just kind of blind-sided us. And those are the kinds of costs that are not being calculated or being discussed.

Cheese pricing at the consumer level has become much more difficult to price out to our customers because we can no longer gauge ourselves based on the CME cheddar cheese price. A lot of customers tell you the price they base on the cheddar cheese. If you include in the whey factor we can no longer gauge ourselves against the cheddar cheese anymore. That's going to be a huge problem for us, pricing our product out there on the market.

The whey component distorts our margins and pricing mechanisms. The whey component factor in the 4b formula significantly increases the price of our number one raw material, milk. And the whey prices have no correlation to the CME cheddar cheese price. However, the cheddar cheese price has a direct correlation to our cost per pound of milk and cheese. We are in the cheese business, not the whey business, and our milk cost should be based on cheese only.

If cheddar cheese stays fixed and does not move and whey goes up and down, I'm going to have to go back to my customers and say, hey, I've got to increase your price. They'll go, wait a minute. Why are you going to increase the price? The cheddar cheese hasn't moved at CME. You know, it's the whey components. They have no idea. Those are the kinds of pricing distortions I'm talking about.

The producers express the lack of correlation --

One thing I wanted to mention between Class 4b and Federal Order. There's an article that we came across and it's Exhibit B. It's an article written by -- it was in the Cheese Reporter and it was written by John Umhoefer. He is the Executive Director of the Wisconsin Cheese Makers Association. His opening paragraph on this article is: "Adding the value of dry whey to dairy farmers milk checks has been an unfair and logically flawed idea for nine

years." I'm going to come back to that in a minute.

The producers express the lack of correlation of the California 4b price with the Federal Order Class III price. This comparison is not valid. According to an article written in the Cheese Reporter by John Umhoefer on January 6, 2012, he states: "If dry whey in November was worth $2.57 per hundredweight for a dairy farm, where does a small cheese plant find that money?" According to the article, the majority of the cheese companies that do not have the capability to process their whey are being charged the full price of whey in the milk price with no means to recover and placing a huge financial burden on the cheese manufacturers.

He performed a study in Wisconsin where he determined "That income is far below the Class III value of $2.57 per hundredweight for other solids." He further states that the "plants always earn less for their wet, unprocessed whey than they have to pay out to their farms in the other solids price." The article continues to say that "one third of Wisconsin's cheese plants are swimming in red ink on the other solids price."

Now you heard Barry mention -- I think he said 123 plants are in Wisconsin. A third of those are swimming in red ink according to Mr. Umhoefer. So, you know, they're sharing a lot of the pain that we're sharing here in

California as well.

So to conclude his statement in his article he says -- he recognizes that the whey factor in the federal order system needs to be fixed. In his words he said: "The only realistic hope for changing this nine-year-old mistake is recognition of this problem in the 2012 US farm bill."

So, you know, here we are saying -- we're hearing a lot of testimony that we should match our pricing mechanism system here in California to the federal. But I'm hearing from the other side that the federal is -- that their federal system is a big mistake, that there's problems here. So they should adjust theirs to maybe California. So here there's a huge disconnect.

Moving forward, our proposed solution will address the problem. We support Farmdale Creamery alternative proposal of returning to the 25 per hundredweight whey factor in the Class 4b formula as was in place on August 31, 2011. This alternative proposal in the 4b milk price will provide margins for cheese makers to invest in new technology to keep the plants operating, to invest funds in research and development that will lead to innovation, new products and expanded products and to new markets for cheese. It will also incentivize the processor community to grow by allowing the majority of the returns to be realized by those taking the risk of the investment and increase milk

processing capacity in cheese plants in a time when there is excess milk.

In conclusion, adopting the Western United Dairymen and the Coalition petition for 4b whey component pricing policy will discourage cheese plant investment and place near-term plant capacity at risk at a time when plant capacity growth is essential to the continual health of both producers and processors. Milk producers are not contributing to the investment required to process whey and alleviate the environmental problems associated with whey. We want to see the whey component of the 4b milk formula revert back to the 4b whey factor of .25 per hundredweight as was in place on August 31st, 2011, unless the milk producer is prepared to contribute to capital investments required to handle whey. We take all the risk in processing whey, producers don't. We take the capital investments in whey manufacturing facilities, producers don't. We take all the losses in weak markets, producers don't.

In your role as regulators and policy administrators from the California Department of Food and Agriculture we are asking you for your assistance to revert back to the 4b whey factor of .25 per hundredweight as was in place on August 31st, 2011. It is not sustainable for us to adjust to the Western United Dairymen and the Coalition petitions and to suffer further financial losses.

California cheese plants are still struggling to adopt to the change implemented as of September 1st, 2011. Which to date has added .4 per hundredweight to the cost of milk. Compounding our problems due to the whey component in the Class 4b milk formula, we are confronting ever higher energy, labor, resin, petroleum-based products and materials and workers compensation cost to operate in California, which has made it much more difficult to be competitive.

Given the serious threat that continuation of the current pricing formula poses to California dairy farmers and the cheese makers, we implore the Department to revert back to the 4b whey factor of .25 per hundredweight as was in place on August 31st, 2011. A regulated system needs to have stability. Revisiting a topic that has been discussed at length numerous times over the past decade is not productive. CDFA must protect the dairy industry. And the inclusion of the whey factor in the 4b price is a recipe for catastrophic disaster by threatening the ability for cheese manufacturers of all sizes to continue in the dairy business. Investments will be limited, innovations will be hindered and buyers on the global scale will not view California companies as reliable suppliers.

Thank you for the opportunity to be here today. I would answer any questions you may have. I would also like to request an opportunity to file a post-hearing brief.

HEARING OFFICER ROWDEN: First of all your request is granted. Questions from the panel?

MR. EASTMAN: I have a couple of questions for you. On page three of your testimony, the first sentence at the top. You list a couple abbreviations, BOD and EC. I am not familiar with those, could you explain what those are and what those are about?

MR. MALDONADO: Biodegradable oxygen demand and EC is electroconductivity. And those are -- those are basically the -- what the cities typically measure the wastewater and they charge you based on BODs and SODs. They have various charges but BODs would be one of them. And ECs, depending on what city it is, they'll charge you based on how much ECs you disposed to the city. Or they'll fine -- they'll fine and report you as a gross polluter.

MR. EASTMAN: So is the wastewater pre-treatment or investment that you made, were those -- was that made to address those?

MR. MALDONADO: We were actually forced by the city of Hanford to place this wastewater pre-treatment plant.

MR. EASTMAN: And then you mentioned at the beginning of your testimony that although as a Hispanic cheese producer some people would argue that's a niche market, it's a specialty-type cheese. However, you state

that I guess the marketing of your cheese has gotten to the point where it's viewed almost as a commodity. Can you explain maybe the factors that have contributed to that or could you elaborate a little bit more on that?

MR. MALDONADO: Absolutely. In the last ten years I would say that the competition in the state of California or the national level, there were just a few players. Now in the last ten years there have been at least five new additional players that have been added to the market that were not here, you know. And those are obviously taking the market share away. And for them to come in, whether they come from Mexico -- although some of them have come from Mexico -- they have come in flooding the market with their products. And that obviously could reduce the prices down.

MR. EASTMAN: Now did you just mention that the competitors are coming from Mexico or from the state of New Mexico?

MR. MALDONADO: No, they're -- as I know there are two that have come from, from Mexico. They have purchased plants here in the US.

MR. EASTMAN: So I guess a follow-up to that would be then, theoretically they would be confronted by the same costs and milk pricing structure.

MR. MALDONADO: That is correct.

MR. EASTMAN: So do you think that they have some

sort of advantage? Is there a way that they are able to surpass your operation? Because you could argue, well they would be confronted by the same obstacles or barriers, correct?

MR. MALDONADO: They would be confronted with the same obstacles and barriers and they still have to pay the same minimum price but they have, perhaps, deeper pockets. These are huge operations.

MS. RANKIN: I have a question. Who is the main customer for your WPC product? Is it export or is it a national market or?

MR. MALDONADO: The national market.

MS. RANKIN: National market, okay. And does the whey -- the whey factor that's in place right now, does that move along with what the WPC-80 market is doing or is there any relation between those two?

MR. MALDONADO: There is actually -- I'll have to take a look at that, I don't have that information in front of me. But for the most part, at the time when we looked at this it was moving right along with the -- with the whey -- with the whey market.

MS. RANKIN: That's all I have.

MR. EASTMAN: Is that something that maybe you could put together and submit in a post-hearing brief?

MR. MALDONADO: Yes.

MR. EASTMAN: You're able?

MR. MALDONADO: Sure.

HEARING OFFICER ROWDEN: Thank you very much.

The next witness is Lynne McBride. Okay, please state your full name and spell your last name and state your affiliation for the record, please.

MS. McBRIDE: Lynne McBride, M-C, capital B-R-I-D-E. I'm with the California Dairy Campaign.

Whereupon,

LYNNE McBRIDE

Was duly sworn.

HEARING OFFICER ROWDEN: Okay. Your testimony will be entered in as Exhibit 51. Please.

(Exhibit 51 was received into evidence.)

MS. McBRIDE: Thank you. Mr. Hearing Officer and Members of the Panel, my name is Lynne McBride. I currently serve as Executive Director of the California Dairy Campaign. CDC is a member organization of California Farmers Union, which represents more than 1,400 farmer and rancher members statewide. CFU is a state chapter of the National Farmers Union, which represents 250,000 farmers and ranchers nationwide. The testimony I will present today is based upon positions adopted by the CDC Board of Directors.

We would like to thank the Department for granting this hearing and greatly appreciate the opportunity to

testify here today.

We testify today in support of the petition put forward by the Coalition, of which CDC is a member, to incorporate a higher value for whey in the 4b pricing formula because it will pay producers a whey value that is based upon prevailing market demand. We support the identical petition put forward by Western United Dairymen.

Already this year in just two counties, Tulare and Kings, 17 dairies have closed their doors. Despite the fact that dairy producer prices improved in 2011, 47 dairies went out of business that year, which illustrates that even when producer prices improve, the toll of a price collapse like 2009 reverberates for years afterwards.

When a dairy closes, that dairy owner is not able to pay a number of vendors along the input supply chain. And as a result, the consequences of the closure of one dairy have a dramatic impact on the local and regional economy. The consequences of the closure of more than 200 dairies statewide in just the last three years is taking a heavy toll on our state economy and dramatically changing the social and cultural landscape of communities across California.

Those dairy farms that remain in operation today continue to struggle to make up for the unprecedented loss of equity that all dairy producers suffered in 2009 and are

once again facing financial crisis due to the fact that producer prices do not cover production costs. We have learned from our producer members that prices paid to California dairy producers this month are actually below $14 per hundredweight, which the cost to produce milk in the state is over $17 per hundredweight. It is extremely difficult for dairy producers to secure credit as banks and other financial institutions continue to tighten credit and other requirements for all dairy operations.

According to CDFA data, feed costs increased by 28.8 percent from 2010 to 2011 and represented 63.9 percent of the total cost of production on California dairies. Feed costs in 2011 reached record highs, but under our current system California dairy producers do not have the ability to pass on these higher costs. With feed and other input costs at historically high levels it is critical that California dairy producers are paid a fair value for the milk they produce based upon the price paid for milk in the market today. Whey represents a significant portion of the value and it is critical that the California 4b formula is modified as called for in the Coalition's petition to incorporate that value.

The future for countless dairy operations around the state is far from certain and it is critical that CDFA consider the impact of today's petitions on producers who

have already endured tremendous financial hardship over the last few years. Our dairy producer members continue to question whether dairy farming in California is feasible given the significant gap between dairy producer prices paid in our state compared with those paid in the federal milk marketing order states.

Despite the fact that California milk is less expensive than milk sold in other states, processing facilities are choosing to locate in states other than California. Processing plants from other states have contacted our dairy producer members to urge them to relocate in order to supply milk to these new facilities. The fact that processing plants are being built in other states demonstrates that cheese processing can be profitable at the same time that dairy producers are paid a fair whey value.

It is also a strong indicator that plants are choosing to locate in other states for reasons other than the price paid for 4b milk.

The attrition of dairy operations throughout California continues and it is critical that CDFA act quickly to increase the whey value in the 4b formula as a good first step towards remedying the already dire situation facing California dairy producers.

We testify in support of the petition put forward

by the Coalition to increase the amount producers are paid for the value of whey. Adoption of the new sliding scale as called for in the petition will be an important step in the right direction toward making the 4b pricing formula more market oriented and more equitable.

Today the price paid to California dairy producers for 4b milk is significantly below the price paid to dairy producers in the federal milk marketing orders. Through our conversations with dairy producers in other states we have learned that the California dairy producer price is equivalent to the price paid to producers for distressed milk in other federal order states. The significant difference in the amount that California dairy producers receive for whey in the 4b formula does not adhere, and this has been said before, to the requirement of the California Food and Agricultural Code that CDFA maintain prices that are in reasonable and sound relationship with the national value of manufactured milk products. Adoption of the Coalition's petition would increase the price paid to California dairy producers for 4b milk and put California prices in a more reasonable relationship with those in surrounding states and the federal milk marketing orders.

On many occasions CDC has testified before CDFA calling for the California dairy pricing system to be reformed so that it is more market oriented. The

Coalition's petition would establish a sliding scale whey value that tracks the market direction followed by the Federal Milk Market Order Class III whey value. The whey value factor included in the Coalition's petition in part achieves our longstanding goal of making the California dairy pricing system more market oriented. The Coalition's petition incorporates a fair value for whey based on market conditions and will make the California dairy pricing of 4b milk more equitable for producers throughout the state. As the amount of milk used to produce cheese continues to grow it is critical that producers are paid a fair price for 4b milk.

In conclusion, we urge CDFA to adopt the Coalition's petition to change the 4b pricing formula so that producers are paid a 4b price that is based on the value of whey in the market and so that the 4b formula is in a reasonable and sound economic relationship with the Federal Milk Market Order Class III price. Adoption of the Coalition's petition will be a good first step towards making the 4b dairy pricing formula more equitable for producers by including a whey factor that relates to prevailing market conditions.

The California Dairy Campaign would like to thank the Department for the opportunity to present our testimony today. We would also like to request the opportunity to

submit a post-hearing brief. We look forward to working with CDFA to improve the outlook for California dairy producers now and in the future. Thank you.

HEARING OFFICER ROWDEN: And your request for a post-hearing brief is granted. Questions from the panel?

MR. EASTMAN: I have a question. Let me find it here. You mention on page two of your testimony -- in the very last paragraph at the bottom of the page it mentions that you have learned that the California producer price is equivalent to the milk price paid for milk that's distressed milk, more or less, in federal orders. Do you have any -- do you have any data, any information that shows any specifics regarding that or is that mostly just anecdotal conversations?

MS. McBRIDE: That happened to be anecdotal conversations but it could be something that we could follow up on in a post-hearing brief. I'd have to make some contacts on that.

MR. EASTMAN: Yeah, that would be great if you can -- if they would --

MS. McBRIDE: If they're willing, yes.

MR. EASTMAN: Obviously it's hard to know what someone will give you.

MS. McBRIDE: Right.

MR. EASTMAN: But any sort of concrete, specific

data would be great to illustrate that point.

MS. McBRIDE: Great. We'd be happy to do it.

MR. EASTMAN: Okay.

MS. RANKIN: I also had a question on page two. You mention that processing plants in other states were contacting producers in this state. Do you know if there is interest among producers in California relocating or is that something that's being considered?

MS. McBRIDE: I think their goal is to stay here in California. This is their home and this is where -- there is a lot of history behind a lot of these dairies and so I don't think that their first inclination is to leave the state. But given the difference between the Federal Order price and the California price it's making it very difficult. There also have been conversations about having California join the Federal Order if the price disparity isn't remedied. But no, I don't think, you know. In terms of our membership, they would very much like to stay here and operate their dairies successfully and profitably. And so the notion that someone is calling them on the phone and asking them to relocate is troubling on a number of levels.

HEARING OFFICER ROWDEN: All right, thank you.

MS. McBRIDE: Thanks.

HEARING OFFICER ROWDEN: Gilbert de Cardenas, please. Please state your full name and spell your last

name and state your affiliation for the record.

MR. DE CARDENAS: Gilbert de Cardenas, D-E, C-A-R-D-E-N-A-S and I'm with Cacique, Inc. in Southern California.

Whereupon,

GILBERT DE CARDENAS

Was duly sworn.

HEARING OFFICER ROWDEN: Do you have any written statements to submit today?

MR. DE CARDENAS: I do not.

HEARING OFFICER ROWDEN: Okay, please.

MR. DE CARDENAS: Cacique is a family-owned company. We are our second generation. We started about 40 years ago. Like Marquez Brothers we focus on the Hispanic trade. We started with a small investment, $1,500 from what we call the three Fs, friends, family and fools. And it's grown from there into a good size family business. Again, focusing on the Hispanic trade.

This situation we find ourselves in now is very interesting to us in the sense that California, it's no secret, everybody here understands, has become a very difficult state to do business in. We are facing more and more competition, as we have heard earlier today, from competitors outside of the state. To the point that in the 30 years, almost 40 years we have been in this business, we have never seen this kind of competition. As a matter of

fact, in California we haven't seen any new competition in the last ten years as far as new facilities, but in the last three years we have seen more and more competition coming in from out of state. Mostly from the Midwest, some from Mexico as well.

Now, if we are not seeing competition being created in the largest Hispanic market in the state -- in the country, excuse me, but we see competition coming in from out of state, that would tell us that the out of state producers -- excuse me, the out-of-state processors have some sort of economic advantage that allows them to compete where we cannot. I'm sorry, we can compete but it's much more difficult to do so.

We understand the differential, the deltas between the federal and the California orders. But there's got to be other factors and I guess we're looking at this for a much larger economic and global situation. What advantages do other processors have in other states we no longer have in California that we have lost our ability to compete or it has been diminished considerably? Our profitability has certainly been diminished considerably. Our ability to go out and market our products out of state are much more difficult. The cost of doing so as there has been consolidation in the retail industry has made it much more expensive. Those are expenses we bear completely and do so

as part of our ability, our want -- our need to compete. But it certainly has become much, much more difficult in the last ten years.

And again, the competition coming from out of state has made things much more difficult in the terms that we have seen a lot of compression -- experienced compression in margins. Any kind of increase in costs of our number one ingredient, which is milk, would further put us in an uncompetitive situation, we feel, to the point that we have stopped all cap ex spending in California. We want to understand how this process is going to play out. If it plays out where costs continue to increase then I don't see us investing in California any further and possibly look to service this area, or this part of the country, from more favorable markets to, to us.

That's basically my testimony for today. Do you have any questions?

MS. GATES: I have one question for you. You talk about the out of state processors having a competitive advantage. Do you know what that was associated with?

MR. DE CARDENAS: We have met with several other states. There are advantages to not milk-based but other economic costs such as power, such as labor, such as discharge or things of that nature that are far less expensive out of state. For example, in the upper Midwest

power is about a third the cost. For a processor that uses a lot of electricity, that's a pretty big difference.

Now again, the delta in milk helps to alleviate some of that situation. But as milk costs in California continue to increase relative to what it is nationally it makes that much more difficult to compete. Does that answer your question?

MS. GATES: Thanks.

MR. DE CARDENAS: I would like to reserve the right to submit a briefing post-hearing, please.

HEARING OFFICER ROWDEN: That's granted.

MR. DE CARDENAS: Thank you.

HEARING OFFICER ROWDEN: Thank you very much.

MR. DE CARDENAS: Thank you.

HEARING OFFICER ROWDEN: Cornell Kasbergen.

Please state your full name and spell your last name and state your affiliation for the record, please.

MR. KASBERGEN: Cornell Kasbergen. The last name is spelled K-A-S-B-E-R-G-E-N.

Whereupon,

CORNELL KASBERGEN

Was duly sworn.

HEARING OFFICER ROWDEN: Okay. Your testimony will be submitted as Exhibit 52. Please.

(Exhibit 52 was received into evidence.)

MR. KASBERGEN: I am Cornell Kasbergen; I own and operate a dairy with my wife, son and daughter-in-law in Tulare, California. We have been in the dairy business for over 35 years. We also own a dairy in Wisconsin that we own in partnership with my brother and is being managed by our son-in-law and daughter. We have owned the Wisconsin business for over 13 years. I also served as a director on the Land O'Lakes board for almost 14 years. I am here to testify on my behalf, not Land O'Lakes'.

There are three areas that I would like to cover. One; first the current relationship of the California 4b pricing versus Class III, the national price for milk used in cheese manufacturing. Second, the effect of the inequity of those pricing mechanisms on California dairies. And third, solutions to correct the inequities.

I have attached a monthly breakdown for pricing on our Wisconsin dairy, Tab number 1. The prices under the actual gross dollars are taken from our milk statement and includes the producer price differential and premiums. I compared those Wisconsin prices to those that would have been received under the 4b schedule. The difference is substantial and sobering.

Wisconsin prices are significantly higher than the California 4b. The average Wisconsin advantage for 2011 is $4.07 a hundredweight. For the first four months of 2012 it

is $4.33. Many have and will state that the Class III price is not being paid for milk in the federal orders. That is a correct statement, Class III milk in the federal orders is receiving a much higher price.

Herein lies the crux of the problem, California and Wisconsin are the number one and two cheese producing states. Both pricing formulas have a basis in current market values. However, the California price received by dairymen is over $4 a hundredweight lower. That is 20 to 25 percent less income received by California dairy families.

Many of the companies that will testify today also operate in the Federal Order, of which Wisconsin is one. These companies are paying the same higher price for milk in the Federal Orders. They come here today to testify they need the huge price advantage offered in California to continue to operate. The fact is that a cheese plant in California today has a significant advantage over any plant outside of California.

These national companies will tell you how difficult and costly it is to operate in California versus the other states. The dairy families of California operate in the same environment. The Wisconsin dairy is very profitable, as opposed to the dire situation in California for dairy. The upper Midwest continues to expand plant capacity. Competition for milk is fierce. All this in an

environment where input costs are 20 to 25 percent higher.

The milk market in Wisconsin is very dynamic. Many cheese plants that do not process their whey operate very successfully. The market in Wisconsin is very competitive. By way of example, we could sell our milk to five different buyers.

The market price paid for milk in Wisconsin is a true market value for milk. I have heard the argument that the California price needs to reflect a clearing price. Where in the statute is that written? How does this comply with the statute 62062 that states our price "shall be in reasonable and sound economic relationship with the national value of manufactured products."

Yes, federal order plants can depool. The reality is that the impact at the producer level is minimal. In fact, when comparing our Wisconsin milk price to an increase in non-pooled milk on Tab number 2, in March of 2011 and December of 2011 it had a little to no impact on our milk price in Wisconsin. The "seller" it should read, of the milk is covering the loss of income if milk is discounted. If costs were charged to the producer, the dairy farmer, they would probably leave that buyer of milk.

On Tab 3 you can see the 22 year price chart on 4b prices. From 1990 to 2009 the difference between 4b and Class III was 55 cents. From 2010 to the present it's $1.90

and it is getting further out of relationship as time goes on.

The CDFA has the responsibility to be the referee for the dairy industry. Until 2009 the Department managed the state's milk industry equitably. The game changer was ethanol and the cost of energy. Until 2008 we were the low cost producers of milk in the country and we could survive and receive less for our milk than the rest of the country. Those days are gone.

The exit of dairy families is accelerating. Just last week I received four different fliers for dairy dispersals totaling 8,000 cows. The dairy families of California deserve better. The California pricing system is causing economic hell. Again in direct conflict with the statute 318101-E. "It's 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."

Why do the administrators of the above statute not follow its mandate? CDFA must recognize the inequity of our 4b formula and give the dairy families a chance to continue to do business in California. It's time to level the playing field and the statute requires you to.

The argument will be made that the plants cannot

process the milk if the price increases. The co-ops have and will continue to manage the volume of milk to best match capacity. The responsibility of the CDFA is to give the dairy families of California a fair chance to compete economically. We cannot compete with producers that are receiving as much as $4 a hundredweight more than we are.

I support the Coalition and the Western United petition. The dairy families of California should not receive less than the Federal Order Class III for our 4b milk, with no caps or floors. This is the benchmark that this panel should consider. To take into consideration the all milk price is not equitable since not all producers own a proportionate amount of quota.

In my interaction with dairy families I have seen the pain that is out there in our communities and much of it is because of the inaction by CDFA. CDFA has been part of transferring over $500 million of producer money to the processors of this state.

We are going to hear that the plants will close down if they have to pay more money for milk. However, it's interesting to note that Leprino, Saputo, Hilmar as well as national co-ops, all have plants in the Federal Orders. They all pay more for the Class III milk in those out of state plants and yet will sit before you today and complain about California pay prices.

We are asking you to give the dairy families of California a fighting chance. You will know at the end of this hearing the pain that your inaction is causing. Your inaction has contributed to many dairy families losing their farms that have taken a lifetime to build. Yes, you have an unenviable position but justice must prevail.

We the dairy families of California have choices. If CDFA fails to correct the inequity between the 4b and the Class III my first choice would be for California to join the Federal Order, which would dismantle the current bureaucracy and replace it with the federal system. That would level the playing field for processors and the dairy producers.

The best solution is for CDFA to act to rectify the obvious inequities.

I thank you for your time today and hope that you make the right decisions for the sake of all California dairy families. Thank you.

(Applause.)

HEARING OFFICER ROWDEN: Okay, hold on. I realize this is an emotional issue but we're trying to, you know, keep this down to a minimum. We're trying to take in facts.

Panel, questions? Thank you very much.

Joey Airoso. Please state your full name and spell your last name and state your affiliation for the

record, please.

MR. AIROSO: Joseph Charles Airoso, A-I-R-O-S-O.

Whereupon,

JOSEPH AIROSO

Was duly sworn.

HEARING OFFICER ROWDEN: Do you have any written statements you would like to submit?

MR. AIROSO: I just have a short statement and I can give it to you when I'm done.

HEARING OFFICER ROWDEN: Okay, proceed.

MR. AIROSO: Good afternoon. My name is Joseph "Joey" Airoso. I operate a family dairy in partnership in Tulare County along with my wife, my mom, my dad and my son. I'm a fourth generation dairy in Tulare County and my grandson who is two will be sixth generation.

Our family celebrated 100 years of dairy farming in Tulare County this year. My great-grandfather came over here in 1912 and him and his sons milked 30 cows. They started out with 30 cows and ended up milking about 180 cows for 30 years. My grandfather went on his own in 1938 and him and my dad became partners. My grandfather passed away in 1963 when my dad was 21. I was born in 1960 and me and my dad have dairied ever since. I'm proud of our operation. We have my son, my grandson.

And, you know, I want to comment about -- most

dairy farmers in this state, we are not going to threaten you to leave because we're here, we're staying. We just want things to be fair. And our families are here, we've grown up here, our kids are here. And to be honest, it's a hell of a lot harder to pick a dairy and a ranch that you've grown on and tilled the soil your whole life and move it somewhere else. A building, a piece of concrete, it's a little bit different story; so we're attached.

And I think part of the disadvantage we have is that we're playing with our cards face up all the time. Processors know how many cows we've got. They know that we've got to milk them at least two times every day. A lot of them have people that literally look at heifer numbers, cow numbers. They know how much milk is coming.

They really can't predict the weather that well. And to give you a good example of this, Tom Wegner will get a great kick out of this but believe it or not, in 2010 at our Land O'Lakes meeting Tom made a comment, you know, sometimes I worry at night that we're not going to have enough milk for the contracts that we sold. This year I seen Tom at our same meeting, I said, Tom, you ought to be sleeping like a baby at night right now; plenty of milk. And it's all -- a lot of it is weather-related.

I mean -- and we can't -- we can't -- cows don't have switches where you can turn them on and off. And I

know the comment has been several times about there seems to be a connection between how many cows and how much milk relates to how good dairy farmers are doing. Really there's no relationship. You make a three year commitment to get a drop of milk. You breed a cow today, she has a calf in nine months. Two years later she starts giving milk. There is a commitment that whole time. And that's a process that's constantly moving. And so we're kind of stuck. We know how many animals we've got.

The other thing that's happened, and Cornell brought it up, is the ethanol thing has changed the game in California here. I still believe that we are some of the most efficient operators in the way we do business out here, the way we take care of our animals. But since ethanol and the cost of doing business in California, the cost of dealing with the feed costs that we have had for the last four years, we just can't carry anybody else on our back. It's not possible. In the last two weeks I have had a neighbor go broke on both sides of our dairy. And I mean, it's a sad thing to see people that have worked their whole lives and go out because really of 2009. They just couldn't ever recover and then we're going into another downturn now.

So I just -- I think one other comment -- I'll continue reading here. For 50 years we have bred and owned market-registered Holsteins. And the reason why I bring

that up is because it has given me an opportunity to talk and make friends with people all over the world.

And so you talk -- the first thing you talk about is the milk price. When we get people who come to visit here from other countries the first thing they want to know is how much we are getting paid for our milk. And then they get their calculators out and they do the calculation. And most of the time here in California I get the comment, I don't know how you guys can make it doing that. And it's because these guys out here are so darned efficient. That's the only reason we have been able to survive to this point. But we can't do it no more.

Last summer good friends in Ohio, $25 a hundredweight with Holstein cows. We're getting -- we had a good price last year if our costs weren't so high. So it's -- we're in a corner.

And I've got to say, today I am so proud that our industry is here together saying the same thing. Because we're a bunch of free-spirited -- you know, there's a lot of thinking and dairy farmers don't normally like to think alike. We're really innovative and we like to do things different and do it my way. But everybody is supporting Western United and the Coalition today and I think it's a testament to how far, how hard we're pushed in the corner.

You know, we have a system that's based off end

product pricing, except the processors want to pick and choose which products are in there. We just want things to be fair.

You know, I said earlier, I think we both need each other but we're against the wall now. And I think for them to sit here and say that there's a portion of them losing money -- everybody here is losing money today, everybody. And so it's a testament to just how tough things have gotten since the fuel price.

And I brought -- there was a letter here that was mailed on February 16th from the Dairy Institute and there was a couple of things in here that I just thought really showed how, how kind of out of touch they are with what we're really dealing with. I got up at three in the morning last Monday morning to take care of my feed bills. It's kind of a gut-wrenching thing to take care of your feed bills now when you've got to write that check because it really just takes everything and more.

And this was a comment that was in this letter. It says: "We do note that the dairy commodity prices and consequently milk prices have declined in the last few months but we understand producer concerns about narrowing margins. But this simply is the market sending a signal that supply is becoming burdensome." But where do we pass the costs on when we're losing money? That's the problem.

There's another comment here. It talks about feed prices. How -- they made a comment about how feed prices are leveling out. Well, they sure haven't the last two months. Of course, this was written in February. But I think they need to understand that we are dealing -- the plants are dealing -- we are dealing with everything they are dealing. All the environmental regulations, all the air and water regulations plus animal welfare regulations. You know, we have things piled on top of us and we just cannot take anymore.

And we're just -- we want a fair price. We have to compete with the rest of the country.

In closing I would urge the Department to make a decision that would bring California milk pricing in line with the rest of the US. The future of the California dairy industry rests on a fair decision that will put dairy farmers in California on a level playing field with the rest of the country. Our livelihoods depend on it and really the processors' livelihoods do too. Thank you.

HEARING OFFICER ROWDEN: Questions?

Did you want to submit your testimony?

MR. AIROSO: Yes.

HEARING OFFICER ROWDEN: That will be Exhibit 53.

(Exhibit 53 was received into evidence.)

HEARING OFFICER ROWDEN: Art Van Beek. Please

state your full name, spell your last name and state your affiliation for the record.

MR. VAN BEEK: Art Van Beek, V-A-N space B-E-E-K. And we own and operate El Monte Dairy in Tipton, California.

Whereupon,

ART VAN BEEK

Was duly sworn.

HEARING OFFICER ROWDEN: Your exhibit that you've submitted with be Exhibit 54. Please.

(Exhibit 54 was received into evidence.)

MR. VAN BEEK: Thank you in advance for listening to me. My name is Art Van Beek. My wife, our four children and I own and operate El Monte Dairy in Tipton, California. We are a second generation family-owned and operated dairy and have been in the business for over 30 years. Today I am asking you to make changes in how you arrive at what to price our milk at. The true value of whey and whey products is not reflected in our price and it needs to be.

With all due respect to the processors as they will tell you a different story, the truth of the matter is the cheapest milk in the nation is in California and that is why they are here. They don't seem to have a problem paying from $1 to $4 more in any other state in the nation.

The largest industry in the state of California is agriculture; the largest segment of that is dairy and dairy

products. Over 99 percent of the dairy farms in California are family owned and operated.

There is a personal side to this story that needs to be told. In 2009 all of our lives changed, yours included. As dairy families we, like everyone else, had adjustments and changes to make. In 2008 there were about 2100 dairy families in the state of California. At last count there were 1628 left in operation. We are losing about 100 a year.

Land O'Lakes, of which we are a member, operates one of the largest single site processing plants in the nation at Tulare, California. It employs about 500 people. In March of this year we had 213 family farms delivering milk to the Tulare plant. During the month of April we lost 17 family dairies who sold out. These dairy farms have ceased to exist. Their reasons were all the same; in one word, financial. We now have 196 family farms. To put things in perspective, at that rate it would take less than 12 months and Land O'Lakes Tulare would close its doors and there would be 500 people out of work, along with the thousands of dairy farm employees of these dairy operations.

The dairy farms in the state of California are in a great depression, much like the Great Depression of 1929. If you told me that 17 -- a year ago that we would lose 17 members in a month I would have said that wasn't possible.

Some ignored the 1929 Depression because it did not affect them. But you can only ignore that so long until it comes knocking at your door.

We support the Coalition's proposal and beseech you to do likewise. Thank you.

HEARING OFFICER ROWDEN: Questions? Thank you very much.

MR. VAN BEEK: You're welcome.

MR. EASTMAN: Question.

HEARING OFFICER ROWDEN: Hold on. Excuse me, hold on.

MR. EASTMAN: I had one question, I'm sorry.

MR. VAN BEEK: Yeah.

MR. EASTMAN: I notice that you had given us a Dairy Cares sort of pamphlet. Is there something that you wanted to highlight in that in particular?

MR. VAN BEEK: Well that Dairy Cares is a reflection of what the dairy families in this state are like. There are generational connections to this business and I thought it would be appropriate for you to see that and read that. And you'll find out that there's just a lot of emotional ties to this business. A while back some lawyer told me, he says, you guys have got to realize, there's life after dairy. And apparently a lot of us are having a hard time accepting that so we're just going to go

down with the ship, I guess.

(Laughter.)

MR. EASTMAN: Thank you.

MR. VAN BEEK: Yeah.

HEARING OFFICER ROWDEN: Thomas Wegner, please. Mr. Wegner, you have been sworn in. Who will you be representing with this testimony?

MR. WEGNER: Land O'Lakes.

HEARING OFFICER ROWDEN: Okay. And that's Exhibit number 55, his testimony. Please.

MR. WEGNER: Mr. Hearing Officer and Members of the Panel. My name is Tom Wegner. I am here to testify on behalf of Land O'Lakes. We thank the Department for calling this hearing to address issues of critical importance to the future of both our California dairy producer members and the entire California dairy industry.

Land O'Lakes is a dairy cooperative with 3,000 dairy member-owners. Land O'Lakes has a national membership base whose members are pooled in the California State Program and five different Federal Orders. Land O'Lakes members own and operate several cheese, butter-powder and value-added plants in the Upper Midwest, East and California. Currently our 240 California members supply us with over 16 million pounds of milk per day that are primarily processed at our Tulare and Orland plants.

Updating the Whey Factor of the Class 4b Formula. The current Class 4b formula contains a whey factor sliding scale that caps the contribution of whey at 65 cents per hundredweight, regardless of whey's price in the Western whey markets. This sliding scale drastically differs from the whey factor in calculating the Federal Order Class III minimum price, which is directly comparable to the California Class 4b minimum price. In calculating the Federal Order Class III minimum price the contribution of whey moves directly with the market price of whey with no artificial cap. Thus, whey's market price drives the contribution of whey in calculating the Federal Order Class III minimum price.

For example, the Federal Order Class III minimum price has averaged $17.44 per hundredweight during the eight months since the Department adopted the current sliding scale whey factor. During the same eight months, the California Class 4b price averaged $14.90 per hundredweight. The Federal Order Class III minimum price has exceeded the Class 4b price by an average of $2.54 per hundredweight from 2011 September through April 2012. By contrast, over the same eight month period just one year earlier, September 2010 through April 2011, the difference between the Federal Order Class III minimum price and the 4b price averaged $1.53 per hundredweight. As a result, the gap between the

two minimum prices for milk used in cheese has become too large and is clearly unfair to California's dairy farmers.

Land O'Lakes is a member of the aforementioned Coalition and we fully support the Coalition's petition. Land O'Lakes also supports the proposal included in the petition submitted by Western United Dairymen. The coalition proposal would amend the current 4b formula by including an updated, market-based whey factor that would result in Class 4b prices that meet the statutory requirement of a reasonable and sound economic relationship to the national value of manufactured milk products.

Updating the Whey Factor Will Directly Address Price Alignment. As you know, the California Food and Ag Code Section 62062 states with respect to classified prices, including Class 4b, that "... 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."

In short, the Class 4b price is out of alignment with the Federal Order Class III minimum price. The Federal Order Class III minimum price represents the national value of milk going into cheese and whey manufacturing, which is directly comparable to the California Class 4b price. As a result of this gross misalignment in price, California producers are not being treated fairly when compared to

producers shipping to processors regulated under federal milk marketing orders or when compared to cheese processors who buy milk from handlers who typically pool this producer milk on federal orders. Adopting the Coalition's proposal will help bring the Class 4b price into better alignment with the Federal Order Class III minimum price and significantly reduce this variability.

Market Competition Ensures that Unregulated Cheese Plants in Federal Order Marketing Areas Pay the Federal Order Minimum Class III Price for Milk.

Previous Department hearings have included testimony asserting that unregulated cheese plants outside of California frequently buy milk below the Federal Order Class III minimum price. The testimony may have been referring to milk purchased by unregulated cheese plants in areas like Idaho that are not currently governed by a federal or state milk marketing order.

Since California is a regulated milk market it makes sense to compare California's regulated milk prices with the regulated milk prices in the federal milk marketing order areas. In addition, cheese plants in federal order markets not only must compete with plants in unregulated areas but must also compete with plants in the regulated market of California where Class 4b prices have been significantly lower than the Federal Order Class III minimum

price, particularly in recent years.

I'd like to focus my comments on sales of regulated producer milk to unregulated cheese plants in federal order markets in which the vast majority of milk in the market gets processed into cheese and whey products. While it is accurate that unregulated cheese plants are not required to pay the Federal Order Class III minimum price, in practice these unregulated cheese plants enter into supply agreements that stipulate that the milk price paid will be at or above the Federal Order Class III minimum price.

Land O'Lakes sells milk to cheese plants not regulated under federal orders and also buys milk from cooperatives and non-member producers for use in our own cheese plants located in the Upper Midwest. Land O'Lakes' experience has been that the vast majority of milk sold to unregulated or non-pool cheese plants is contracted at prices at or above the Federal Order Class III minimum price.

It only makes economic sense that the milk sold to unregulated cheese plants by cooperatives, who pool this milk on a federal order, is not priced at levels below the Class III minimum price, since the cooperative must account to the federal order pool for the Class III sales at the Federal Order Class III price. Pricing this milk below the

Federal Order Class III minimum price would end up requiring the cooperative handler to make up the difference between the sale price and the Federal Order Class III minimum price. The milk would be sold at a loss.

As previously noted, Land O'Lakes pools producer milk on several Federal Orders each month. In fact, Land O'Lakes pools producer milk on the Upper Midwest, Central, Northeast, Appalachian and Southeast Federal Milk Orders. Combined, these five orders account for over 70 percent of the 55.9 billion pounds of Class III milk pooled in the entire federal order system during 2011. In the Upper Midwest Federal Order alone, the Class III milk pounds averaged 82 percent of the total pounds pooled in 2011.

Additionally, the price charged for milk sold to unregulated plants has direct consequences on a co-op's ability to pay a competitive price to their producers and thereby successfully retain their current producers and attract new ones. There is no value proposition in selling milk to unregulated cheese plants at a price below the Federal Order Class III minimum price when the co-op handler who sold the milk must account to the federal order pool at the Class III minimum prices. In sum, Land O'Lakes' customers that are unregulated cheese plants will typically buy milk at the current Class III minimum price or higher. Selling below Class III minimum prices would negatively

impact the financial position of Land O'Lakes and weaken Land O'Lakes' competitive position in the procurement of producer milk. Either of these actions doesn't make rational economic sense.

Previous hearings have also included statements about the advantages of depooling or the voluntary choosing by handlers to remove a portion of their milk from a federal milk order pool. Let me offer another perspective on how depooling impacts prices paid to producers.

There has been an assertion that processors who depool milk have an advantage over California processors. But the fact is that Land O'Lakes and other handlers who depool milk must continue to compete for milk supplies. They must remain competitive in their markets to retain their milk supply.

Unregulated cheese plants buying milk from a handler regulated under a Federal Order must still pay the going market value for milk, whether it is pooled or depooled. The going market value is at least the Federal Order Class III minimum price. As stated earlier, unregulated cheese plants typically enter into supply agreements that stipulate that the milk price paid will be at or above the Class III minimum price.

The volume of depooled milk has decreased significantly in recent years, in part resulting from

amendments proposed by processors and cooperatives and adopted by producers in the Upper Midwest, Central and Mideast Federal Orders. These are the three Federal Order markets where the vast majority of depooling has occurred. The amendments limit the volume of milk a handler may pool during most months to 125 percent of the volume of milk pooled in the immediately preceding month. Handlers can still depool milk, but the volume a handler chooses to depool will directly limit the volume that the handler can pool in the following month.

Keep in mind that handlers can also choose to depool milk used in Class II and IV products as well as milk used in Class III products. This is especially important to note since the Class IV minimum price has exceeded the Class III minimum price in 75 percent of the months during the two year period January 2010 through December 2012. The higher priced Class IV has provided an incentive for handlers of Class IV milk to depool their Class IV milk in 18 of the 24 months. That should actually read January 2010 through December 2011.

Financial Conditions on California Dairy Farms Since Adoption of the Fixed Whey Factor.

California dairy farms have gone through very trying financial times since December 2007 when the Department first implemented the 25 cent whey factor. To

briefly recount, in 2008 income over feed dropped 32 percent from 2007 levels, and in 2009 margins over feed dropped to a catastrophically low level of $2.74 per hundredweight, representing a decrease of 73 percent from 2007 levels.

The financial train wreck of 2009 left many California dairy farmers with severely reduced equity, mounting debt and tightening credit lines. Margins in 2010 rose back to profitable levels for most but didn't come close to repairing the financial damage inflicted in 2009. We understand that cow and facility values on some California dairies improved but we contend that overall the equity position of California's dairy farmers has still not even come close to a full recovery from 2009. This weakened equity position makes them much more financially vulnerable in the event that we encounter another period of catastrophically low margins like 2009. Margin projections for the remainder of 2012 do not look promising for California's dairy farmers.

Feed costs for California dairy farmers rose dramatically in 2011. Using data from the Department's Cost of Production Survey revealed that total feed costs rose to $11.11 per hundredweight in the final quarter of 2011, the highest feed cost during the five year period 2007 through 2011.

Total feed costs for California's dairy farmers

increased by $2.41, an increase of 28 percent in the 12 months from the final quarter of 2010 to the final quarter of 2011. Hay and grain mix prices drove this escalation in feed costs. Hay prices increased by $104 per ton, an increase of 59 percent, and grain mix prices rose $51 per ton, also an increase of 59 percent over the same period. Accordingly, feed costs as a percentage of total milk production costs rose from 58.7 in Q4 2010 to 65.3 percent in Q4 2011.

Currently, margins have been squeezed to very low levels, due in large part to the collapse of farm milk prices. The California overbase dripped from $19.54 in July 2011 to $14.10 in April 2012, the lowest overbase price since December 2010. This precipitous drop of $5.44 in just nine months has resulted in negative margins on many California dairy farms. This price collapse also highlights another challenge facing California dairy farms, price volatility.

According to the financial -- excuse me. Adding to the financial stress at the farm level is the fact that because of the structure of the 4b factor, California dairy farmers have one less tool to utilize to protect themselves from the negative impacts of volatile milk prices. More specifically, the whey factor has severely hindered a California dairy farmer's ability to make effective use of

the Class III futures market to hedge their milk price. The variability of the basis between the California 4b and Federal Order Class III minimum price renders the Class III futures ineffective in protecting the milk price for California dairy farmers.

For example, the Class III futures contract offered by the Chicago Merc is the most heavily used of the dairy product futures contracts. As noted earlier, the Class 4b price and the Federal Order Class III minimum price differed by an average of $1.56 per hundredweight from January through April 2011. This difference, the basis, drastically reduces the risk that a California dairy farmer takes on when entering a Class III futures contract to hedge their milk. Price movements in the Class III futures market may not be offset on a one-to-one basis in the cash 4b market, primarily due to the difference in whey value between the two regulated minimum prices.

In fact, the size of the basis can be quite volatile, even from one month to the next, due to the stark differences between whey values in each of the formulas. For example, the Class 4b price (sic), Class 4b minus Federal Order Class III -- excuse me, the Class 4b basis -- in February 2011 was -8 cents; in March 2011 the Class 4b basis had expanded to -$2.64; and by December 2011 the basis ballooned to -$3.63. The gross difference between the Class

III futures price and the 4b cash price has widened and displayed a high level of volatility, effectively preventing California dairy farmers from making use of Class III futures as a hedging tool.

Some California dairy producers have become so discouraged by this variable basis that it has driven them away from using any kind of milk price protection at a time when they need to develop and execute a risk management strategy, now more than ever before due to the unprecedented level of milk price volatility.

Land O'Lakes' California producers significantly reduced the use of their Class III futures in 2011. Forty-two percent less producer milk has been hedged with Class III futures in 2011 compared to 2010. This corresponds with the period of time when the basis expanded to $3.63 in December 2011. In fact, since the June 2011 hearing, the 4b-Class III basis has averaged $2.38 per hundredweight. By contrast, Land O'Lakes' milk producers in the Upper Midwest region expanded their use of Class III futures by 30 percent in 2011 compared to 2010 volumes.

Further, cheese processors who made use of the Class III before the misalignment of 4b and Class III can easily avoid this basis risk by utilizing the Chicago Merc's cheese futures contract, which tracks their end product prices much more closely than the Class III futures. Since

mid-2010, California's cheese processors can offset this basis risk by using the cheese futures. By comparison, California's milk producers find themselves operating in a very volatile milk price environment with one less hedging tool to use to offset milk price variability.

On the feed side -- I'm going to move on this part and go on to the small cheese plant discussion.

All California cheese plants, large and small, benefited from the fixed whey factor adopted by the Department in 2007. From 2007 through 2011 August, the 25 cent fixed factor has benefited cheese plants. By limiting the financial exposure to a maximum cost of 25 cents for a product with the potential for capturing far more than that value in the market, the 25 cent fixed factor provided a huge financial incentive and a golden opportunity for small cheese makers to develop a whey business.

The monthly Western dry whey price series used by the Department in the whey portion of the Class 4b formula has continued to show significant market strength since September 2011. Of the eight months since September 2011 through April 2012, whey markets have traded at levels of 60 cents or greater 75 percent of the time.

This is why market strength stands in stark contrast to the comments in the Hearing Panel Report regarding the public hearing held June 30 and July 1, 2011

in which the Panel stated, quote: "It is more likely for dry whey commodity prices to fluctuate within the ranges of 20 cents to 60 cents based on past experience." Clearly, this has not been the case since September 2011. If the Department adopted the whey factor sliding scale with the intent of having the whey values in the Class 4b formula to be market driven, the performance of the sliding scale has fallen far short of that intent as whey value in the 4b formula has been artificially capped at 65 cents in most of these months.

Further, it's important to note that the current whey factor sliding scale caps the contribution of whey to the 4b price at 65 cents whenever the monthly average of the Western dry whey price equals or exceeds 60 cents per pound. Thus, the sustained strength in the whey market has provided California cheese processors, both large and small, a financial benefit from marketing their whey. Even with the adoption of the whey factor sliding scale, California cheese processors have continued to have a generous market incentive to market their whey and develop their whey business.

We are very curious to know how small cheese processors handle their whey and if they have explored ways to take advantage of the rising values in the whey market. We would be interested in hearing how small cheese

processors manage to compete for milk supplies if they have no outlet for their whey.

Since 2007, Land O'Lakes has had firsthand experience with the issue of a small cheese plant finding an outlet for whey processing. Initially our Orland cheese plant had been condensing and trucking the whey to our Tulare plant for further processing. This ended in 2010 when we chose to idle our cheese and whey processing facility in Tulare. Currently, we continue to condense Orland's whey into whey protein concentrate and established a new business relationship with a cheese manufacturer in California for further processing. We don't capture the full value of the lactose in the permeate, which is sold to area dairy farmers, but we have found an outlet for our condensed whey.

After looking at the potentially huge windfall profits that the large California cheese makers that process whey have been granted by the whey factor, it would be interesting to hear how their whey enterprises have performed since December 2007 and to compare and contrast their California cheese plants' financial performance to the financial performance of their cheese plants that they operate in federal order markets. It would be instructive to know how their whey enterprises have performed since the adoption of the whey factor sliding scale in September 2011.

On the surface it appears that California's cheese plants, large cheese plants, have had a significant advantage over cheese plants operating in Federal Order markets because of the fixed whey factor.

Industry's Role in Balancing California's Milk Supply. The market conditions of the past few months have led to a huge surge in milk production in California and the entire US. Land O'Lakes' California producers have experienced this increase in milk production as well due to the mild winter leading to the ideal milk producing condition on the dairies. Earlier this year Land O'Lakes took corrective steps to manage our own milk supply in California to better balance milk supply and demand.

We are confident that we have the programs in place to continue to manage the milk supply in California and to do our part in matching milk supply with plant capacity and market demand. We understand other cooperatives and one cheese processor have also taken steps.

The spring of 2012 represents the second data point, along with the period in 2007-08 when cooperatives and one cheese processor took steps to balance the state milk supply. Providing evidence that the California dairy industry has the tools and the programs to manage milk supply with plant capacity and market demand.

Impact of Class 4b Price on Cheese Processing

Capacity. Testimony presented at previous Department hearings has suggested that any actions that raise the Class 4b price would negatively impact or devastate future plant investments in California. The recent record of cheese plant investments inside and outside of California strongly suggest that the Class 4b price, and more generally, farm level milk prices, may not be as critical a factor when processors consider investing in new or expanded plants as we may have been led to believe. I have assembled two tables that shed light on this issue.

Appendix Table 1 lists the publicly announced expansions or proposed new constructions of cheese plants in states outside of California from December 2007 to present. Appendix Table 2 lists the four year average of the USDA's All Milk price for each of the ten states that have had plant expansions announced.

Recent history in California speaks for itself. Since December 2007 there has been one cheese plant expansion, Leprino's expansion of the Lemoore facility, and no cheese plants constructed -- and no new cheese plants constructed. During this four-year period 2008 to 2011, California's all milk price averaged $15.39 per hundredweight. California's all milk price was lower than the all milk price of each of the ten states that have had new plant capacity announced.

Collectively, the ten states listed have had roughly 45.2 million pounds of daily raw milk receiving capacity announced over the same period. All ten states had a higher average all milk price than California over the four year period. Wisconsin alone has seen over seven million pounds of raw milk receiving capacity being planned to be added despite an all milk price that averaged $1.74 per hundredweight higher than California's.

Clearly there are limits to what a low milk price can do to attract new cheese plant investment. The recent record of cheese plant investments seem to suggest that a low milk price does little to attract cheese plant investment. Perhaps the Department needs to consider other factors that may attract investment in cheese plants and take into consideration the financial sustainability of California's dairy farmers when hearing concerns about the level of the 4b price and its impact on future plant investments.

Our position on the Farmdale proposal: We oppose the Farmdale alternative proposal.

In conclusion, we thank the Secretary for calling this hearing. We thank the panel for your considerations and Land O'Lakes would like to request the opportunity to file a post-hearing brief.

HEARING OFFICER ROWDEN: Your request for a post-

hearing brief is accepted. Any questions from the panel?

MR. EASTMAN: I have a few questions for you regarding some of the comments you made regarding milk that is non-pooled in federal orders. When it comes to -- we know based on anecdotal evidence that -- and this has been presented at hearings in the past -- that Dairy Market News will oftentimes relate certain times of the year where milk is sold below class prices at a discount.

And so how in your experience, although you state that there's not a financial incentive there, somebody has to pay ultimately. Someone has to pay, especially if it's a co-op or handler; someone has to eat that cost. But it seems that it happens occasionally. How exactly are you aware of how that works in certain times in the Upper Midwest, whether it be during the spring flush. Is Land O'Lakes -- how do they handle that situation where milk is on at a discounted price, say?

MR. WEGNER: I recall conversations like this with you about a year ago, Hyrum. The same story applies. We will sometimes offer milk at a discount in order to have the milk sold and processed. We still are obligated under the federal order to pay that minimum price. So there is milk that is moved. Distress loads have been moved. Certainly a spring like this there's even distress loads that have moved. But the obligation to the pool remains.

MR. EASTMAN: Right. So in essence then, so as a co-op would that -- would that loss just be blended down to its members, so to speak? Is that -- or how would --

MR. WEGNER: Not so to speak, it would be a cost to the cooperative, absolutely.

MR. EASTMAN: There has been testimony earlier today that stated that when it comes to cheese production most -- most cheese processing is happening with proprietary plants. And that producer cooperatives over the last decade or so have gotten out of cheese. Would you like to respond to that? I know that Land O'Lakes had two plants until a few years ago, one in Tulare and one that still operates in Orland, and a decision was made not to produce cheese in Tulare.

MR. WEGNER: Um-hmm.

MR. EASTMAN: Is there some comment that you could make about why that plant was closed in light that California has, say, lower cheese milk prices than other parts of the nation. Were there other factors that contributed to that or?

MR. WEGNER: Yeah. I would say that the condition of the plant contributed to it. It's an idled plant at this point. When you asked the question about cooperatives getting out of cheese did you mean in California? Did you mean nationally?

MR. EASTMAN: Yes, exactly.

MR. WEGNER: I wouldn't say that from a Land O'Lakes perspective we're necessarily getting out of cheese. We've idled the plant and we're looking for other opportunity at this point. I wouldn't put a blanket statement on that like that cooperatives are getting out of cheese for Land O'Lakes nor generally for the other cooperatives in the room. They can speak for themselves regarding cheese.

MR. EASTMAN: So one question I have is oftentimes in order to wrap our minds around the differences between Class III prices and the 4b price revolves this whole issue of non-pooled milk. Are you aware of any data sets or any information that would show quantities or prices of discounted milk to get a sense of what percentage that would be and at what sort of discount? Are you aware of any data out there that would help in that regards?

MR. WEGNER: Excuse me, that's two different issues. Just to make sure I understand you. There's distressed milk, we talked about that already, and then there's depooled milk. I know that there's an attempt to estimate the amount of depooled milk. You had that in your exhibit. I don't know of any source other than Dairy Market News' occasional commentary about distress loads of milk. In terms of the price. Even less information that's

publicly available.

MR. EASTMAN: That's sort of what I thought. Appreciate that.

MS. GATES: Mr. Wegner, could you expand a little bit on the base program that Land O'Lakes has in place. It's one of the most aggressive ones that we have, you know, heard of and seen, with 17 producers that -- dairies that have gone out. And if I understand correctly, that goes off June 1st. And how do you see that moving forward? Is that going to correct the problem that you have with your facility or do you look at that moving forward continuing?

MR. WEGNER: A couple of notes I'd like to make. You're right that this spring Land O'Lakes has made, using your term, an aggressive base program action. It has taken care of the immediate problem for us at our Tulare facility. It will continue to be in place, it does not go away on June 1 and I think that we are going to continue to look over at the -- look over the balancing of the milk supply with the demand. And that we are going to involve our producers in that discussion and continue to make decisions about that as we go forward.

MS. GATES: Thank you.

MR. WEGNER: Does that answer most of your question?

MS. GATES: It does, thank you.

MR. WEGNER: Okay.

MS. RANKIN: I have a question. Are your plants in other, other states outside of California, faced with the same capacity issues as California? For instance, your base program being implemented here.

MR. WEGNER: Just to make sure I understand your question. Are other plants in the Land O'Lakes system, what was the last part of it, I'm sorry?

MS. RANKIN: Facing any capacity issues.

MR. WEGNER: Not to the extent that we're facing them in Tulare.

MS. RANKIN: I was also going to ask you about -- you mentioned a little bit about hedging using Class III.

MR. WEGNER: Um-hmm.

MS. RANKIN: And you gave a fairly specific number saying 42 percent less producer milk has been hedged using Class III. Is Land O'Lakes involved in hedging, like in terms of being involved with producers hedging?

MR. WEGNER: And that specifically was with Land O'Lakes' assistance that we do that. The other thing I'd mention is that certainly options have become more of what producers will use. Options are typically more expensive for the dairymen than the Class III futures has been. But yes, that specifically notes the programs that Land O'Lakes offers the producers. We don't have complete knowledge of

what individual producers do on their own.

MS. RANKIN: And it was stated earlier that Class III continues to be what producers kind of favor in terms of futures contracts. Is that?

MR. WEGNER: I don't think that's true in California at this point. I think in the rest of the country where the Class III futures reflect and track directly with the Class III price it does. Not here anymore because of that basis widening so much.

MS. RANKIN: All right. But would you say that that's what producers typically use when they're hedging?

MR. WEGNER: Well, again, in the past there was more correspondence, more correlation, they moved together. I don't think that's the future at this point. So I think it would be preferred but it's not available because of that wide basis. You can't predict it. Don't move in lock step.

MS. RANKIN: I think my final question, on page six of your testimony you speak to the current whey factor. And you mention that it's been at the top of the sliding scale for most of the time that it has been implemented. In your opinion do you see whey staying at the top of that scale?

MR. WEGNER: Of the current scale?

MS. RANKIN: Correct.

MR. WEGNER: It depends. What I mean by that -- I

am not trying to be too cavalier -- is that certainly the export demand is a big part of that with nearly 50 percent of it going out of the country. So I guess we'll see. Frankly, a year ago I didn't expect it to go that high. So take this for what it's worth. I think it will retain strength because of the dwindling supply of actually Plain Jane whey being produced, from my understanding, and I think the demand will hang in there. So I think we're in for another sustained strength, at least for the next six months or so.

MS. RANKIN: That's all I have.

HEARING OFFICER ROWDEN: All right, thank you very much.

MR. WEGNER: Thank you.

HEARING OFFICER ROWDEN: We are going to be taking a five minute break. Afterwards we will be taking the three minute testimony so we'll be collecting the names of those who will be testifying. So we'll reconvene back here at 3:05.

(Off the record at 3:00 p.m.)

(On the record at 3:09 p.m.)

HEARING OFFICER ROWDEN: Please take your seats. Our first witness is Tom Barcellos. Let's see if everybody will listen to you, Mr. Barcellos, and not me.

MR. BARCELLOS: You guys want to sit down, please.

HEARING OFFICER ROWDEN: Thank you.

MR. BARCELLOS: Please take a seat.

I've got three minutes?

HEARING OFFICER ROWDEN: Hold on.

Please, one more time, take your seats.

Okay. Please state your full name, spell your last name and state your affiliation for the record.

MR. BARCELLOS: My name is Tom Barcellos, B-A-R-C-E-L-L-O-S. I own and operate T-Bar Dairy in Porterville.

Whereupon,

TOM BARCELLOS

Was duly sworn.

HEARING OFFICER ROWDEN: Please, go ahead.

MR. BARCELLOS: Mr. Hearing Officer, thank you for this opportunity to speak, and the Hearing Panel, Director Masuhara. I'm a third generation dairy producer on a facility built by my grandfather in 1940.

We milk 800 cows and our herd numbers do not fluctuate. We were talking about milk production per cow and number of cows in recent times. The last real herd production controls and herd cow kill program we had was in the summer of 2006. And that was with 105 to 110 degree temperatures where cows were dying and milk production was just being devastated. At that time the plants were screaming for milk because there was no milk to be had

because cows do not like that kind of weather.

The last 20 months we have had perfect cow weather. when we have weather like we have had the last 20 months the cows breed on time, they continue to give milk up until the time they dry for their dry period before they calf again. Therefore you have that milk per cow production going up. You have more calves. The cows do not have any stress, therefore they stay in the herd longer. When they stay in the herd longer your cow numbers go up. So therefore in the last 20 months you have seen that increase in milk per cow and herd numbers.

The scenario that plays out is a producer has a 100 cow pen. In the wintertime when things get really bad for cow comfort you kind of cut it back to 95 cows. In ideal weather conditions you can put 105 in there, therefore you have that little bit of flexibility. In the last 20 months I think everybody has had 105 cows in those pens because their herds were good.

And the next cow kill that we're having is currently today and that's an economic cow kill. Because people are going out of business because they can't pay their bills.

The situation that is going to occur is we don't have to deal with the whey factor because there's not going to be any milk to produce to have to deal with the whey.

That being said, we need to move quickly. I support the Western United and the Coalition petitions and hopefully we can get the situation straightened out on the California dairy industry. I thank you.

HEARING OFFICER ROWDEN: Questions?

Thank you very much. John Galley -- Gailey.

MR. GAILEY: It's John Gailey. My last name is spelled G-A-I-L-E-Y. I manage a dairy, Milky Way Dairy in Visalia, California. We milk about 4,000 cows there.

Whereupon,

JOHN GAILEY

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MR. GAILEY: I wanted to just start out by answering some of your questions that you had earlier that I didn't feel were answered completely about why we have the increase in cows and in production. Some of them have been addressed a little bit here by Tom and by some of the other speakers.

But about six years ago we have had a new technology coming out in breeding with sex semen and that's become very pervasive throughout the industry. It was -- we're able to breed a cow using semen that only produces female offspring. So instead of having 50 percent bulls and 50 percent heifers we can now come close to having 90

percent or better heifers. That's been used more and more in the industry, especially when times were good and our cows, animals were more expensive. A lot of people started using it.

As one of the dairy producers mentioned earlier, it's a two year and nine month time frame from the time you make a decision on what to breed a cow to or to breed a cow, to when you actually have an animal in production.

For us to slow down our production of new animals takes two years and nine months. For us to try to respond to market conditions based on the milk price, we don't know what the milk price is going to be two years and nine months from now. So I just wanted to clarify that. That back in 2005, 2006, 2007, we were producing a lot of replacement animals and those animals are now all in the pipeline. And there's no stopping them, they are coming into the pipeline.

Now another thing has happened. Because there are so many replacement animals the values of those cattle have dropped supply and demand. This has caused our banks to lower our cattle values and put a lot of people into default positions on their borrowing basis that the banks have. So that's another factor that's happened because of this over-supply of animals.

But you would think that, you know, we had a drop in the milk price, people should not milk as many cows.

Well, when you have all these cows coming fresh you have no choice but to either milk them or sell them. And if you want to sell them for a bottom of the barrel price at a sales yard because there's too many, or you have an option to milk them -- like he said, you either milk with 95 cows in your pen or 105 cows. It seems like not a big increase but it's ten percent. So if you have ten percent more cows because you have the animals anyway, it's a no-brainer. If you have the room you're going to milk her. And that was one of my points.

A lot of these cheese plants -- moving on to another point here. They talk about how there's no new cheese plants being built in California. But if you look on that list that was submitted to you in Appendix Table 1 from Land O'Lakes you'll notice two of the largest cheese plants that were built here in the United States recently are from California, basically California dollars going out of state. They are taking the dollars that are coming out of our milk checks and they're building, you know, giant new, brand new, efficient plants in other states, Hilmar in Texas and I believe Leprino in Colorado. If you want to follow the money that's, you know, you can see where our money is going.

Other than that I think a lot of the items have been addressed pretty well. That's all I have to say.

HEARING OFFICER ROWDEN: Questions?

Thank you very much.

John Moons. Please state your full name, spell your last name and state your affiliation.

MR. MOONS: My name is John Moons and I am a -- that's M-O-O-N-S. I'm a dairymen from Visalia, California. I'm on the Board of Directors of CDI. I'm also a member of the Coalition, the representative on this coalition. A few things I'm going to point out is --

HEARING OFFICER ROWDEN: One second. First of all, are you representing CDI or just yourself?

MR. MOONS: Just myself.

HEARING OFFICER ROWDEN: Okay.

Whereupon,

JOHN MOONS

Was duly sworn.

HEARING OFFICER ROWDEN: Okay. Proceed.

MR. MOONS: Thanks. A point made earlier on the futures hedging. I, myself as a dairyman, use the commodity markets to hedge my milk. And being 40 percent of the milk price in California is cheese milk. I try to -- when I am hedging 100 percent of my milk in milk production I do hedge 40 percent of that on the Class III market. And to be able to do that I look at the difference in that whey value. And with the Federal Order price is and the discrepancy in that

it makes me -- it makes it difficult, more difficult to try to tie that to my business model. And so just to answer that issue earlier that was discussed today.

The second one was on the Federal Order versus the California Milk Marketing Order here in the state. I have always thought that the California state order is more responsive to the dairymen and the industry here in California. However, with this whey issue it hasn't seemed to be equitable. I think that's the overriding theme here, is whether it's equitable to what's out there in the marketplace in the national orders, the federal orders.

Four years ago when the Class I price was out of whack with the adjoining states the Department was pretty quick to take a dollar away from the California milk producers' check and make it equitable to the states around it. And I'm not an economist, I don't have the numbers in front of me so I have no data with me, but you probably as a Department know what situation I'm talking about three or four years ago. And so in that same sense I would expect the Department to act equitably in, you know, adjusting our milk prices to what's out there in the federal markets.

And then thirdly I'd like to show appreciation and thanks to all the fellow milk producers that are here in the room that came to support us in our endeavor to act unified in our stance on supporting both the Coalition and Western

United positions. And that's all I have to say.

HEARING OFFICER ROWDEN: Questions?

Thank you very much.

MR. MOONS: Thank you.

HEARING OFFICER ROWDEN: Kevin Ornellas. Please state your full name, spell your last name and state your affiliation.

MR. ORNELLAS: My name is Kevin Ornellas, O-R-N-E-L-L-A-S. I'm with Ornellas Dairy.

Whereupon,

KEVIN ORNELLAS

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MR. ORNELLAS: First of all I want to thank you for this opportunity. I'm a fourth generation dairy farmer from Tracy, California. We have been dairying in Tracy for 75 years. We ship to DFA and our milk goes to Leprino Cheese, the Tracy plant. We have two dairies and we farm over 600 acres. We have 12 full-time employees. Me personally, I have been working on the dairy for 30 years.

Our operation has been through drastic changes over the last three years. The highs and the lows, much more lows than highs, have put us in situations that we have never experienced.

We have looked at cutting feed prices. We have

cut our hay, we have cut our grain. We are now growing 100 percent of our forages. We actually went out and doubled our farm size to supply both dairies with 100 percent hay needs. We went out and bought trucks to pick up reject fruits and vegetables to feed our cows. We have done everything that we can to lower our feed costs and still we're in a negative cash flow.

As of November my milk price was 19.79, today we were at 13.79. Everything we've done -- my feed bill from November to today is up $20,000, just my grain bill. We understand that all the cuts the dairies have made over the last three years, there's no more cuts to make; we're done. There's nothing we can do. We're running on negative cash flow. 2009 hurt us. And we are asking to help us. Not help us, we can do it ourselves. We need to get paid fairly. If these plants are selling their products in other states or they are paying for their products in other states they'd be paying more money.

I'd like to say that three years ago if you asked me what I do I would have said, I'm a dairyman. Today if you ask me what I do for a living I'm going to tell you I'm a dairyman, I'm a farmer, I'm a veterinarian, I'm a nutritionist, I'm truck driver, I'm an accountant, I'm a futures analyst, I am a local cornbelt world weatherman, I'm a politician, an environmentalist, a China economist and a

world economist. And if this doesn't change I may say I'm unemployed. And that's all I've got to say. Thank you.

HEARING OFFICER ROWDEN: Questions?

Thank you very much.

Jeff Wilbur, please. Please state your full name, spell your last name and state your affiliation.

MR. WILBUR: Thank you. Jeff Wilbur, W-I-L-B-U-R, dairy producer from Tulare, California.

Whereupon,

JEFF WILBUR

Was duly sworn.

MR. WILBUR: I'd like to thank you for the opportunity to be here today and to listen to our industry. My wife and I have Rio Blanco Dairy in Tulare, California. Our family has been there since about 1900. Our daughters represent the fifth generation on the farm and I am here representing our history of our family and our neighboring dairymen.

Our family and our fellow dairymen are simply interested in a fair market value for their product. Like the last speaker, we are not asking for an entitlement, just a fair shot with a fair price.

I'd like to ask you to require the processors to pay what the product is worth for the whey component of our milk. This would be accomplished by adopting the petition

as submitted by the Coalition and Western United Dairymen. If the product is not worth much then that's what we're going to get paid. But if the product is worth a fair value that's what we'd like to have represented in our milk check in our business, a fair value.

I would also like to speak on the element of hedging. On a weekly level, a weekly basis we review our positions as they relate to the markets in the futures market on a margin basis. And our broker often has a suggestion for positions as their model dairy, which is based in the Midwest. And so often there is an incentive to have a hedge position that's far greater than that that represents our dairy business in California and it generally comes back to the disparity in the basis for the milk that we produce.

Even at the elevated prices for the fall in the second -- I'm sorry, the third and fourth quarters, the margins are hardly break-even to about a ten cent margin. And that's just on a cash basis for the business. And I will say that's with fairly aggressive production estimates and a fair amount of homegrown feed.

I think we are doing all we can to produce an efficient and safe product but the margins just aren't there to compete. And that number I gave you of a small margin does not have any ROI or return to operator or depreciation

costs so it's just really day-to-day operating costs.

And I will say we use the California state study numbers. We participate in that and we're very competitive in those numbers. So I think as far as representing the industry, we're doing our best to compete and really don't show a solid value. So a fair return for the whey value is deeply desired.

So as a family and as an industry in our area we deeply support the proposals as presented today and urge you to implement those whey value -- whey values for our -- for our dairy operations in fairness to the families of California.

I will say there has been a lot of discussion about the number of dairies leaving the industry and I fully concur that that's the case. I don't think there are many bankers that have new loan requests or dairymen that are looking to build dairies. In fact, from my question and answer with those people there are none so I think that is also writing on the wall for the direction of this industry at the moment.

So again, fairness for our product is appreciated and we thank you for the opportunity to be here today.

HEARING OFFICER ROWDEN: Questions?

Thank you very much.

Tony Machado. Please state your full name, spell

your last name and state your affiliation.

MR. MACHADO: My name is Tony Machado, M-A-C-H-A-D-O and I own Couco Creek Dairy in Turlock, California. And I approximately milk 3,000 cows.

Whereupon,

TONY MACHADO

Was duly sworn.

HEARING OFFICER ROWDEN: Please.

MR. MACHADO: Right now our costs to maintain our herd, it's costing around $10 a hundredweight. That is to feed the heifers, the cows and everything. And with fixed costs you've got approximately another $4 or so. And at $12 milk we cannot exist.

In the last few months we have had approximately four dairies within three miles of me gone broke. And it's just going all around. They can't make it. And the people that are buying them are cheese makers. They own plants in our area and they're taking the money from the cheese to buy the existing facilities' property. So that tells you that there's a lot of money being made on whey and we're not competing in a fair market. That's all I've got to say.

HEARING OFFICER ROWDEN: Questions?

Thank you very much.

MR. MACHADO: Thank you.

HEARING OFFICER ROWDEN: Is anybody near that back

table to see if there is anybody else signed up?

MS. DAPPER: No more.

HEARING OFFICER ROWDEN: No more? All right. Okay, we'll continue on with the regular testimony. The next one up is Jonathan Kennedy. Please state your full name, spell your last name and state your affiliation for the record.

MR. KENNEDY: My name is Jonathan Kennedy. My last name is spelled K-E-N-N-E-D-Y. And I'm with Farm Credit West out of Tulare, California.

Whereupon,

JONATHAN KENNEDY

Was duly sworn.

HEARING OFFICER ROWDEN: And the exhibit that he has given me is Exhibit 56. Please.

(Exhibit 56 was received into evidence.)

MR. KENNEDY: Mr. Hearing Officer and members of the Panel, my name is Jonathan Kennedy and I am a Senior Vice President and Branch Manager of the Tulare Dairy Center of Farm Credit West. Thank you for allowing me to speak today.

Farm Credit West has been financing the dairy industry in California for the past 95 years and currently has over $1.1 in outstanding loans to California dairymen. I have been a lender with Farm Credit West for the past 23

years in the Southern San Joaquin Valley. I was asked by some of the dairy operators that we finance to discuss the financial health of the dairy farmer from the view of the lender.

I ask that the panel review the current pricing formula and make adjustments to ensure that California dairy producers are fairly compensated for their milk and that there's parity in the formula so that both the dairymen and the processors have the opportunity to earn a reasonable return on their investment. The dairy farmer needs processors and outlets for their product as much as the processor needs a reliable supply from dairy farmers. The dairy industry in California will only be as strong as the weakest segment, and the dairy farmer today is not very strong financially.

In reviewing USDA's Economic Research Service monthly and annual milk production costs and returns, the 2011 statistics reflect California having the lowest milk price and the second-highest feed cost in the nation, with by far the lowest milk income over feed cost margin in the nation. California producers are at a disadvantage compared to the operations in the other states as they are getting less for their milk and having to pay more to produce it. A copy of the report is attached for your review as Exhibit A. These statistics support he inequality between what dairies

are receiving for their milk in California compared to those in the Federal Order.

As a result of the severe downturn in milk prices that started in 2008 and into 2009 coupled with high feed prices, dairies in the San Joaquin Valley region lost $962 a cow in 2009. And that's according to the statistics in the Dairy Farm Operating Trends, December 31, 2011, published by Frazer, LLP, which is an accounting firm that has prepared financial statements for dairy producers for many years and prints summary financial information sourced from its clientele. A copy has been attached for your review as Exhibit B. The numbers represented in their reports mirror the results seen in dairy operations financed by Farm Credit West. The recovery in 2010 and 2011 has only partially recovered what was lost in the last downturn and we are entering another year of losses in 2012 if current pricing trends continue the remainder of the year.

In addition to the operating losses, dairy operations have experienced a decline in market value of their livestock and the dairy facilities. Dairy cows and replacements decreased from an average price of $1,760 a hear in 2007 to $1,200 a head in 2009. In addition, there has been a significant decline in the value of dairy facilities in the past three years with declines in excess of 50 percent in some instances.

Although I am unable to share specific credit quality statistics at Farm Credit West for the dairy portfolio, I will state that there has been a material decline in the credit quality of the portfolio due to the 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. The operations that expanded with debt and purchased dairy facilities and cattle at he peak high values sustained the worse losses as they suffered operating losses as well as losses to the value of their livestock and facilities. As a lender in the agricultural industry, I don't recall any bankruptcy filings in the valley for dairy operations in the 20 years leading up to 2009. I don't have the statistics but I know there have been numerous filings over the past three years in this region and there will most likely be more as the industry is facing a challenging year in 2012 with the significant drop in milk price compared to last year without any material reduction in feed expenses causing most operations to be operating at a loss today.

Due to the extreme volatility in milk prices and the level of losses incurred by the majority of dairy farmers in 2009, lenders must factor in the chance of periodic losses when evaluating dairy operations. Although

current milk prices have not reached the lows of 2009, feed prices are higher than 2009, resulting in higher break-even price, with most operations currently losing money. Due to the volatility of both milk prices received and cost of feed, the level of risk has increased to the dairy operations and the lenders that finance them. As a result, operations that are well-managed and have low debt levels and adequate levels of liquidity to survive the 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, they also have to 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. These additional borrowings are coming at a time of historically low interest rates. Should rates increase in the near term and milk prices stagnate, dairy operations face the additional burden of higher interest costs.

At Farm Credit West we see many existing successful operators are not expanding their California operations or building new facilities. Instead they are looking at moving or growing out-of-state, or converting their assets, land based alternative uses, or exploring an exit of the business altogether. Some of those well-managed and well-capitalized operations previously mentioned are questioning the future of dairying in California. The

significant inequality in returns for California producers, partially due to the state's pricing structure, threatens the survival of many operations over the short term. Should current economic condition persist over the longer time horizon, those operations that remain will upgrade and expand their facilities to a lesser extent, thus threatening the overall milk supply available to processors, subsequently impacting their returns over the long term as well.

And that is the conclusion of my verbal testimony and I request permission to have the option to submit a post-hearing brief.

HEARING OFFICER ROWDEN: That request is granted. Panel, any questions?

MS. GATES: I just have one question.

MR. KENNEDY: Yes.

MS. GATES: The percentage of dairy loans, you know, at Farm Credit West over this last year. Are you financing less? Do you have a percentage? You know, I can tell by the testimony that it is but do you have any numbers with that? You know, comparing 2009 or --

MR. KENNEDY: I mean as far as numbers that have gone, there's some very critically hanging on. In 2000 and 2011 operations were exhibiting some recovery. Where they're at now, trade creditors don't want to extend credit.

The banks have to limit on how much credit they can extend. Even the neighboring farmer doesn't want to extend credit to deliver feed so you are in a situation. There's some operations that are very close to reaching the end, in my opinion, as far as I have knowledge of.

I am also receiving applications from operators that their existing lender has expressed that they want to exit the relationship and some of those we're taking a look at. And some of those, if they're already over-extended in some cases there's not much we can do, especially going into a downturn that we're facing now, to take on more risk.

So it's -- a good portion of the portfolio is in distress. I know other banking institutions have the same -- that are financing the dairy industry are in the same situation. Dairy farmers today, I think just probably only just a handful that I could name on one hand that are actively financing the dairy industry in California today. Down from numerous options 20 years ago.

MS. GATES: Thank you.

MR. EASTMAN: I have a couple of questions. Just for the record, does Farm Credit West have any business outside of California? Do you have other offices in the West?

MR. KENNEDY: Farm Credit West, our regional territory is just in California. We do have some operations

that have expanded operations that we followed out-of-state in some cases. We also, in terms of operations today, any of those that are looking at expansion has been looking at out-of-state as far as doing other things. Those are somewhat limited because California equities are depleted and, you know, for the most part they do have equity. From the bank's point of view we're saying, you better preserve it for the next downturn.

MR. EASTMAN: In addition to the conditions that you state in your testimony has Farm Credit West been affected in the last few years due to the financial sector? A few years ago there was a macroeconomic recession in the United States that affected the financial sector. Was Farm Credit West affected at all?

MR. KENNEDY: No, not by those same circumstances. The farm credit system as a whole came through, the agricultural sector in general through that recession, did very well. With the weak dollar and the exports agriculture has been one of the high spots, you know, in terms of the last three years. Dairy has been impacted the worst of some of the operations. Really I think dairy and probably, you know, some of the wineries have been impacted in terms of the economic downturn. Some of the other operations, when you look at the grains and nuts and all those types of crops, are doing extremely well.

And that also kind of adds more competition for California dairymen. Competition from urban plannings. Land values are being pushed up sky high. So even if the dairyman wants to try to expand their farming operation to reduce feed costs today it really doesn't pencil, it's not a viable solution to go pay $15-20,000 an acre to cheapen up your feed ration. So right now it's at a level of there are some restrictions to growing here in California today as a producer.

MR. EASTMAN: All right, thank you.

HEARING OFFICER ROWDEN: Thank you very much.

MR. KENNEDY: Thank you.

HEARING OFFICER ROWDEN: William Schiek. Please state your full name, spell your last name and state what -- state your affiliation.

DR. SCHIEK: It's William Schiek, that's S-C-H-I-E-K; I am Economist for Dairy Institute of California.

Whereupon,

WILLIAM SCHIEK

Was duly sworn.

HEARING OFFICER ROWDEN: And his testimony is Exhibit 57.

(Exhibit 57 was received into evidence.)

HEARING OFFICER ROWDEN: Please.

DR. SCHIEK: Okay. Mr. Hearing Officer and

members of the Hearing Panel.

My name is William Schiek and I am Economist for Dairy Institute of California and testifying on the Institute's behalf. The position presented at this hearing was adopted by our Board of Directors.

Dairy Institute is grateful for the opportunity to testify at this hearing, where proposals to change the Class 4b pricing formula is being considered. Not surprisingly, Dairy Institute opposes the petitions of Western United Dairymen and the Producer Coalition and maintains that the Class 4b formula should not be adjusted at this time. In justifying its petition, the producer coalition has placed much stock in their own interpretation of Section 62062 of the State's Food and Ag Code, which states in part that -- and we've heard this several times this morning so I'll skip over that.

The coalition then makes several leaps in economic logic to conclude that the federal Class III price is the bellwether of what constitutes a reasonable relationship to the national value of manufactured milk products for California, despite the fact that its construction takes no aspects of California's dairy industry, its programs or the dynamics of its local market into account. One must conclude from their argument that crucial aspects of the market for milk in California have no bearing on what

constitutes an economically sound and reasonable relationship, which is a ridiculous proposition.

In authorizing the state's dairy regulatory program the Legislature has declared that "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." It's interesting we all quote the same sections. I'm not sure we take the same meaning from them. But to paraphrase this section: orderly marketing is the stated purpose or role of dairy regulation in California. Achieving orderly marketing is primarily manifested in the local market for milk. Put another way, if California is to embrace the policy goal set forth in Section 61802(e) of the Food and Ag Code then the California market for milk must be functioning in a way that is orderly.

The Secretary is directed to establish minimum producer prices at fair and reasonable levels so as to generate producer incomes that will promote orderly and intelligent marketing of milk in the various classes, given consideration to the combined income of all class prices in relation to the cost of producing and marketing milk for all purposes, including manufacturing purposes, that prices

shall insure an adequate and continuous supply in relation to demand of fresh and wholesome market milk for all purposes. In short, the California milk market must be orderly and must clear to meet these statutory directives. The Coalition's assertion that the current formula violates the law is ironically erroneous in that their proposal's sole focus on their incorrect interpretation of a small part of Section 62062 would require the Secretary to ignore many of the other legislative directives governing the pricing and regulation of milk, thus causing the Secretary to actually violate the law.

The level of regulated price plays a key role in maintaining an orderly market. Thus, in determining what is an economically sound and reasonable relationship to the national value of manufactured milk products, the state must consider the impact of such prices on the orderly marketing of milk in California. the fact that what defines "reasonable" under Section 62062 is in part specified by the other sections of the Code was explained in last August's hearing panel report. The reasons why price parity with Class III, or something very close to it, is inconsistent with the broader goals of California dairy policy were likewise set forth in the hearing panel report.

And I've got an excerpt here that discusses this. And basically this is the section where price alignment was

discussed. And it identifies key differences in the -- I would call -- how binding the regulated price is.

And in particular it talks about the ability to clear distressed milk at prices below minimum regulated values and notes that there are a couple of mechanisms where this can happen, depooling being one and what we would call diversion to non-pool plants or handler-to-handler transactions being another.

"As a result of this difference" you say "a strict comparison of the California Class 4b price to the federal order Class III, without considering other factors, is inappropriate if processors operating in federal orders are not strictly required to pay the federal order prices at all times."

These findings y the panel were and remain absolutely correct and precisely on point. Unfortunately, in producer newsletters that I have seen on the whey pricing issue, the Department's rationale for not pegging Class 4b to the Class III prices is glaringly absent. There is no substantive discussion as to why from their perspective the Department's logic and reasoning are incorrect, nor are there any real economic arguments supporting the notion of Class 4b and Class III parity. Rather, there has been a lot of noise about state-sponsored discounting of milk that appeared crafted to inflame rather than inform the readers.

The reasoning set forth by the panel from the last hearing was simply ignored by the producer groups in favor of a narrative that made for better copy to meet their desired goals. However, the choice by the Coalition and Western United Dairymen to ignore these substantive economic arguments does not make them any less important or valid.

The rationale set forth in last year's panel report remains accurate and applicable today. The relevant point is not whether or not federal pool is made whole by the co-ops when diversions to non-pool cheese plants occur, or whether the average price for depooled milk is higher or lower than the regulated price. The relevant point is that in the federal orders there are mechanisms whereby excess milk supplies may clear to cheese plants at less than regulated minimum prices. Because the federal order price is not strictly binding on cheese plants that buy milk in federal order areas, and because California has no similar flexibility, the Grade B producer designation being too cumbersome, milk in federal orders can clear through safety valves outside the pool -- (coughing). Excuse me. Rachel, you might have to get up and read.

MS. KALDOR: I can't claim authorship.

HEARING OFFICER ROWDEN: Okay. I still need to get your name.

MS. KALDOR: My name is Rachel Kaldor.

HEARING OFFICER ROWDEN: Spell your last name, please.

MS. KALDOR: K-A-L-D-O-R.

HEARING OFFICER ROWDEN: And you are representing?

MS. KALDOR: Diary Institute of California.

HEARING OFFICER ROWDEN: Thank you.

Whereupon,

RACHEL KALDOR

Was duly sworn.

HEARING OFFICER ROWDEN: Okay, proceed.

MS. KALDOR: Okay. I'll begin where Bill -- unfortunately he's been nursing this for several weeks, I believe.

The rationale set forth in last year's panel report remains accurate and applicable today.

Where did you want me to start?

DR. SCHIEK: California's lack of these safety valves.

MS. KALDOR: California's lack of these safety valves, combined with producers' propensity to oversupply the market with milk 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.

Regulated Prices Must be Minimum Prices. In establishing a regulated price so that milk production and

marketing are orderly, it is important that the Department balance the market. Producers are not ultimately helped when the Department sets prices so high that consumer demand is negatively impacted and investment in new plant capacity, technology and market development is stifled.

The role of regulated prices should be to undergird the market, providing some stability, yet laving room for market forces to work. In particular, there should be room under the state's pricing regulations for market-based premiums to allocate milk according to the market's needs. If most market transactions are occurring at or very near the regulated price, then resources are probably being misallocated and milk is not moving to the highest use.

Stability in the regulated pricing system is also of paramount importance. To processors, stability means that the pricing rules do not keep changing so that existing investments are put at risk and new investments are discouraged. Regulatory uncertainty discourages investment because it creates too much risk for those who are paying millions of dollars to create or maintain a business in California. This regulatory risk that has existed in California since 2003 due to the whey factor goes a long way toward explaining the scarcity of cheese plant investment since that time. Yes, there are other factors that have been important as well, but the stability that was in place

from late 2007 until last year had created a new interest by cheese investors in California. Last year's 4b increase put potential investors in a wait and see mode. Another increase to the regulated price at this time will send a signal to potential investors in cheese and whey plants that CDFA is engaging in a process of escalating the 4b price and will eventually give the producers all that they are asking. If potential cheese plant investors see this situation unfolding they will likely bypass or leave the sate.

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. Producers have proposed the reestablishment of aggressive whey contribution to the 4b price and we are having another hearing less than one year since the 4b price formula change. This type of regulatory uncertainty will likely scare away any potential new investment in cheese manufacturing unless the Department takes a clear stand that pricing stability and encouraging plant investment are its goals. 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 milk.

Current Price Levels Result From a Market Reaction That Will Eventually Correct. Regulated prices must send appropriate signals to producers and processors. Prices are the means by which producers and processors get economic signals from the marketplace. Higher prices tell producers to produce more and lower prices tell them to produce less. Prices have fallen in 2012 because milk supplies are overabundant and the market is sending signals to slow production. Regulated pricing formulas that shrink plant margins tell dairy product manufacturers to produce fewer dairy products in California. With milk production growing strongly and a lack of adequate capacity to process the milk supply that we continue building absent the artificial constraints of cooperative base plans, there can be no justification for increasing regulated prices at present. Additional cheese and whey plant investments are being considered and that capacity will be needed as milk production grows. These should be encouraged, not hindered.

As we have stated before, 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. Conversely, if regulated prices are set too low relative to the prices of finished dairy products, market-based premiums will develop

to ensure that milk supplies are adequate to meet the market's needs. 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.

Current Milk Supply and Demand Balance. Milk output fell in 2009 as high contracted feed costs and low milk prices created negative margins for most producers. As prices began rebounding in 2010 and continued moving to much higher levels in 2011, milk production has recovered. California milk output in 2011 was up 2.7 percent over 2010. For the first four months of 2012, milk output is up 5.7 percent on a daily average basis compared to 2011. This astounding milk production growth, in Exhibit A as we show it, has strained milk plant capacity and led to milk moving outside the state to find processing homes at a discount, and in some cases not being marketed. These conditions can hardly be described as orderly. Unfortunately, as milk production has grown the number of dairy farms has declined, and that's shown in Exhibit A2. As noted by CDFA in its Hearing Background Resource, from 1950 to 2011 there has been a six-fold increase in milk production from 6 billion pounds to 41.4 billion pounds, while over the same period

there was a 91 percent decline in the number of dairy farmers from 19,428 to 1,668.

Some point to the decline in dairy farm numbers as a sign that the industry is under severe stress. No doubt there are significant numbers of dairymen that are experiencing financial stress given current feed costs and milk prices. Dairy Institute's members sympathize with producers who are operating in this difficult environment, but we note that the overall trend in milk production has been ever higher even as farms have left the industry. Recent output gains can be chalked up in part to good milk production returns in 2010 and 2011. A review of the longer trends shows that this type of consolidation has been a regular occurrence over the past 50 years and is part of the bigger story of dairymen becoming larger and more efficient, rather than being a harbinger of a producer sector on the verge of collapse, as some have suggested. Contrast the milk production charge for California with that of Wisconsin. The production growth of Wisconsin in the 1990s and the first part of the 2000s is what a struggling industry looks like. California, although it has many more challenges than in the past, does not evidence that type of pattern.

At last year's hearing we talked about an impending lack of plant capacity in the state. While some

of the producer witnesses maintained that plant capacity was adequate, we maintained that the state was likely to run up against plant capacity limit in early 2012. We were correct. An updated estimate of daily average milk processing capacity and milk production from 2006 through April 2012 is presented in Exhibit A5. The state appeared to bump against its processing capacity limits in February and the situation has continued into April. Further evidence of California's oversupply of milk this April was chronicled in a Hoard's Dairyman article from April 25th. As we noted earlier, the cooperatives in the state have re-implemented their base plans with penalty changes for production in excess of base amounts. Until new plant capacity comes to the state, there is simply no room for additional milk production in California.

We want to caution those who believe that cooperative caps on milk supply through their base programs and excess marketing penalties provide an opportunity to increase regulated prices. First, producers int he state have shown by their actions that they want to grow the size of their operations. The base plans and overbase penalties, which while commendable as a mechanism to deal with emergency conditions, are not a viable long-term or solution to the state's need to attract additional plants or to accommodate producers' latent desires and economic

incentives to expand their operations. Using the base plans temporary effectiveness as an excuse to push regulated prices higher will not further the state's progress toward increasing competition for producer milk, boosting innovation and efficiency in the production and processing sector, or establishing the state as a formidable competitor in the global marketplace.

One of the more curious differences between California, Wisconsin and other states is the rapid rate of milk production growth in California relative to that of other states. Given that milk prices in California are lower than those in most federal markets, one would expect to see such growth, all things equal. But clearly all things are not equal. Despite recent claims to the contrary, the preponderance of evidence suggests that California still has one of the lowest milk product costs in the country. USDA's recently updated base year, 2010, shows California with the second-lowest production cost in the country with a level at more than $4 per hundredweight below the average of all states and almost $8 below Wisconsin. Now, USDA data on milk production costs are not particularly accurate, especially when economic formulas are used to update the base information as they were in 2011. However, data from accounting firm Genske, Mulder and Company tell much the same story as the 2010 USDA data. In both 2010 and

2011, California had the second-lowest production costs of the states reported by Genske-Mulder and in 2009 it had the lowest. The top 25 percent of Genske-Mulder clients are competitive with the top 25 percent of any other state. This is important because all things being equal, milk prices trend toward production costs in the long run. Therefore, if you have the lower costs, over time you will tend to have the lowest price as returns to dairying equalize with those in other regions. This is another reason why pricing parity with places like Wisconsin is elusive.

Apart from the cost of production considerations there are differences in the location value of manufactured products. These differences are based on supply/demand factors in the various regions of the country as well as transportation costs. For a product like cheese we generally expect to see prices between California and Wisconsin differ by the cost of transporting cheese between the states. The reason for this relationship is because at the margin cheese moves east for sale. Recent data put the cost of moving product by truck at over 10 cents a pound, which imputed to a milk value is a difference of more than $1 per hundredweight. I am aware that a recent paper by Dr. Charles Nicholson put the location value between California and the Midwest at 60 centers per hundredweight

of milk but that study was based on 2006 costs and doesn't square with the current cost of transportation -- of moving product, excuse me. Also, imputed location values for manufacturing milk are derived from the transportation costs of the finished product. When you have a situation like we have in California, where we have run past our manufacturing capacity and are shipping raw and concentrated milk over long distances, it is the cost of moving these liquid products, which are much higher, that begin to impact the location value for milk, leading to even larger disparities in location value between regions.

The differences between California and the Upper Midwest pertaining to cheese manufacturing, whey processing, investment climate and minimum pricing were discussed at length in our testimony at the 2011 hearing. We will not reiterate them here but hey remain accurate and important today. When all of the differences between the industries, the pricing systems and the local supply/demand issues in the different regions are taken into account, the petitioners' proposal simply cannot be considered seriously.

The current trends for supply and demand of milk in the state and the scarcity of plant capacity suggest that increases to the current 4b formula are not warranted. We feel compelled to note again that the continued viability of our end-product based regulated pricing system is in

jeopardy due to changes in the market and industry consolidation. We should be spending our time and effort on developing a system that works for the entire industry instead of fighting in this zero-sum game.

Thank you for the opportunity to testify, on behalf of both of us, and I am willing to answer any questions you may have at this time. And he's rested up. I also request a period for filing a post-hearing brief.

DR. SCHIEK: Thank you, Rachel.

MS. KALDOR: You're welcome, Bill.

HEARING OFFICER ROWDEN: First of all the request is granted. Questions from the panel?

MR. EASTMAN: I have a few questions. One comment theme of today happens to be the price alignment issue between Federal Order Class III prices and California Class 4b prices. And one question I've asked and it's starting to repeat itself has to do with data availability. Obviously in order to compare the two, being able to have a sense of how much milk might be not -- whether it be depooled, diverted, never regulated et cetera and sort of the prices that that milk would be going for would help to come up with some sort of comparison between the two.

I know it appears there's not a lot of solid data. Do you have any sort of information, conversations, any sort of sense of whether over time what any of those levels

could be to get an accurate sense of that relationship?

DR. SCHIEK: No. I think Tom Wegner hit the two main sources. You've got some Federal Order reports on milk depooled that you referenced from the Upper Midwest and you got the anecdotal reports in Dairy Market News. There's really not too much out there.

I will say that it's a common situation in Wisconsin, based on what I have heard from folks who work in the regulatory arena up there. That most of the plants that actually make the cheese are set up as non-pool plants. And that's because the co-ops -- it's a somewhat different system. The co-ops pool the milk. So the co-op is set up as a pooling entity and so the -- they report to the pool, they pay the minimum price obligation to the pool so they're obligated for that and they pay producers. Whereas the transaction between the co-op and the customer that actually buys the milk to make the cheese is essentially an extra-regular, unregulated type of transaction.

And, you know, I believe Tom is absolutely right in that he says that these mostly are set up on contracts and, you know, they may have a regulated price reference in them. But the opportunity exists, as we have seen from the Dairy Market News, that when there's excess milk or the market needs to be cleared to make the market function in an orderly way and avoid hauling milk really, really long

distances, there is the ability to step outside that regulated price and clear the milk.

MR. EASTMAN: I have a couple of questions regarding a few of the exhibits or attachments in the back.

DR. SCHIEK: Sure.

MR. EASTMAN: I guess starting with Exhibit B1, that's where it shows the USDA Milk Cost of Production by State, which appears to come from ERS. And you make mention there that California as a state has a lower cost of production than the majority of the other states in the study. And the question I have is obviously a lot of -- it looks like that report, there are certain formulas that they use in order to arrive at these costs, which have some sort of margin of error in there, people would argue.

DR. SCHIEK: Sure.

MR. EASTMAN: So the question I have is, do you have any sense or what is your thought on if there is some margin of error in there. Do the formulas tend to more accurately reflect costs in one state over the other?

DR. SCHIEK: Yeah.

MR. EASTMAN: Do you feel that as a trend or if you compared one state to the other, even though maybe the number is not incorrect maybe at least the comparison would be correct with one state being higher than the low?

DR. SCHIEK: Right, right. You know, I put the

data in just because it tended to just be one of a set of numbers that's out there and then I included the Genske-Mulder. If you'd like I think I've got data from Frazer and Toret that has the state comparisons. I could put that into a post-hearing brief so you could see how those numbers compare as well.

But I don't, I don't really know. The basic problem I think I have with -- as I understand the USDA milk cost production data is they'll put together a base year which is probably where there's the most accurate interstate type comparisons. And then in subsequent years the data will be updated using, like you were saying, economic formula. The problem is most business operations of any kind adjust what they do with changing input prices. And so what tends to happen is the behavior in the base year gets imputed in the upcoming year so it doesn't really -- as you begin to update it -- it's an indicator of where prices are going but it doesn't necessarily indicate relative costs all that well going forward. Which is why I am not a huge fan of the data but it is one of the data sets that's out there.

MR. EASTMAN: Flipping over the page to the next one when it comes to the Genske-Mulder. I notice that one shows just Large Farm Cost of Production and then the next exhibit has more milk production costs. Do you have a sense of -- the B2 then would be large farms. Does B3, do you

know if that's just -- what would be their entire clientele regardless of size of farm?

DR. SCHIEK: Yeah, I'd have to, I'd have to go back and look at those two reports and see what the difference is there. I think it's -- I think these are both -- my recollection is these are both close to the same data set, it's their clients. But I will double-check that and get back to you in the brief.

MR. EASTMAN: Okay. Because I'm assuming Genske-Mulder does have some clients that would be mid-size or considered smaller, depending on how you would define that, I guess.

DR. SCHIEK: Well I think, I think one of the key -- I think one of the issues here is when you are looking at the Upper Midwest there is such a huge disparity between operations in the Upper Midwest versus the Western States. So the idea of the large farm, you're getting something closer. You're not getting the 30 cow or 50 cow dairies probably in this data set. But I will find some more detail on that.

MR. EASTMAN: All right.

MS. GATES: Dr. Schiek, to follow-up on the question that Hyrum had asked you on the non-pool plants and you had said that there are cheese plants that are set up non-pool?

DR. SCHIEK: Well, simply that are not pool plants under the orders.

MS. GATES: Are not pooled.

DR. SCHIEK: Yeah.

MS. GATES: So is it correct to assume that those plants that are set up as non-pool plants are not in the depooled data set that we had, you know, shared at the workshop?

DR. SCHIEK: No, the milk that those receive -- and this is one of the things that's a little different in that system versus ours. The milk is pooled milk that is received in the plants.

MS. GATES: Okay.

DR. SCHIEK: Because it's the co-op's milk.

MS. GATES: Okay.

DR. SCHIEK: The co-op pools the producers whose milk they ship to the plant. But the plant itself is a non-pool entity. I think we do have non-pool plants that receive pool milk from co-ops in California so it's sort of like that, that deal.

MS. GATES: Okay.

DR. SCHIEK: Except, you know, whereas our regulated -- non-pool plant still is obligated to pay the minimum class price, there is no regulatory obligation on the handler buying from the co-op in the federal order if

it's a non-pool plant.

MS. GATES: Okay.

DR. SCHIEK: So that's an unregulated transaction. And there -- you know, they could pay more. They probably do in a lot of cases because the market conditions in Wisconsin are such that, you know, that's what it takes to get milk into the plants. But there are -- you know, it's not a regulated transaction. So there are times when there's extra milk around when they do have the ability to buy extra supplies in at below minimum to clear the market.

MS. GATES: I have one more question and that is on page five.

DR. SCHIEK: Um-hmm.

MS. GATES: In that middle paragraph under Current Milk Supply and Demand Balance. You talk about there is a considerable amount of milk going out of state and not marketed. Do you have any idea of the amount?

DR. SCHIEK: No.

MS. GATES: No.

DR. SCHIEK: No. No, except that it was happening. It was a regular occurrence. It was showing up, I believe, in the Dairy Market News that it was happening on a regular basis.

MS. GATES: During that time period.

DR. SCHIEK: During that time period earlier this

year. And, you know, I know that we're hearing that in order for some of the folks to keep under their base that there's milk ending up going to the calf ranches and such to make sure they market near their base levels.

MS. GATES: Thank you.

MS. RANKIN: I just have one extra question. On page four of your testimony you mention that if market transactions are occurring at or very near regulated prices then resources are probably being misallocated. Is it your understanding that where we are currently at prices being paid are near minimum prices or do you have any idea?

DR. SCHIEK: Yeah, I'm speaking more here as a caution of getting a regulated price level that's really intrusive on the market in the sense of it takes away the room for premiums to allocate milk supplies. And I know that when milk is long premiums do tend to come down. But my sense still is that most, most cheese plants are paying some premium right now. Maybe less than it was.

HEARING OFFICER ROWDEN: Thank you.

Mike McCully.

MR. McCULLY: Can I defer to tomorrow morning? I don't have my testimony right now.

HEARING OFFICER ROWDEN: All right. David Ahlem. Please state your full name, spell your last name and state your affiliation for the record.

MR. AHLEM: David Ahlem, the last name is A-H-L-E-M, and Hilmar Cheese Company.

Whereupon,

DAVID AHLEM

Was duly sworn.

HEARING OFFICER ROWDEN: And are you speaking on behalf of Hilmar Cheese?

MR. AHLEM: Yes I am.

HEARING OFFICER ROWDEN: All right. Mr. Ahlem's testimony is Exhibit 58.

(Exhibit 58 was received into evidence.)

MR. AHLEM: Good afternoon. Mr. Hearing Officer, Hearing Panel, thank you for the opportunity to be here today. My name is David Ahlem. I am the Vice President of Dairy Procurement and Policy for Hilmar Cheese Company. Hilmar is a cheese and whey products manufacturer with locations in California and Texas. In California, Hilmar Cheese Company processes over 12 million pounds of milk per day, more than 10 percent of the milk produced in California each day, and purchases milk from over 200 dairies. Finished products are sold to over 50 countries around the globe.

Hilmar Cheese Company, Inc. was formed in by a group of innovative market oriented Jersey dairymen who sought to capture the full value of their high quality milk.

They founded the company on the ideal that producers should receive a competitive market-driven price for their milk.

I am here today to represent Hilmar Cheese Company and our dairy producer owners. Hilmar Cheese Company opposes the petitions from Western United Dairymen and the Coalition of producer groups. Hilmar Cheese Company supports a low regulated minimum price that allows the market to efficiently set high market-driven prices.

The West Coast is Swimming in Milk. That was the aptly titled March 27, 2012 article by Hoard's Dairyman chronicling the tremendous growth in the West and the measure being employed to curtail it. Near-record high prices and strong producer returns in 2011, coupled with ideal weather conditions, had driven California milk production and cow numbers higher. In April of 2012, California milk production was 3.3 percent higher than the same month last year. This is equivalent to over 70 tanker loads of milk each day or more than 3.5 million pounds of milk per day. Enough to fill a medium sized plant.

While a portion of this gain can be attributed to ideal weather and ever-improving herds, this growth stems from more than just efficiency gains. Since April of last year, dairy producers in California have added an estimated 23,000 cows to the state herd. The growth in cow numbers outpaces all other states. In comparison, Wisconsin, the

country's next largest dairy state, added 4,000 cows in the same time frame. Producers have clearly responded to the favorable price signals received in 2011.

While milk supplies have grown every month since late 2009, this in California, the same is not true of farm numbers. The story in California the past several years is one of consolidation, not overall supply contraction. Farm numbers continue to decline in California, like most regions in the country. High feed prices have dramatically changed the competitive position of California producers. Those who have the ability to grow their own feed are in a much better financial position than those who purchase outside feedstuffs. The purchased feed model that was once integral to California's success is now a detriment to some and the industry is undergoing a painful adjustment to this changing dynamic. The ongoing consolidation trend has yet to curtail supply growth in aggregate. Producers who remain in the industry are growing at rates that exceed the overall state growth rates.

The outcome of this tremendous supply side growth is a marketplace that is oversupplied. Current supply exceeds the state's processing capacity. Most milk buyers have publicly acknowledged the capacity limitations in California. Many buyers have implemented contract caps, base programs with stiff penalties, and some have even

called for reductions in production. Since the beginning of the year, Hilmar Cheese has regularly moved milk out of state as there were no available buyers within the state. We have also rigidly enforced contract caps. To comply, many of our producers have sold numerous loads of milk to calf ranches because no alternative buyers for their milk existed.

Just a few years ago California experienced an extended period of time when milk production exceeded the state's manufacturing capacity and it looks as though we are finding ourselves in the same situation once again. Surplus milk is being shipped out of state, sold to calf ranches and dumped, all at significant cost to producers. 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 in California will encourage continued oversupply and prolong periods of low prices during oversupply conditions. This is exactly what California experienced in 2008 when milk went to the ground without a viable market and the situation appears to be repeating itself again this spring. The regulatory system should be activated to clear the market, not create the market. Current market conditions do not warrant an increase in the regulated minimum price.

Declining cheese processing capacity: Processing

capacity growth has not kept pace with the growth in supply. Recent history also indicates that the state's cheese processors have not had financial incentive to expand in California. In fact, the opposite appears to be true. Natural American cheese production and processing capacity within the state has fallen. The following is a short list of plant closures within the past ten years. And several of these have already been pointed out. The plant of Land O'Lakes Tulare and Golden Cheese DVA, Petaluma DFA and I have the rest of the list there.

Although the overall trend is a declining one, there have been some stories of growth. Leprino finished a project that was decided upon in the late '90s and we have also seen some growth in small specialty cheese plants, which will be the most at risk if we increase the 4b price again. Nevertheless, the overall declining trend and reduction in capacity in California is clearly not the picture of an industry with a great financial incentive to expand.

The story outside of California is much different. Natural American cheese production and capacity has grown in recent years. In the fall of 2007, Hilmar Cheese Company participated in this out-of-state growth with the opening of our facility in Dalhart, Texas. Although milk was available in California, we chose to invest in a region where we could

operate outside the constraints of the regulated pricing system and thus be better positioned to compete with our primary domestic and international competitors. Since then we have also seen other significant investments in new production facilities outside of California, i.e., Leprino in Colorado, Green Meadows in Iowa and several other Midwest projects. Several more projects in other regions are also on the drawing board or scheduled to start up in the next 12 to 18 months, i.e., Bel Brands in South Dakota, Kansas Dairy Ingredients and I believe there are more.

Demand for cheese is growing domestically and abroad, while processing capacity in California declines amidst available milk supplies. This is clearly not a picture of a processing segment with great incentive to expand. Increasing the regulated minimum price will further discourage investment in capacity in California. This is not the right move for a state that is currently oversupplied and short of the capacity necessary to create additional competition for milk.

Minimum regulated prices, not market prices: The petitioners' financial comparisons assume all processors pay the 4b minimum price. This simply is not true. Minimum prices are just that, minimums. Nothing precludes processors from paying more and nothing prevents sellers from asking for more from their buyers. Many California

processors pay premiums to producers above the 4b price. Hilmar Cheese Company is one such example of a processor who pays market-driven premiums for protein, fat, whey and quality. Since its inception, Hilmar Cheese Company has consistently paid premiums to its producers well above the 4b price.

While acknowledging the current challenges in the producer community we find the Coalition's request to be misplaced and misdirected. Many of the cooperative members who control the vast majority of the milk in California regularly negotiate supply agreements with buyers of 4b milk. This is the proper place for these discussions to take place. Instead of going to the marketplace and asking their customers, cheese processors, for a higher price, these cooperatives have chosen to delegate this responsibility to the California Department of Food and Agriculture. This is not the intended function of the regulatory system. The 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 the value for milk above and beyond the regulated price, which often occurs today.

High regulated prices distort market signals: Regulated prices and the resulting component values assume all milk is the same. Hilmar Cheese Company pays on a

component yield formula that results in significant values above the minimum price. These premiums are based on levels of milk protein, yield and milk quality, which are all very important to a cheese plant. A low regulated price allows us to pay high market-driven premiums and send those premium dollars directly to the producers who have invested in the 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. This inhibits our ability to send price signals directly to our producers to produce the type of milk the market demands.

When the regulated minimum price is increased, many of our producers lose when they receive less revenue for their milk as the value they have created is redistributed through the pool to others who have not invested in producing what the market wants. This was the outcome of the last hearing for many of our producers. In our rapidly changing global marketplace it is essential that we do not mute these market signals and continue to incentivize processors and producers to produce the products and the milk the market wants.

High regulated prices stifle innovation and new

product development: End product pricing formulas already are a hindrance to innovation and new product development. Increasing minimum prices will stifle innovation and new product development even further. These formulas discourage processors from producing new products by introducing considerable risk when the price of the products of the processor deviates from the products used to set the regulated price. Increasing the whey factor contribution will further contribute to this risk. This impacts business decisions as Hilmar Cheese Company and others consider further investment in California. This disconnect was one of the key reasons our company decided to invest in a facility outside of California, where we have the opportunity to opt out of the regulatory system. It also leads the risk averse to oversupply the market with products it does not want and further decrease the value of milk.

Furthermore, artificially increasing the minimum price of milk does not increase the real value of milk. The only sustainable means of increasing the real value in the global marketplace is to develop products the marketplace demands. Our industry remains weak in terms of value creation and innovation. This has been to the detriment of dairymen. Instead of creating value, many in our industry have been trained to go to the regulated system to get more out of milk. Attempting to extract value from those

producers who still have viable business propositions via an increase in the regulated price is not the solution. Instead we must develop a regulatory system that incentivizes and rewards both processors and producers to invest, innovate and develop new products which increase the value of milk long-term.

Comparing Class III and 4b is like comparing apples to oranges: As we have highlighted, many have highlighted, they are different pricing systems. When comparing California to the Federal Orders it is important to recognize that there are some distinct differences in the pricing systems. One of the key differences is that cheese processors out of state, our primary competitors, are not always required to pay Class III, even when they operate within the boundaries of Federal Milk Marketing Orders. The Federal Milk Marketing Orders 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.

It is not uncommon for milk to trade below the Federal Order minimums when milk is in surplus. This year we have seen numerous examples of milk trading at $3-$5.50 a hundredweight below Class III. And I have some -- attached some examples from Dairy Market News. Hilmar Cheese Company has experienced these values firsthand as we have both bought and sold milk for our Texas facility in these

markets. When market conditions dictate we have also seen longer term contracts executed at values below the Class III price.

California does not have a like mechanism and all milk purchased from producers and cooperatives must be purchased at or above the minimum price. As a result, California's regulated minimum price must be set at a market clearing value.

Different regional supply and demand conditions. When comparing California prices to other regions, we must also consider regional supply and demand characteristics. Today in California milk supply is chasing capacity, while in other regions of the country capacity is chasing supply. We are in a surplus situation while other regions are in a milk deficit situation. Wisconsin is one such example. They reportedly import 10-16 percent of their milk to meet local processing demand. This has been well-reported in the trade press and I've attached a few articles. Unfortunately, California is in a much different situation than the milk deficit states of the Midwest. Increasing the regulated minimum price in California will further encourage supply growth and discourage investment in much needed capacity.

Is parity with Class III the solution? The petitioners also assume that price alignment with Class III

is the right solution. Careful consideration of the issue will reveal that the Class III price is not an optimal solution for cheese processors in high whey markets and cheese processors in California are not the only ones expressing this view. Like California, cheese plants in the Federal Order who don't process their own whey are unable to make up the revenue in this marketplace. John Umhoefer, Executive Director of the Wisconsin Cheese Makers recently said "One third of Wisconsin's cheese plants are swimming in red ink on the other solids price." California was in this situation once before and wisely made the choice to return to a fixed whey factor in 2007. Let's make sure we avoid making the same mistake twice.

Increasing the regulated minimum price puts California cheese processors at a competitive disadvantage: The proposed minimum price increase puts California cheese processors at a further disadvantage to our primary competitors in unregulated markets, both domestically, i.e., Idaho, and abroad, for example, New Zealand. Outside of California most cheese and whey processors operate or have the option to operate outside of the confines of federal and state price controls. In these regulated markets our competitors are not obligated to pay minimum prices or pay for milk according to regulated end product pricing formulas. 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 compete. If we become uncompetitive, California will lose business to its competitors out of state who are not subject to the same constraints. The outcome will be a further reduction in demand for California milk.

Regulatory uncertainty impedes investment: In the past ten years we have had 25 milk price hearings in California, not including the one we are in the middle of today. The whey component of the 4b formula has not been immune from this changing pricing environment. The whey factor was first introduced to the 4b formula in April of 2003. Since that time the whey factor has been changed in 2007, 2011, and now we are considering a change again in 2012. Each of those changes significantly impacts margins and the returns for all cheese processors. As individual companies consider long-term investments that require massive amounts of capital, this frequently changing regulatory environment discourages investment by creating uncertainty. This uncertainty adds tremendous risk to investment decisions.

In this environment is it any surprise that new investment in California has been scarce? Even if the appropriate market signals existed today, any potential

investor would have put their plans on hold while they wanted for the outcome of this hearing. This does not benefit a state that desperately needs additional plant capacity to create more competition for milk.

This regulatory uncertainty paralyzes the industry and increases the risk of new investment. Continuing instability will drive investment to other regions. It's time we introduce some stability into our pricing environment and allow market signals to drive investment decisions.

The real solution is real reform: As a producer-owned entity we believe we would be better served to focus on fundamental reform that moves us towards growing the value of milk over time. The whey factor debate is a symptom of a much larger problem and a simple adjustment to the whey factor will not solve our problems long-term. As long as we remain entrenched in formula pricing we will continue to have contentious debates around value sharing. Producers will continue to bear all the market risk, inappropriately, and our industry focus will be on the system, not the customer.

Instead of trying to extract value from the regulatory system, it's time we let market signals reign and turn our focus towards customers, markets and growing the value of milk. Further insulating the industry from market

signals will not benefit dairymen. We need to learn to respond to market signals and develop the skill sets necessary to compete in the global marketplace.

Both the McKinsey Report and the Innovation Center's Report on Globalization concluded that there is tremendous opportunity for California and the US in the global marketplace. However, they both suggested that the industry adopt market-oriented policy initiatives and pricing reform. both warned that failure to do so might compromise our competitive position long-term. We are now at that critical juncture. We must choose a path. If the California dairy industry is to retain its position of strength we must make fundamental reform. Simply tweaking formulas will not alleviate today's challenges but will only continue to place the emphasis on regulatory solutions versus creating valuable milk-based products for customers here and abroad.

On behalf of Hilmar Cheese Company and its producer-owners I urge the state to reject the petition from Western United Dairymen and the Coalition of producer groups. In view of the very recent change to the 4b whey factor, the misplaced comparison of 4b with the Class III price and the state's current oversupply situation, now is not the time to further distort market signals by increasing the minimum regulated price. The proposed increase in the

regulated minimum 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.

Thank you for your time and consideration and I am requesting the opportunity to file a post-hearing brief, if necessary. And I would be happy to answer any questions you may have at this time.

HEARING OFFICER ROWDEN: And your request to file a brief is accepted. Questions from the panel?

MS. GATES: Mr. Ahlem, I have a question. I don't know that you can answer it but I'm going to ask it anyway.

On page three you talk about that Hilmar consistently pays premiums over the minimum price.

MR. AHLEM: Um-hmm, um-hmm.

MS. GATES: Could you share a percentage? What amount would that --

MR. AHLEM: Well I can't share details but I could -- probably in the last year, couple of years -- I mean, we're talking tens of millions of dollars.

MS. GATES: Okay. Above the announced?

MR. AHLEM: Above the regulated minimum price. That's why the comparison when we have these two and three hundred million dollar figures comparing -- strictly

comparing Class III and 4b. That's the concern. They don't take into account premiums that are paid to producers. So it's not reflective of the market place.

MS. GATES: Which I'm sure that it's not out there. It's not --

MR. AHLEM: It's not publicly available information.

MS. GATES: So it's not available.

MR. AHLEM: Which is what they're working with. Understood.

MS. GATES: Thank you.

MS. RANKIN: I have a question. How has the current whey factor impacted Hilmar in terms of maybe adjusting or implementing any marketing of whey?

MR. AHLEM: How has the current whey factor affected the marketing of whey in terms of how has it impacted or sales or what we do or the change? Could you clarify it for me?

MS. RANKIN: Maybe the change from -- the change from the fixed factor to the sliding scale. Has that impacted how you market your whey products?

MR. AHLEM: I would say the biggest -- you know, it has not changed how we market our whey products. So we are still doing the same thing, marketing those around the world. The bigger change has probably been to our

producers. So what happened is many of our producers after that hearing received less pay in a sense because their premiums were reduced as it was redistributed through the pool. So in many cases we were probably less impacted by other -- since we are already paying significant premiums we were less impacted because we are paying now. It's just being redistributed via the pool rather than directly to the market and those investors creating that value.

MS. RANKIN: And your Texas plant, have you had capacity issues there similar to California?

MR. AHLEM: In Texas we're looking for milk. There's been opportunity and that's where there's been growth and we have even seen folks from California move out there to capture that opportunity.

MS. RANKIN: That's all I have.

MR. EASTMAN: With regards to the milk supply in Texas that you're referring to. Have you -- I know that in the last year or so Texas in terms of weather, they went through drought over the summer. Theoretically you would have thought that would have affected their milk production. Has that played a factor over there? Is there simply not enough supply there to begin with? Is there less supply than what you anticipated when you built the plant?

MR. AHLEM: I would say really -- I would say the general trend in Texas reflects what we have seen in

California. We have had strong, surprisingly strong production. And when I say we're looking for milk, we have been growing that facility on the long-term and we're taking new producers and signing new producers in that area over the long-term. But spring, we're seeing spring flush volumes come earlier and stronger than we expected just like we are in California so it's following that same trend.

And there were some drought conditions last year but we did not even -- we did not see a drop in production last year through the drought conditions. I thought they would come this year as folks got into new feedstuffs and it hasn't happened. And again, I think folks -- in 2011 there were some pretty strong price signals, in Texas as well, so I can't tell if that's adding cows or production per head. With a lot of cows coming in and out it's hard to tell what's going on exactly.

MR. EASTMAN: I had a question regarding -- I guess Hilmar apparently -- do they have a base program or do they just --

MR. AHLEM: No, we don't have --

MR. EASTMAN: -- strictly stick to the maximum amount of milk in the contracted amount? How is that working, how are you managing that?

MR. AHLEM: Kind of the latter. We have what we call contract caps. So we will execute a contract with a

producer and say, we agree to take up to 5,000 gallons a day or 10,000 gallons a day. That's a hard cap.

And then we have -- we have a program in place, if you ship over that for a duration of time -- so you can be over for a month or two months. And then there's a process that if you continue then that contract is subject to termination.

Typically though what happens in our system is folks will get rid of that milk. They'll stay under that contract cap and sell that milk, either to other people who are out there purchasing milk in the marketplace, other milk handlers, or more recently as there hasn't been homes for milk I would say most of it has gone to calf ranches. I would estimate even this week as it's the end of the month, as producers are trying to remain under the cap there's probably been dozens of loads that have gone to calf ranches. I was getting some reports back yesterday that some folks were -- calf ranches were full and didn't have room for milk either.

MR. EASTMAN: So in essence then, since it's a hard cap, you don't necessarily try and help your producers move milk if they get above the cap or try and charge them some sort of fee to ship it to wherever you could find a home?

MR. AHLEM: You won't let me do that. No. So it

is not legal for us to pay more than the minimum price. So unfortunately, if I could find a home and I could ship that out of state I cannot, I cannot do that, I cannot facilitate. We have to place a hard cap.

When we do -- when my forecasting and my place is wrong and we're low on milk we bear the cost of that. So some have said today that producers bear all the costs. That's not true in the case of a proprietary. We bear the cost of shipping milk out-of-state, which we have done quite regularly since the beginning of the year, so we can't pass that on.

The alternative we have is to discontinue our relationship with producers and let them go but that's not the long-term scenario we'd like to be in.

MR. EASTMAN: Thank you.

MR. AHLEM: Thank you.

HEARING OFFICER ROWDEN: Thank you very much.

That will be our last witness for today. Tomorrow we'll reconvene. Mr. McCully, you'll be first up.

And again I thank you all for cooperating. I believe the hearing went quite well. Thank you again, see you tomorrow morning.

(Thereupon, the public hearing adjourned at 4:47 p.m., to resume June 1, 2012 at 9:00 a.m.)

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CERTIFICATE OF REPORTER

I, RAMONA COTA, an Electronic Reporter, do hereby certify that I am a disinterested person herein; that I recorded the foregoing California Department of Food and Agriculture consolidated public hearing; that I thereafter transcribed it.

I further certify that I am not of counsel or attorney for any of the parties to said public hearing, nor in any way interested in the outcome of said matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 4th day of June, 2012.

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RAMONA COTA, CERT*478