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

WEDNESDAY, JUNE 3, 2015

8:00 A.M.

Reported by: Ramona Cota

A P P E A R A N C E S

CDFA Panel

Hyrum Eastman, Dairy Economic Advisor
Division of Marketing Services

John Lee, Branch Chief
Milk Pooling Branch

Donald Shippelhoute, Branch Chief
Dairy Marketing Branch

CDFA Staff

John Suther, Bureau Chief - Hearing Officer
Bureau of Livestock Identification

Mike Francesconi, Supervising Auditor
Dairy Marketing Branch

Karen Dapper, Research Manager
Dairy Marketing Branch

Also Present

Annie AcMoody
Western United Dairymen

William Schiek, PhD
Dairy Institute of California

Barry Brokaw
Sacramento Advocates
On behalf of Kraft Foods Group

Antonio de Cardenas
Cacique, Incorporated

Joe E. Paris
Joseph Gallo Farms

Eric Erba, PhD
California Dairies, Inc.

A P P E A R A N C E S

Also Present

Greg Dryer
Saputo Cheese USA Inc.

Lynne McBride
California Dairy Campaign

Alan Zolin
Zolin International LLC
On behalf of Pacific Cheese Company

Scott Hofferber
Farmdale Creamery, Inc.

Peter van Warmerdam
Van Warmerdam Dairy

Lucas Deniz
Deniz Dairy

Jerry Corda

Antoinette Duarte
Duarte Family Dairy, Inc.

Tom Barcellos
T-Bar Dairy/Barcellos Farms/White Gold Dairy

Frank Mendonsa

Adolfo Sanchez
Los Altos Food Products, Inc.

Emily Rooney
Agricultural Council of California

Barry Murphy
BESTWHEY, LLC

David Ahlem
John Jeter
Hilmar Cheese Company, Inc.

Elvin Hollon
Dairy Farmers of America, Inc.

A P P E A R A N C E S

Also Present

Leonard Vandenburg
Pacific Gold Milk Producers/Pacific Gold Creamery

Pete Garbani
Land O'Lakes, Inc.

Xavier Avila

Ivan Rizo
Rizo Lopez Foods, Inc.

Cornell Kasbergen
Kasbergen Dairy

John Rutherford
Alouette Cheese USA

Rien Doornenbal
R. Doornenbal Ranches

Rob Vandenheuvel
Milk Producers Council

John Rumiano
Rumiano Cheese Company

Sue Taylor
Leprino Foods Company

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E X H I B I T S

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P R O C E E D I N G S

8:03 a.m.

HEARING OFFICER SUTHER: All right, good morning, everybody. May I have your attention?

Before we start the hearing this morning I'd like to go over a few things that will help ensure that this hearing will be as productive as possible.

Please turn off your cell phones so they don't disrupt the hearing.

Second, anyone planning to testify, other than the petitioners, must sign in on the Hearing Witness Roster located in the back of the room.

Third, each person has one opportunity to come forward to provide testimony for up to 20 minutes. If you do not use up all of your allotted time you will not be allowed to come back up again. Witnesses will be called in the order that they sign up in. The time clock to my right has been established to assist you when testifying. Remember that the testimony you provide for the Hearing Officer and the Panel is entered into the record in its entirety so you may want to speak to the highlights of your testimony if you think you will run out of time. You will be testifying from that chair with the microphone on the left side.

Fourth, if you want to submit an exhibit, please bring it up to me before you testify.

Remember, the purpose of this hearing is to take testimony and to gather evidence. It is not to make findings or to render a decision. Therefore, be courteous and respect the hearing process, those testifying and those hearing the testimony.

Another point of order. The restrooms are outside of this room. Make a left and then they will be on your right.

We will probably break for lunch around 12:00 o'clock depending upon the flow of the testimony and we will probably take a break somewhere around 10:00 o'clock.

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, Wednesday, June 3, 2015, beginning at 8:00 a.m.

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

On May 1, 2015, the Department called a public hearing on its own motion to consider proposed amendments to the Stabilization and Marketing Plans for Market Milk for the Northern and Southern California Marketing Areas for the Class 4b pricing formula with a sunset clause having an expiration date not to exceed 24 months.

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

Alternative Proposals were submitted by the California Dairy Campaign/Milk Producers Council/Western United Dairymen, a joint proposal, and the Dairy Institute of California. They will each have 30 minutes to submit their testimony and relative material to support their proposal, which will be followed by questions from the Panel.

Anyone who has signed in on the Hearing Witness Roster located in the back of the room will be allowed 20 minutes to give testimony and evidence. Please note that only those individuals who have testified under oath during the hearing may request a post-hearing brief period to amplify, explain or withdraw their testimony. Only those individuals who have requested a post-hearing brief may file a post-hearing brief with the Department. Any information submitted after the close of the hearing will not be included in the record for consideration by the Hearing Panel.

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 panel members.

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

Questioning of witnesses other than the Department's 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 John Lee, Branch Chief, Hyrum Eastman, Dairy Economic Advisor, and Don Shippelhoute, Branch Chief. Again, I am not a member of the panel and will not be taking part in any discussions relative to the hearing.

The hearing is being recorded by the firm of 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 and on the Department's website following the hearing decision announcement.

Testimony and evidence pertinent to the call of the hearing will now be received. At this time Mike Francesconi, Supervising Auditor with 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 and it is spelled F-R-A-N-C-E-S-C-O-N-I.

Whereupon,

MIKE FRANCESCONI

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

MR. FRANCESCONI: Okay. Mr. Hearing Officer, my name is Mike Francesconi; I am a supervising auditor with the Dairy Marketing Branch of the California Department of Food and Agriculture. My purpose here this morning is to introduce the Department's Composite Hearing Exhibits numbered 1 through 35. Relative to these exhibits, previous Exhibits 7 through 35 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 27, 2015.

An abridged copy of this exhibit is available for inspection at the back of the room at the sign-in desk back there. At this time I am going to ask that these composite exhibits be received.

But before I walk these up there to you I have two other items I would like to submit and then I will bring all three up there at that time.

Additionally I am entering a data request posted to the Department website on June 1st, 2015 showing pounds of milk shipped to out-of-state plants from California ranches and plants. This will be entered into the record as Exhibit 36. A copy of this exhibit is available for inspection at the back of the room.

I would also like to enter the following correspondence. This first is a letter from Tony P. Cardoza, Inc. dated June 1st, 2015 and signed by Tony P. Cardoza. And I would like to enter this as Exhibit 37.

So if you want I'll bring these over to you at this time.

HEARING OFFICER SUTHER: Yes, please bring those exhibits.

Exhibits 1 through 35 and 36 and 37 are now entered into the record.

(Exhibits 1 through 37 were entered into the record.)

HEARING OFFICER SUTHER: Thank you, Mr. Francesconi.

Are there any questions for the Department's witness regarding the Department's exhibits?

Seeing none, we will continue.

MR. FRANCESCONI: Okay. Before you close, Mr. Hearing Officer, I just also want to request the opportunity to provide a post-hearing brief, if needed.

HEARING OFFICER SUTHER: So entered.

MR. FRANCESCONI: Thank you.

HEARING OFFICER SUTHER: Your request for the post-hearing brief is granted. Thank you very much for your testimony.

MR. FRANCESCONI: Thank you.

HEARING OFFICER SUTHER: I will now call a representative testifying on behalf of the alternative proposal submitted by California Dairy Campaign, Milk Producers Council and Western United Dairymen. You will have a total of 30 minutes to submit your testimony. Please notice the time clock on my right. And I believe that is Annie AcMoody.

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

MS. AcMOODY: My name is Annie AcMoody; the last name is spelled A-C-M-O-O-D-Y and I am with Western United Dairymen.

MS. McBRIDE: My name is Lynne McBride, M-C, capital B-R-I-D-E, and I am with the California Dairy Campaign.

MR. VANDENHEUVEL: Rob Vandenheuvel, V-A-N-D-E-N-H-E-U-V-E-L, with Milk Producers Council.

HEARING OFFICER SUTHER: Thank you.

Whereupon,

ANNIE AcMOODY

LYNNE McBRIDE

ROB VANDENHEUVEL

Were duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements or other things you would like to enter into the record at this time?

MS. AcMOODY: Just what you have with you.

HEARING OFFICER SUTHER: Okay. So these will be entered in as Exhibit number 38.

(Exhibit 38 was entered into the record.)

HEARING OFFICER SUTHER: Are you testifying on behalf of an organization?

MS. AcMOODY: Yes, Western United Dairymen.

HEARING OFFICER SUTHER: Thank you. You may proceed.

MS. AcMOODY: Thank you. So as I said, my name is Annie. I am the Director of Economic Analysis for Western United Dairymen. We are an association of dairy farmers, representing the state's dairy families. And elected board of directors governs our policy and the board of directors approved the position I will present here today at our last board meeting on May 15, 2015.

Joining me today, as we mentioned, are Rob Vandenheuvel of Milk Producers Council and Lynne McBride of California Dairy Campaign. While they plan on presenting additional testimony at a later time, I wanted to point out their presence, not just because they would make good bodyguards, but mainly because it represents strong unity in the producers' community. The proposal we are presenting here today was submitted as a joint effort between the three producers trade association. In addition, it has the full support of the three main co-ops in the state - CDI, DFA and Land O'Lakes. The clear unity you see today is testimony to the undeniable disruption caused to California dairy families and their employees by the inequity in 4b pricing compared to the price discovery mechanism in states operating under the federal system.

We would like to thank Secretary Ross for the call of this hearing on her own motion. We would also like to thank Governor Brown for his oft expressed support and recognition of California's agriculture and dairy in particular. The issue at hand for this hearing, the whey portion of the Class 4b formula, is not a new source of concerns for the producer community and we are thrilled that the Secretary recognizes it needs to be addressed.

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. The issue became particularly apparent in 2011 as the value of dry whey started to rise. The producer community, concerned with the inequality, overwhelmingly supported some changes. Land O'Lakes submitted a petition in 2011. And agreeing the issue should be revisited, the Department called a hearing in June 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. 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 that hearing were an improvement for producers but because the whey value is allowed to fluctuate. But while we appreciated the modification, we believed it still fell short of a fair method to determine the whey value in the 4b formula. Hence, we submitted a petition to the Department on December 2011, proposing a whey factor that would 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 had been put in place averaged a staggering $1.75 per hundredweight. California dairy families clearly needed a better way to capture the whey value. Unfortunately, at that time the Department decided not to act on the matter.

The last update to the whey scale occurred in 2012, when the Secretary increased the upper end of the scale by 10 cents. Following this decision, she created the Dairy Future Task Force in the hopes of finding common ground between industry participants to improve the California pricing system. Almost three years later, no significant changes occurred and producers are still getting a Class 4b price that does not recognize whey's market value.

Every producer group in this state has worked really hard on getting this issue resolved. While we very much appreciate the open dialogue with the Secretary, the Undersecretary and her staff, the current formula still falls short in determining the whey value.

We will delve into more details later, but in short, our proposal adjusts the whey scale to allow the whey value in the Class 4b formula to mirror the whey value in the Class III formula for a period of two years. More specifically, as outlined in the Department's analysis, if the producers' proposal had been in place for the past five years, the California Class 4b price would have averaged $1.46 higher with our proposal. This represents almost $.70 on the overbase price.

It is no secret that the current producer dissatisfaction stems largely from the growing gap that exists between the Class III price and the Class 4b price. The part of the Food and Agricultural Code that states "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 Section 62062 has been mentioned so many times in the last few years that most of us in the room probably have it memorized, although I still had to read it for some reason.

According to CDFA analysis, with the current formula, the Class 4b price would have averaged $1.80 per hundredweight less than the federal order Class III for the period April 2010 to March 2015. The difference is even more striking when looking at the last twelve months of data, where Federal Class III was an average $2.57 per hundredweight higher than Class 4b. Instead of observing a shrinking gap between the two price formulas since the last change was made, the gap has widened. Now that's new information we're considering. This in itself should be evidence that the current Class 4b formula fails to determine the cheesemilk's value appropriately. Clearly, the current scale violates the mandates outlined in 62062 of the Code.

The deviation between Class III and 4b prices was caused by several factors. But the whey value is what creates the most variance between the two class prices and it seems the Secretary recognized that, calling a hearing with a scope pertaining only to the whey value of the Class 4b formula.

While producers would very much like to see the Class 4b equal to Class III, the scope of this hearing did not allow for such a proposal. The next best thing was getting a comparable whey value in Class 4b to the one generated by the Class III formula. If a formula that achieved that had been in place for the past five years, the difference between Class 4b and Class III would have been -$.34, instead of the -$1.80 with the current formula. California cheesemakers would have still gotten to pay a cheaper price for cheesemilk than their Federal Order counterparts.

Therefore, 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 the federal order. As outlined in the proposal, we propose the following scale, and you have that in your testimony here.

And I also include a chart that illustrates the discrepancy that has occurred in whey values in recent years. So you can see that on the screen up there. For those in the audience, the blue line on top is the federal order whey value and the double dotted line is the California whey value. In the last five years that gap has just really grown to unbearable levels. And Figure 2, which you have here in your testimony is a little bit different than the one that is going to show up there, but it shows the proposal, what it would have achieved in terms of getting those two whey values closer. And on the chart here you can see a little red like that just popped up on top. It's what our proposal would have achieved. So clearly much closer to the whey value in federal orders.

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. The Department seems very concerned with that situation, being that it specifically included a statement in the hearing analysis that says, "plants in federal orders can avoid the minimum Class III price by depooling; plants in California are always subject to the minimum Class 4b price." This statement seems to indicate a bit of the Department's bias on this issue. In fact, I would like to point out that in California plants are technically not always subject to the minimum Class 4b price. The option to depool may not be the same but there are options for plants to pay less than the minimum Class 4b price. When a producer elects to go Grade B, no minimum price applies to that producer. Plants, whether they are pooled or not, can agree on whichever price they want with the producer. In 2013, Grade B represented approximately 1.6 percent of total milk production in the state. In 2010, that percentage was closer to 5.3 percent. The picture in California is not as different from Federal Orders as some processors would like us to believe. While there are some differences between the two systems, it is recognized that depooled volumes in Federal Orders are also minimal. In 2013 and 2014 only 4.2 percent and 8 percent of the milk in federal orders, all classes combined, was depooled due to price.

So if it hadn't been for the Department's statement I probably would have skipped that information because really what we want to emphasize here is not whether these percentages are accurate or not, it is actually irrelevant to the current issue of Class 4b (sic) being a valid benchmark price. It is not because "plants can avoid the minimum Class III price by depooling" as CDFA states, that they necessarily pay less than the minimum price when they operate outside the pool. Whether the milk goes into the pool so a plant can take a draw out for its producers, or whether it stays out of the pool, depriving all other producers in the pool of the withdrawn higher class price is irrelevant - the plant could have still paid the Class III price regardless. The depooling decision is separate to the decision of paying Class III prices.

The most important question is: do plants really base their pricing off of Class III? Whether that Class III price is widely used, even when milk is not in the pool, is a point California processors are quick to jump to. Because when milk is not in the pool, it is easy to use that as an excuse because there's not really good numbers that are published for that information. But talking to anybody outside of California, it is easy to get anecdotal evidence that the Class III price is a commonly used benchmark.

Anecdotal evidence is helpful, but it is also useful to look at actual data to corroborate those statements. One way to get an idea whether plants pay close to the Class III price is by looking at a FMMO area where there is published pricing data. Specifically, it is useful to look at an area that has a high Class III utilization. Order 30, the Upper Midwest Order, fits the bill very well. In 2014, the order's utilization of Class III milk was 85 percent. Clearly, the price paid for cheesemilk has to weigh heavily on the area's price average. The all-milk price, which is defined on CDFA's website as the "weighted average of the prices dairy processors pay for all milk, should give us a good idea. It includes all milk, whether in the pool or not. It is important to remember the issue we are looking at with the price comparison is not what producers are actually getting paid once the milk goes through the pooling process, but what processors are actually paying. After all, that is what California processors are arguing, that other cheese processors don't have to pay the Class III price, and if they did in California they couldn't be competitive.

Therefore, the all-milk price should be a good barometer of what is paid by processors in an area dominated by Class III utilization. The table below shows data for 2014 in Wisconsin, which is part of Order 30. For the year the all-milk price averaged $1.68 higher than the Class III price, and that's adjusted to the state's average fat test, which you also have on the table. While what other plants are paying for milk is also included in the all-milk price, in an area where cheese plants represent close to 85 percent of the utilization, it's safe to say that with an all-milk price $1.68 over Class III, cheese plants certainly could not have been paying much under Class III.

Since California processors also mention that Order 30 is pretty far from California, which geographically that's true, another comparison with an area closer to California is helpful to validate that the Class III price is used as a benchmark throughout the country. Idaho, an unregulated area, is certainly a good place to look at. Since it is unregulated, plants there have the option to pay whatever they want. Discussion with the Idaho Dairymen's Association and Glanbia allowed us to find that:

Jerome Cheese pays Class III+12 cents.

Gossner pays Class III.

Sorrento pays Class III-25 cents.

Glanbia, the largest player, pays on a formula but over the last three years averaged 50 cents below Class III.

And Darigold pays on a percentage of Class III and Class IV.

Clearly, even when plants are not required to pay the Class III price, they use it as a benchmark to price milk. Class III is the price benchmark nationally for cheese milk. It's time our pricing system in California recognized it.

Given the current volatile 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 stabilized in recent years, but in doing so also seem to have reached a new higher norm and the following chart illustrates that trend. That's the California cost of production as calculated from CDFA. And it's hard to see but it goes back to 2003 on the left part of the chart.

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 from just over 50 percent of the total cost of production in 2003 to 60 percent of total costs by the third quarter of 2008. Since then, feed prices have skyrocketed and a new higher "normal" seems to have been reached on the feed cost side. You can see that on this chart here. Again it goes back to 2003. In recent years we can see we have reached a new high for feed costs.

Nationally feed prices may be low, but costs remain higher in California. As an example, according to USDA data, in 2014 the average hay price was California was $248 per ton; the average U.S. price was $202 per ton. Similarly, the average corn price was $4.70 per bushel in California versus $3.65 per bushel in the U.S. While 2015 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 an overbase that averaged $13.91 per hundredweight for the first four months of 2015, the current financial snapshot for producers is not great.

Due to al those increased costs, California dairymen have lost much of their competitive position relative to the rest of the nation. Failure to capture the value of whey, which has turned out to be a very marketable product, is hurting their competitiveness further. We reviewed the cost of production information because the Department must take into account -- and I have the quote here from the Food & Ag Code.

While 2014 was no doubt a record year for milk prices in California, a comparison of California blend prices to the average cost of production in California since 2006 reveals the challenge faced by producers. And you can see that on the chart here. Sorry your copy is in black and white but obviously what is under going lower is a negative and the -- you can see on the chart that there is a lot more red than there is blue in the situation comparing the milk price, which is the cost of production.

The latest cost of production data is not available for 2015, but based on feed prices that likely did not move much, combined with milk prices $7.73 per hundredweight lower than last year for the first quarter of 2015, it is not hard to imagine producers' financial situation has been hit seriously. Moreover, there is no sign the milk price will increase much above where it is now. The average overbase price for the second quarter of 2015 will likely be in the low $14 range. And current market conditions are not pointing to a rapid price recovery any time soon. To find a clear sign that the financial situation in California has deteriorated, one needs to look no further than USDA's *Milk Production* report. Indeed, so far in 2015 in the first four months, milk production in California has averaged 2.8 percent below last year. In the U.S., in contrast, milk production has been up an average 1.7 percent year-over-year. And you can see that chart here. The blue line is the U.S. milk production and the blue line is California. So clearly down drastically compared to last year.

The reason we are having this hearing does not pertain to plant capacity. With milk production lower than year ago levels, the previous plant capacity issues that have been mentioned in the past should not weigh on the discussion today. Still, I would just like to point out, that keeping the lower milk price in our state only contributes to the financial plight of dairy producers, not to bring supply more in line with capacity. Producers are the ones hearing the cost of a lack of capacity and will respond to it by either building capacity or reducing production via their plant's supply management program. The current whey issue is one of fairness with prices observed in the rest of the country. It is a well-known fact that the state is losing dairies. In 2014 there were 1,470 dairies left in the state, down from 1,752 five years ago. Adding to that, there is evidence that new plant capacity was built in the state in the past five years.

Two mid-size companies have built plant capacity and there is one underway. Several small farmstead operation have also started. Looking at the list of handlers in the state, there are more in operations now than there were five years ago. That is a stark contrast with the number of dairies still in operation today.

California dairy farms are the backbone of the dairy economy. And according to a recent study by UC Davis, the impact generated is quite impressive. Indeed, according to that study, the dairy industry generated $21 billion in economic activity for a total of $65 billion of dairy-related economic activity and it supported 55,000 milk production and processing jobs. Kind of a big deal.

In the Secretary's notice to industry detailing the last changes to the whey scale in 2012, she outlined her concerns about high feed prices, which were "exacerbated by a drought that is gripping vast parts of this country, causing crop failures and driving up grain and hay prices." 2012 really was just the tip of the iceberg. According to California Farm Water Coalition, "last year saw an unprecedented amount of farm water cuts - zero water - for vast parts of the state and 2015 will be worse." Trying to speak as fast as Jim Gruebele gets really challenging. In a study conducted by UC Davis last year, it was estimated that 429,000 acres had been fallowed statewide - a $2.2 billion loss to the state's farming industry. When there is no surface water available, farmers have no choice but to fallow their fields or turn to underground water. But using groundwater comes at a cost, since well drilling is rather expensive. And to find water, most have to dig deeper and deeper. According to an estimate from an article in National Geographic, there is a quote: "deeper wells don't come cheap. Arthur & Orum charges an initial fee of $5,000 plus $225 per installed foot. All in all, once a 1,000 foot well is installed, tested and fitted with pumps, it costs $300,000-$500,000." Again based on the UC Davis study, it was found the Central Valley was hardest hit, particularly the Tulare Basin, with projected losses of $800 million in crop revenue and $447 million in additional well-pumping costs. Another example: water board fees alone, simply for holding a permit, are up 400 percent since 2007. So the drought has been certainly a big problem.

After the last five years of price ups and downs, margins at the dairy remain fragile. I think you could have seen that with the chart earlier that outlined the difference between the milk price and the cost production. The memory of the 2009 dairy crisis is still fresh in producers' minds. 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. The effectiveness of hedging really 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 Class III. The difference between futures and cash prices is called the basis and the hedge will never be perfect due to that basis. But over time, with similar formulas, dairymen can assess their basis risk 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 margins does not perform as they intended.

So the unpredictability of the spread, due to the completely different structure of the whey value formula, makes it riskier for dairymen to hedge by preventing them from being able to determine their basis effectively. Just an example, if you look at the month of April. Two years ago the whey value in Federal Orders generated $2.16 more than California. This year it generated $1.09 more than the current sliding scale. So looking back at the past is really no good predictor of the basis.

If the crisis is fresh in dairymen's minds, it's not very far from lenders' minds either. Lending standards have tightened and banks like to know where their borrower's bottom line will be. Adjusting the whey factor to allow fluctuation with market prices will better enable California dairymen to utilize risk management tools.

Even the safety net that came out of the latest Farm Bill is an issue for California producers with the discrepancy that exists between California prices and the rest of the country. The correlation between Class III and the all-milk price, which is the price series used to determine program payment under the Margin Protection Program, is much stronger than Class 4b and the all-milk price. The difference between the U.S. all-milk price and the Class III averaged $1.64 over the past five years. The difference between the U.S. all-milk price and Class 4b averaged $3.50 over the past five years. The larger gap with 4b is not too surprising, considering what we already mentioned above, because Class 4b has just been significantly lower than Class III. But still, it makes the program a lot harder to relate to California producers with California pricing being that much lower than national averages. Additionally, it is harder to predict the difference between Class 4b and the U.S. all-milk than it is the difference between Class III and the U.S. all-milk. The standard deviation of the difference between U.S. all-milk price and Class III was $.71, while the deviation of the difference between U.S. all-milk price and Class 4b was $.96.

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.

A study conducted by the Wisconsin Whey Opportunities Working Group in 2013 points to the growing potential of whey. "On a global level, demand for whey-based protein products remains strong with export growth averaging 7 percent a year, and prices hovering near a five-year high level. In 2012, while the U.S. increased its share of the world cheese trade, it lost some on butterfat and whey product. And while Wisconsin produces the most whey, both California and Idaho continue to export more of what they do produce. With strong export growth potential ahead, this seems to present opportunities for California whey, not the opposite.

America's dairy farmers understand the importance of developing higher-valued products and have contributed to this process over the years through research at DMI. 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. Producers and processors should both be able to benefit from higher prices in the whey product markets. The argument often repeated by California cheesemakers that plants outside of California pay less for cheesemilk, as mentioned above, does not hold. The Wisconsin Whey Working Group actually added a statement to that effect in its study. Quote: "It should be noted that due to Wisconsin's practice of paying dairy farmers premiums above minimum Class III milk prices, actual payment prices were much higher than the Federal Order calculated minimum prices."

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.

In the 2011 Panel Report when the scale was first implemented, CDFA stated: "such a sliding scale could be devised and updated, if need be, to better correspond with California conditions compared to an end-product pricing factor." California conditions, as I have spent probably way too much time for people in the audience talking about, clearly they warrant an update.

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 $.75, there is tremendous potential for discrepancies between the Class 4b and Class III. Similarly, a floor of $.25 also creates a potential for discrepancies. The scale proposed in our petition significantly reduces 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.

And I have got another quote from the panel here in the document that you can read. But looking at the producer side of the equation, the continued use of a price ceiling in the California formula has placed California producers at a competitive disadvantage since there is none that used in federal orders.

In the past, it has been argued that a cap is necessary for small cheese processors who do not process whey. Whey has had a value for years and 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 in their feed ration for the cows. 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. 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.

Other proposals:

We oppose the alternative proposal submitted by the Dairy Institute. While we appreciate their creative effort to reform the scale, it clearly falls short of achieving what needs to be done to restore fairness in the Class 4b pricing formula. CDFA's analysis reveals that over the past five years it would have increased the Class 4b price by around $.41 per hundredweight. This is clearly below the $1.46 requested in our proposal. But most importantly, based on the latest WPC prices, it would generate an extra $.06 on the Class 4b price. Since their proposal is looking at only the next six months, it is unlikely to generate much more than that. Clearly, we cannot support a proposal whose intentions are not to move the Class 4b price closer to the Class III price.

I have a little summary here of what I talked about.

This concludes our testimony. The members of Western United Dairymen thank CDFA staff for their effort in preparing for this hearing. And we would be pleased to answer any questions you may have and also request the option to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

MS. AcMOODY: Thank you.

HEARING OFFICER SUTHER: Are there any questions from the panel?

MR. EASTMAN: Since I'm running the clock he let me go first; that's nice of them.

Okay, so I have a few questions for you. You mention in your testimony when you were formulating your proposal there were certain limitations within, I guess, the call of the hearing that kept you from being able to submit a proposal that would make the 4b pricing equal to the Class III price. If that flexibility would have been given there would you have crafted a proposal so the 4b price would have equaled the Class III price?

MS. AcMOODY: I think I don't -- the Board didn't necessarily take a position on that because of the scope varying. But I see a lot of thumbs up in the audience so yes, we would have crafted it that way.

MR. EASTMAN: That's good that you brought someone from the Board.

MS. AcMOODY: Yes, I know.

MR. EASTMAN: That's good. On Figure 5 you show the difference between the blend price and cost of production. Was the blend price that you used, was that the blend price that CDFA announces?

MS. AcMOODY: Correct, yes.

MR. EASTMAN: Okay. You talked a little bit about having price floors and ceilings and your proposal actually does include both a floor and a ceiling. Are you opposed to -- it doesn't appear that based on your proposal you would be opposed to either of those. Is it just the level at which the floor and the ceiling come into play that you're worried about rather than the theoretical foundation of having one in the proposal?

MS. AcMOODY: Right. So the current scale is too narrow, it doesn't allow the price to fluctuate enough, and that is why our scale obviously -- I think if we could have gotten rid of the one ceiling we probably would have. But being confined in the scale structure without having to go for five pages, you know, we kind of have to put a floor and a ceiling in at some point.

MR. EASTMAN: Okay, so that was just to keep your table to one page then?

MS. AcMOODY: Pretty much, yes.

MR. EASTMAN: Okay.

MS. AcMOODY: I think this could have been achieved with a formula structure. But with the, you know, the previous Department's willingness to adjust the scale we tried to keep it within the confines of the scale.

MR. EASTMAN: That makes sense. And then you mention that the proposal that, the alternative proposal submitted by the Dairy Institute, you're opposed to it. Is your opposition to that proposal based on the whey value that it generates and/or is it also based on maybe the methodology of how they're constructing it or the use of WPC34 as the dry whey finished dairy product that would generate the value? Can you speak to that?

MS. AcMOODY: No, we're opposed to it because it does not achieve the intent of our desire to get the whey value of Class 4b aligned with Federal Order Class III and their proposal does not do that.

MR. EASTMAN: So that's the overriding sort of factor that would be considered. So hypothetically if they would have submitted an alternative proposal that would have provided the exact same value that your scale did, although they based it on WPC34, you would have been indifferent between the two?

MS. AcMOODY: As long as it achieves -- again, I can't really speak for the Board. But as long as it achieves a close relationship. It's a little bit hard to say that w could support that because WPC prices move differently than dry whey prices.

MR. EASTMAN: Right.

MS. AcMOODY: And especially because they are asking for it for just a period of six months. I'm not sure it's worth moving away from dry whey, which is what they're doing in the rest of the country. It seems just moving further than getting closer.

MR. EASTMAN: And then I had one final question. Hopefully I'm not stealing these guys' thunder.

You mentioned that -- well, let's suppose hypothetically that the Department were to go ahead and implement your proposal.

MS. AcMOODY: That would be great.

(Laughter.)

MR. EASTMAN: Okay. I assumed that would be -- I gathered as much. I have one more question after this, I apologize. If that were to happen do you think that on the milk production side or on the dairy we would kind of flash back to what was happening prior to say, maybe 2008, 2009, where the ability to produce milk -- milk production growth was obviously back then on a different trend than it is now. I don't remember offhand the percentage. Maybe it was 3 or 4 percent almost every year for quite a while. In the last number of years that hasn't been the case. It seems that milk production growth and trends are different compared to, say, 8, 10 years ago. If we were to implement your proposal do you think on the dairy we'd be able to get back to that where there would be opportunities for growth and expansion?

MS. AcMOODY: I think it would help maybe preventing losing as many dairies as we have. But there's a lot of factors of preventing the industry in the state to grow, environmental regulation, the drought. I mean, all those things that are hitting the dairies are going to remain, even lending standards have tightened, so I don't think we would get to a point where the industry would grow significantly. What we are trying to do is prevent the exit of all the dairies that we have been losing. So I don't think that increasing the price would get us back to -- If by some miracle production in the state was to go up, there's, you know, supply management programs and plans at the co-ops and proprietary plans that would prevent that from happening.

MR. EASTMAN: Okay. Rob and Lynne, do you have any comment on that same question?

MS. McBRIDE: Yes. I would say given the changes in prices over the years and the increase in costs, I think the mindset has really changed to one that is more conscious about expansion, in terms of the members that we represent. So we don't foresee returning to that time.

Again as Annie mentioned, the pressures that dairy producers are facing throughout California, be it the drought, be it regulatory costs, other costs; again, I just don't see that as a real possibility.

MR. VANDENHEUVEL: I'll be providing testimony on behalf of MPC later so I don't want to occupy too much time now but I would echo a lot of their sentiments.

MR. EASTMAN: Okay, perfect. And I guess my last question. Maybe this will need someone else from the audience to come up to confirm whether or not you were testifying as fast as Jim Gruebele has in the past.

(Laughter.)

MR. EASTMAN: I've never heard that so we'll kind of have to see how that goes. But my throat was getting dry listening to you.

MS. AcMOODY: Thank you. Appreciate that.

MR. SHIPPELHOUTE: I had a question on your comment on milk that is not regulated, and that being the Class B. I'm sorry, the Grade B milk. Producers can switch to Grade B and that milk would not be subject to minimum pricing provisions. Do you have any thoughts on the products that could be made with the whey that is manufactured from Grade B milk and if there is any limitations to that? You speak to the difference between milk being deregulated in a federal order and maintaining market grade standard as opposed to having to switch to manufacturing grade to be deregulated in California.

MS. AcMOODY: Really I put that there because I thought that the statement in the analysis was a little bit strong saying that minimum price is always applied in California. Really it kind of detracts from the issue at hand that I really don't think that it matters whether the milk is pooled or not. Your question is more to, what kind of products you could make. I don't think I've got much to add to that.

MR. SHIPPELHOUTE: And my other question you already answered on supply management.

Back in your testimony you talked about the premiums that these plants are paying in other parts of the country. Have you looked at any premiums that California processors are paying and could you speak to that?

MS. AcMOODY: Yes. There's not really set data on the premiums and I think it is known that some premiums are paid and I'm sure some processors can testify to that later. I think the main issue here is that if they are able to pay those premiums on this product that producers should be getting a fair return, then it should be shared in the pool and not just, you know, paid individually.

MR. SHIPPELHOUTE: Okay. There's premiums paid on other classes as well. Would your thoughts on those premiums be the same, that premiums for other classes should be pooled as well?

MS. AcMOODY: Well, no. What we are trying to get at is the basic raw commodity for whey, really, that is part of the regulated system in other parts of the country. I think premiums are great. You know, if we were in the free markets, plants could do whatever they wanted paying the producers. But since we are stuck within the confine of this heavily regulated system, we have to make sure that the basic raw commodities are accounted for in the pool and that producers are getting a fair return from them.

MR. SHIPPELHOUTE: Thank you. And that was all the questions I had.

MR. LEE: I have one question. If your proposal would be validated to be approved.

MS. AcMOODY: That would be great.

MR. LEE: What are your thoughts as to how would that affect the whey market in terms of price and volumes? Do you have any thoughts on that?

MS. AcMOODY: I don't think it would affect the whey market, technically. If the plants are already paying premiums to their producers as, you know, some people have stated, then it would just be a reallocation of those monies to the pool so it shouldn't affect the whey market prices.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: If there's no further questions --

MR. SHIPPELHOUTE: Actually I want to follow up on that last comment. There shouldn't be any changes to, you're suggesting there wouldn't be any changes to the raw product cost because with your proposal those monies would just be directed to the pool rather than to premiums for the supplier.

MS. AcMOODY: I think the question was on the whey market price, right, on the finished product? Is that what you were getting at, John?

MR. LEE: Yes.

MS. AcMOODY: Yes.

MR. SHIPPELHOUTE: So do you think that your proposal, the dollar amounts in your proposal pretty closely reflect the premiums that plants are paying now?

MS. AcMOODY: That's a good question but that's what you'd expect. Since the Class III price is a benchmark that's heavily used I would think that plants have to pay something close to that.

MR. SHIPPELHOUTE: That's it.

HEARING OFFICER SUTHER: Any further questions from the panel?

Thank you Ms. AcMoody, Ms. McBride and Mr. Vandenheuvel.

MS. AcMOODY: Thank you.

HEARING OFFICER SUTHER: I will now call on the representative testifying on behalf of the alternate proposal submitted by the Dairy Institute of California. You will have a total of 30 minutes to submit your testimony. Again, please notice the clock. And I believe it will be Bill Schiek.

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

DR. SCHIEK: Yes. My name is William Schiek, S-C-H-I-E-K; and I am representing the Dairy Institute of California here today.

Whereupon,

DR. WILLIAM SCHIEK

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other written statements other than the ones you have provided us here?

DR. SCHIEK: No, this is it.

HEARING OFFICER SUTHER: Okay. And would you like these entered into the record?

DR. SCHIEK: Yes, please. Although if you'd like more I could probably come up with some.

(Laughter.)

HEARING OFFICER SUTHER: These will be entered into the record as Exhibit number 39.

(Exhibit 39 was entered into the record.)

HEARING OFFICER SUTHER: Again, you are testifying on behalf of an organization?

DR. SCHIEK: Yes.

HEARING OFFICER SUTHER: The Dairy Institute. You may proceed.

DR. SCHIEK: Thank you. Mr. Hearing Officer and members of the Hearing Panel:

My name is William Schiek and I am Economist for Dairy Institute of California. I am testifying today on the Institute's behalf. Dairy Institute is a trade association representing 30 dairy companies which process approximately 70 percent of the state's fluid milk and manufacture about 90 percent of the state's cheese and 75 percent of its cultured dairy products and ice cream. Dairy Institute's members operate in both marketing areas in the state. The position presented at this meeting was adopted by our Board of Directors.

Dairy Institute is grateful for the opportunity to testify at this hearing where proposals to change the whey contribution scale in the Class 4b pricing formula are being considered. In authorizing the state's dairy regulatory programs the legislature has declared: "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." Indeed, orderly marketing is the stated purpose of most dairy regulation. The level of regulated price plays a key role in maintaining an orderly market.

In establishing a regulated price so that milk production and marketing are orderly, it is important that the Department balance the needs of producers, dairy product processors and manufacturers, and consumers, not favoring one group's need over the others. 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. It is not in producers' collective interest if the Department sets prices for milk so high that it forces small cheese plants out of business by requiring them to pay more for milk than they can obtain in revenue from the products they sell after paying necessary manufacturing and marketing costs.

Unfortunately, the proposal by the three producer trade associations, Western United Dairymen, Milk Producers Council and California Dairy Campaign, under consideration here today, would do just that. By forcing cheese plants out of business their proposal would reduce not only the number of milk buyers in the state but the overall plant capacity in the state, thereby shrinking the size of the California milk market and leaving dairy producers without a home for milk. Their proposal would devastate the cheese industry in the state and would violate the directives to the Secretary set forth by the legislature in the state's Food and Agricultural Code. More detail on the legislature's requirements of the Secretary in setting regulated minimum milk prices and the government's appropriate role in milk pricing is contained in Appendix A.

Calendar year 2014 was an outstanding year for dairy farm margins in California. The combination of high dairy commodity prices and lower cost for concentrate feed helped fuel a record year that saw dairymen pay down debt, pre-purchase feed, defer income, and drill deep wells for on-farm water needs, including forage production in many cases. Milk output rose in 2014 to an all-time record high, despite there being fewer milk cows and fewer dairy farms in the state than was the case the year before. Average milk prices have fallen significantly from where they were early last fall, as a global surplus of milk has developed in response to an extended period of high global prices that began in 2013.

Milk production in California has fallen off slightly in the first several months of 2015, which is not too surprising considering how extremely strong milk production was in the first quarter of 2014. Milk output is somewhat lower this year on slightly fewer cows and lower milk per cow, which has been attributed to poor feed and forage quality being fed in California. It is also reasonable to suspect that rBST use is down this year since the marginal value product associated with its use has fallen relative to its price because of the lower average milk prices in the state this year. Still, despite these headwinds and the uncertainty generated by the drought, milk production in California during the first four months of the year is the third highest for that period in the state's history, falling behind only 2012 and last year's record output. There have been occasions when milk output has fallen in recent years, only to be followed by years with new record high milk production.

The modest reduction in milk production, which averages 2.7 percent in the January through April period relative to last year bears watching, but it is not indicative of a crisis nor cause for alarm. It is certainly no justification for putting the cheesemaking sector at risk through a regulated price increase that will make a large percentage of the state's cheesemakers unprofitable. Regulated price increases are neither appropriate nor effective as a tool for mitigating the impact of drought on dairy farm operations because of their negative impact down the supply chain. What good is it to try to alleviate on-farm drought impacts by making dairymen's market for milk vanish in the process?

There seems to be an assumption by producer advocates that cheese plant margins are so large that cheesemakers can easily absorb and sustain big increases in the regulated 4b milk price. That assumption is flat out wrong. The changes that have occurred in plant capacity are instructive. The state's producer cooperatives have been divesting of their large cheese plants. DFA closed its Corona facility in 2007 after selling its Petaluma facility a few years earlier. Land O'Lakes sold its mozzarella plant in early 2007 in 2010 ceased production of cheddar cheese at its Tulare facility. Also during the past few years DFA, Land O'Lakes and CDI have expanded their capacity to make dry milk powders. DFA has chosen to make its new powder investment in Northern Nevada, voting with its feet about the desirability, or lack thereof, of siting a plant in

California. This pattern of behavior would seem to suggest that co-ops have found the profitability of butter-powder operations to be greater than in cheesemaking, contradicting the notion that regulated prices for cheese plants should be increased and cheesemaker profitability decreased, yet the co-ops are supporting just such an illogical proposal at today's hearing. More detail on the current milk supply and demand situation is presented in Appendix B.

In Federal Milk Marketing Orders where a dry whey end-product formula is used in the Federal Class III price, the regulated minimum price is optional. Plants that are non-pool plants, a category which includes many of the cheese plants operating in the Upper Midwest, are not obligated to pay the regulated minimum price for the milk they buy. Furthermore, these plants do not pay the regulated minimum price on spot milk purchases when milk supplies are heavy. For example, last week, spot milk sold for as much as $10 per hundredweight below the class in the Upper Midwest and multi-dollar discounts have been common throughout the spring.

In contrast, proprietary cheese plants in California must pay the regulated minimum Class 4b price on every drop of Grade A milk they buy. If the price established by the state is too high for plants to recover from the products they make, they have no practical option but to quit the business. The proposal by the producer groups would leave many cheese plants in California with no options but pursuing an exit strategy. There is a false premise that has been put forward by producer groups which states that regulated prices for milk used to make cheese in California and the federal orders should be set equal to each other or nearly equal because both systems set minimum prices for the various classes of milk. Under this false premise, any incidence of the California Class 4b price being lower than the Federal Class III price is erroneously characterized as a loss to California producers. That they have been robbed of something to which they are entitled.

However, sound economics and basic logic reveal that the regulated price levels for milk used in cheesemaking in California and in the federal orders are not and should not be the same. Producer advocates fail to acknowledge the mandatory nature of California's milk prices compared to the voluntary nature of federal order prices. They fail to acknowledge the difference in the location value of cheese and consequently the differences in the location value of milk used in cheesemaking. They fail to even consider the possibility that the federal formula might overvalue milk to cheesemakers, or the differences in industry structure and costs in California that necessitate a lower price for milk here. By failing to acknowledge these important differences, producer advocates have perpetuated a falsehood to everyone's detriment. The differences in milk value between California and the federal orders are discussed in more detail in Appendix C.

At previous hearings we have testified at length about the problems associated with incorporating an end-product whey factor into the regulated pricing formula. Some of those arguments re repeated here: most cheese plants receive no value for the whey byproduct of their cheesemaking operations, about half of those that do receive some receive revenue less than is assumed by the Class 4b formula, the revenue streams of plants that do capture value from their whey find their revenue does not track well with dry whey, and only one plant in the state is currently making dry whey. More on the problems associated with the inclusion of whey in the Class 4b and Federal Order Class III formulas is contained in Appendix D.

More recently, some of the small- to medium-sized cheese plants in California have been investing in equipment to concentrate liquid whey, either through reverse osmosis or ultra-filtration. Increasingly, this liquid whey product is being sold to other cheese plants for finishing, which is drying, either directly or after further concentration of the liquid whey. The liquid product is most often being sold to cheese plants at a price that is driven by movements in the WPC34 price. It is therefore possible to construct a whey contribution scale that is based on the WPC34 price and that reflects the value that cheese plants selling liquid whey to "finishing" plants are able to recover.

Some may suggest that using this approach we should also include a value for the liquid lactose permeate. There are probably a couple of plants selling liquid whey that have also found a viable market outlet for their liquid permeate. However, these plants are the exception rather than the rule. Most small to medium sized plants, if they ultra-filter their whey, still find that dealing with the permeate represents a significant disposal cost, not a moneymaking product. For this reason it should not be included in any regulated minimum price formula.

This approach is more in keeping with the concept of minimum regulated prices, those that reflect revenues that can be recovered by most cheese plants. It should be noted that such a scale still runs the risk of overvaluing milk to small plants that are unable to make anything saleable with their liquid whey byproduct. It is important, therefore, to have an upper limit or cap on the whey contribution that would keep smaller plants from being severely impacted when market conditions drive WPC34 prices to high levels. The notion of using WPC34 as the mover of a regulated price whey contribution and the notion of a reasonable upper limit have support in the cheese industry outside California, as shown in Exhibit E.

Dairy Institute's Proposed Changes.

The Institute's proposed changes are shown on the page, on this page. Items that have changed are highlighted. Basically, it is a new whey contribution schedule that has a minimum value of $.25 per hundredweight for WPC34 prices below $.75 and then they increase as the WPC34 price increases, reaching a maximum value of $1.25 per hundredweight when the WPC price is greater than or equal to $1.35. And the rest of the formula is the same.

The whey price series used in the formula would be the simple average of the weekly Central and West 34 percent Whey Protein Concentrate-Mostly prices as published in USDA's *Dairy Market News* between the 26th of the prior month and the 25th of the current month. The changes are proposed to make the Class 4b pricing formula better reflect the current market situation and to balance the needs of producers and the diverse types of cheese plants that operate in the state of California. It is reflective of the value of whey to cheesemakers that concentrate liquid whey and sell it to other plants for further processing, and is therefore more appropriate for inclusion in an end-product formula designed to calculate minimum regulated prices for milk.

Underlying the table that we submitted as our proposal is a formula that basically takes the WPC34 price and subtracts $.15, then subtracts $.35, multiplies by 1.8 which is the WPC yield and 0.8918 which is a proportion of skim whey in 100 pounds of milk, and less a fixed transportation cost.

The $.15 number is the discount to the WPC34 price that applies to purchases of liquid WPC34.

The $.35 reduction is the cost per pound to make liquid WPC34.

The 1.8 is the yield of WPC34 solids. That's 1.8 pounds from 100 pounds of liquid whey.

And as I said, .8918 is the proportion of milk that ends up as skim whey in a cheddar cheesemaking operation.

A discount of $.15 per pound from the WPC34 price is applied because the plant buying the liquid product must undertake additional processing to make a finished dried WPC product. We are estimating that it takes an additional $.15 per pound to dry liquid WPC34 to its dried form. Plants that further process the whey to higher concentrations will incur higher costs. This discount to the WPC34 price is something that moves with market conditions and with the amount of competition on the buying side. A market with lots of buyers will see smaller discounts.

The cost to make liquid WPC is about $.35 a pound of WPC34 solids in the liquid product. These costs are appropriate for the plant scale and solids concentration level that we are assuming. We are also assuming a WPC34 yield of 1.8 pounds per 100 pounds of liquid whey. This equates to a bit over 1.6 pounds of WPC34 yield per 100 pounds of milk and is consistent, though probably on the high side, with what would be achievable by small- and medium-sized cheese plants making liquid WPC34. The proportion of the skim whey is 0.8912. It was derived by assuming that 100 pounds of milk yields 10.2 pound of cheese and 0.62 pounds of whey cream at 35 percent fat, which is the cream equivalent of 0.27 pounds of whey butter at 80 percent fat. So the remainder, 100-10.2-0.62, is 89.18 and that is the skim whey portion.

Also embedded in the whey table is an assumed transportation cost for moving the liquid whey 100 miles at a concentration of 10,000 pounds of solids per load, which is typical. Some liquid product moves at higher or lower concentrations, but the value we use is representative. We note that some liquid whey moves as much as 300 miles for processing, while other liquid whey shipments are less than 100 miles. The average distance for moving liquid whey in the state is probably somewhat higher than 100 miles. The transportation cost to move concentrated liquid whey 100 miles comes to about $.05 per pound of WPC34 solids, which is equivalent to about $.08 per hundredweight of milk given the WPC34 yield from milk. Dairy Institute proposes that the new whey scale described above be in effect for a period of six months.

The whey scale currently being used in the Class 4b formula as described in the Stabilization and Marketing Plans is based on dry whey and is no longer representative of the whey values received by cheese plants operating in California. It is completely ad hoc in construction and has no technical or rational basis. This same flaw is in the Western United, Milk Producers Council and CDC proposal. Their whey table is not representative of whey revenues achievable by California plants nor does it represent the products that are actually made by California cheese plants. It mimics a feature of a different regulatory system that does not enforce minimum pricing on all plants, as does California.

The number of plants in the state making dry whey has diminished, while the few plants selling liquid whey increasingly find their liquid whey product's value is more closely tied to the price of WPC34. Also the prices for whey protein products that are made by the large majority of cheese plants in the state that actually process whey are more closely correlated with prices for WPC34 than for dry whey.

The changes are proposed to make the Class 4b formula better reflect the current market situations and the actual products produced by California plants and to balance the needs of producers and the diverse types of cheese plants that operate in California. By including a cap at $1.25, we allow for additional revenue to pass through to producers through the regulated price when whey prices rise, while attempting to limit the damage such changes would do to cheese plants without whey processing capabilities. With our proposal for a $1.25 per hundredweight cap, Dairy Institute's members felt that it was important to retain the current $.25 contribution floor.

The increase in the top of the whey scale is significant, and while we believe that this increase be borne by cheesemakers, we have proposed limiting the duration of the change to six months. If the 4b price increase generated by our proposal leads to negative impacts on small cheesemakers, these can be remedied by reversion to the existing scale. If, however, the new scale proves workable for the industry, we believe it has a rational and sound economic and technical basis and could be evaluated as to whether it should be extended or refined at a subsequent hearing.

Dairy Institute opposes the producer group proposal. Their proposal is highly similar to ones that have been brought out during the past several hearings and rejected by the Department and there is no new compelling evidence that has suddenly solved all the problems with this proposal that the Secretary has noted in past decisions. It increases regulated prices on cheesemakers by too much, is not representative of whey products made in California, is ad hoc and not supported by evidence of it being representative or applicable to any group of cheesemakers in the state. Its adoption will reduce demand for milk in the state while increasing milk supply, leading to uneconomic movements of milk and disorderly marketing as was the case in 2007-2008. It should be rejected.

The best regulated price policy to help dairy farmers is one that expands the demand for California milk by encouraging investment in new products, new plants and new technology that will help us grow our markets both domestically and internationally. High market-based milk prices that are realized through growing demand for dairy products are a far more effective and sustainable path than raising the regulated price and squeezing margins for plants. High commodity and milk prices are the direct result of growing the market for California dairy products in the domestic and global marketplace. That is where our focus should be. The proposal to increase the regulated price will hinder that effort.

We note that the 2013 weighted average manufacturing cost of cheddar cheese was higher than the current manufacturing allowance by a substantial $.0303 per pound. Looking over the past few years, cheese manufacturing costs were higher than the make allowance during each year from 2004 to 2008 and again each year since 2011. Therefore, any increase made to the whey contribution scale should take into account that the cheese manufacturing allowance is below the weighted average manufacturing cost. Cheese plants in California are already seeing their margins under pressure from an inadequate make allowance, so any large increase in the whey contribution will diminish plant margins to the point that many will become unviable, being unable to make a profit and therefore likely to exit the industry to the detriment of producers in the state. Any whey formula or schedule more aggressive than what we have proposed would put cheese plants and their associated plant capacity at risk.

Thank you for the opportunity to testify and I am willing to answer any questions you may have at this time. I also request a period for the filing of a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Are there any questions from the panel?

MR. EASTMAN: I have a few questions. Before I get to those I'd like to go to your appendices and just kind of look at some of the graphs and make sure I understand what they are and where the data is coming from.

DR. SCHIEK: Okay.

MR. EASTMAN: On page 4, figure 1A, we have seen this sort of graph before. I think this is similar to what you have presented in previous hearings.

DR. SCHIEK: Yes.

MR. EASTMAN: And I assume the methodology and your thought process was the same?

DR. SCHIEK: Everything is the same, yes.

MR. EASTMAN: On Appendix B you have a few figures, B3, B4, B5, and they all look at income and feed costs and comparison of those two things. When it comes to the income side of that comparison where are those -- where are those income figures coming from?

DR. SCHIEK: The income actually comes from the line in the quarterly milk production cost comparisons, income-over-feed cost.

MR. EASTMAN: Okay.

DR. SCHIEK: And then the price is adjusted for marketing costs so to avoid kind of taking it out twice. So that's where that originates. So it comes from the cost surveys, the same place as the cost numbers.

MR. EASTMAN: Perfect. And that's for all three, right?

DR. SCHIEK: Yes.

MR. EASTMAN: Sorry, I'm just flipping through this. I appreciate you not speed-reading through all of your appendices. It is entered into the record without you talking about them.

Great. Now I just have a few questions based on your testimony itself. In constructing your table you base it off of the WPC34 finished product.

DR. SCHIEK: Right.

MR. EASTMAN: We know that the *Dairy Market News* portion of the USDA releases that weekly based on the Western and Central regions.

DR. SCHIEK: Right.

MR. EASTMAN: And that was your intention, to use that price series, based on your testimony?

DR. SCHIEK: Exactly.

MR. EASTMAN: Are you aware of any other price discovery mechanism for WPC34 at all?

DR. SCHIEK: At this point no, I am not. I believe that's the only published WPC34 price out there.

MR. EASTMAN: Okay. And granted, I think there will be some cheese processors testifying later. Do you have any sense if that's the main price series that they use when they're actually marketing their product and making their financial decisions?

DR. SCHIEK: My understanding is that it is the benchmark they use when they are pricing whey products, whether it be liquid whey or pricing other whey products.

MR. EASTMAN: Okay. And then when you were talking about the formula that was the basis for your table on page 6 of your testimony. Where were the sources that you derived these factors from? Did you survey your members? Is there some -- not that there is secret society of WPC34 information, I suppose.

(Laughter.)

DR. SCHIEK: No. Consulted some industry experts who work with whey processors and building whey plants and who are familiar with prices paid for liquid whey here in the state. When we developed this we also put it in front of our members, some of whom actually buy some of the liquid whey, some of whom sell some liquid whey, so they were able to kind of help us fine-tune that to get it in line with what market reality here in California is. This is not -- this is representative of California, not of, you know, what's going on in Wisconsin. Liquid whey sales is a bit more of a local kind of market, obviously, because it's bulky to transport. So that's where it came from.

The 1.8 yield factor is also corroborated by some data from whey equipment manufacturers.

MR. EASTMAN: Okay. With regards to switching to WPC34 from dry whey. You mentioned in your testimony that one advantage is that in California cheese plants that make a finished dry whey product -- there are more plants that make WPC compared to dry whey.

DR. SCHIEK: Right.

MR. EASTMAN: That's one advantage. Do you see other advantages to switching to using WPC34 besides that one factor?

DR. SCHIEK: Well, I think one thing that's true, it's certainly true in California and it's true nationally, is that the volume of dry whey that is being produced is decreasing and the number of plants producing that product is decreasing. There aren't many plants in the Western Region that actually can be -- that produce dry whey kind of week in/week out. The number is diminishing every year.

So there's a sense that the industry is kind of moving away from that product. I think that product will still be around but its importance is becoming less and less all the time. Of course, we have all these membrane fractionation technologies and people produce WPCs of various concentrations and whey protein isolate and hydrolysate. I don't know if I said that right; I should probably let the whey people talk about that before I embarrass myself. Too late.

(Laughter.)

DR. SCHIEK: But yes, it does seem that WPC is the product that is on the rise and variations of it are the product of the future and moving in that direction makes sense.

MR. EASTMAN: Do you think that's primarily driven on the demand side, people wanting WPC compared to dry whey, or is it based more on the manufacturing side of it where you have greater flexibility to fractionate or maybe the return on investment is better for WPC34 compared to dry whey. Do you have a sense of whether it is demand driven, supply driven, is it both, is there any clear answer?

DR. SCHIEK: Yes, I think it's both. I think initially it was, you know, when it was a newer product there was the thought that it was a value-added product and you could -- by going into it you could enhance your returns. And I think that probably made some sense at the time.

But the difficulty with whey markets in general is with the size and scale of the cheese plants we have today, one plant switching their product mix, for example, can have a big impact on the market. If every plant that's, you know, out there making cheese today was still making dry whey we wouldn't even be talking about whey value in the formula because there would be no value to that whey. it's the ability to kind of go out there and actually help create the demand by informing people technically of what they can do with the product, how it can be used, that that market has been grown and now there's more demand.

Dry whey has some human use but also an animal feed use. That's one of the big demands for dry whey.

MR. EASTMAN: Okay. And then on the flip side, maybe this sounds more like an interview question you always get, but do you foresee any weaknesses in switching from dry whey to WPC34? Or things to be concerned about.

DR. SCHIEK: Yeah. I think our bigger concern is, has to do with raising the cap from $.75 where it is currently, to $1.25. That's a $.50 increase in the cap, that's fairly substantial. We do have some concerns how that will impact smaller cheese makers. I think there are some here who are going to be testifying today and they can, they can talk about what concerns they have about it. That would be one of the shortcomings.

Currently, you know, there is no -- like you say, basically there is one price series. We don't have a futures price yet on WPC34 but I do think that that's something that's -- if pricing moves that direction there will be a 34 market pretty quickly, I would think.

MR. EASTMAN: And that would then just enhance the ability to use the product, to risk manage, to hedge, whatever?

DR. SCHIEK: Right.

MR. EASTMAN: In your proposal you choose a sunset clause of six months. Is that primarily because of the newness, for the uncertainty of switching to a different price series in a different sort of whey value structure? Is that just have a short test drive of it or is there any other reasons why?

DR. SCHIEK: So that's one of the primary reasons. The other one I think was our experience with the last temporary price increase in I guess September 2013. We extended the sort of temporary price increases out to July 1, 2014. By the time those came off we were adding a temporary increase onto what was already record prices. And I just think if you get too far out with temporary changes -- market conditions change really dramatically. I think it is best to have them for a shorter duration and then reevaluate whether they are still needed or not.

MR. EASTMAN: All right. I think that's what I have for right now.

MR. SHIPPELHOUTE: On the second page of your testimony you talk about if the producers' proposal was adopted that we would lose plant capacity. Do you have any thoughts on the volume of capacity that would be lost?

DR. SCHIEK: No, I don't and I can't really speculate. I have personal opinions but I don't have a position on how much is likely to be lost. I think that, you know, there are several ways plant capacity can be lost. Number one, I think you will see an exit of small cheese plants because that increase of $.15 a pound of cheese, that wipes out profit margin and the ability of some of the smaller cheese plants to pass on an increase like that in a competitive marketplace just isn't there, so we have that concern. Obviously the small plants don't amount to a lot of volume, a lot of total plant capacity, but we do think that that's a number of businesses and employees that won't be there.

On the sort of next wave or medium-size cheese processors. I think those are the ones that are going to -- they'll try to do some other things. But what we are finding is that it is very difficult to get revenue out of whey unless you have a certain scale. It is very difficult to get -- to make a investment pay off unless you have a certain kind of scale. So those plants, some of whom have even invested in whey, are going to find their business is really challenged and their viability challenged with an increase of that magnitude.

Another issue is the ability to go out with that kind of a cost increase on the input side, the ability to go out into the marketplace and be competitive with your cheese product. The other sort of way I see plant capacity in, I'm talking more willing plant capacity, what plants are willing to buy, I see that being affected. Cheese plants may not be able to make as many sales. They may not be able to sell as much volume because places where they are competitive now they won't be anymore and so we see that volume decreasing. I see that volume decreasing from an economic perspective.

MR. SHIPPELHOUTE: On the same page you also make a comment that the 2.7 percent decrease is not indicative of a crisis nor a cause for alarm. Do you have any sense of what percentage decrease would indicate a crisis or cause alarm?

DR. SCHIEK: Yeah. Well, you have to kind of look at where we're coming from; that was the point I was trying to make. I mean, 2014 was a record year. We had plenty of milk, plants were running very full a lot of the year. Reports I get from our members is right now the market is really fairly in balance, there's not a lot of folks out really looking hard for milk now. Maybe others have a different opinion of that but at least in terms of our membership that's what we hear.

MR. SHIPPELHOUTE: You make reference to the conditions in the federal order, the Upper Midwest in particular. You mention that there is milk moving at $10 below the announced price. Do you have any sense of the volume or percentage of that milk?

DR. SCHIEK: No, no. You know, these are the things you pick up in the *Dairy Market News*, the weekly Midwest Cheese or Midwest Milk sections. They usually don't have any volume although there was a statement that there were longer term below-class contracts being made. You know, going out, say through June and into the summer. So that's -- typically they're kind of a week-to-week thing, just very much a spot sale, but it sounded like there had been some reports that it's going on a little bit longer than that.

MR. SHIPPELHOUTE: Okay. That's all I have.

MR. LEE: I have a question. I asked the same question of the producer, the petition from the producers version. What do you think if, as compared to their proposal, your proposal, how would that affect the whey market, whey market prices? Do you think it would have any effect or would it -- would it affect the ability to sell the same amount of whey that is being done today, by an increase?

DR. SCHIEK: Well, you know, I would like to give that some more thought and answer it more carefully in a post-hearing brief. One of the things that our members feel is important is having their milk costs match more closely the products they actually sell. So to some extent, you know, you could see maybe more effective marketing and sales of the WPC, which might boost the demand for that product. I really don't know. But I'd like to give that more thought and respond in a post-hearing brief, if I could.

MR. LEE: Okay. And now, do you have any opinion as to if the proposal that was presented by the producers' petition? What would be your thoughts on their -- how those increases would affect the market?

DR. SCHIEK: I'd like to give more thought --

MR. LEE: Okay.

DR. SCHIEK: -- and answer that in a post-hearing brief as well.

MR. LEE: I've got one more question. Regarding your table and the long, involved formula that's used. Do those factors or those numbers that you are presenting, does that change from batch to batch? Would that be a more better way of reflecting a rate better?

DR. SCHIEK: You know, that's a good question, John. I don't see it as something that changes from batch to batch, but as I indicated in my testimony, some of those technical factors do have some market orientation and they are impacted, for example, with new buyers. If there were more buyers of liquid whey in the marketplace some of those might change. If you had more of what I would call "specialists" in the whey business, if you had a lot of those who had more scale economy, you know, that might change. It might suggest a change in the make allowance. I don't know. But I think any market that's more competitive, certainly that pricing number is the one that's most variable and might change with market conditions. The pricing discount.

MR. LEE: Thank you.

DR. SCHIEK: Okay.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Schiek.

DR. SCHIEK: Thank you.

HEARING OFFICER SUTHER: We are going to take about a five minute break.

But before we do that, we have a special provision to allow witnesses to present testimony for three minutes or less. We are going to set up another sign-up sheet in the back of the room if anybody would like to do that.

And also the post-hearing brief will need to be -- it will need to be turned in to the Department -- it is due to the Department by 4:00 p.m. on Monday, June 8th, so that will need to be turned in by then. If it is not in by then it will not be presented into evidence.

So we are now off the record for about five minutes and we will start back again.

(Off the record at 9:41 a.m.)

(On the record at 9:54 a.m.)

HEARING OFFICER SUTHER: All right, we will now be coming to order. It is 9:55 and we will be coming to order.

MR. SHIPPELHOUTE: We are back on the record.

HEARING OFFICER SUTHER: All right, ladies and gentlemen. Okay, as I said, we are now back on the record. We will now proceed with the public testimony section of this hearing. Our first witness is Mr. Brokaw.

Mr. Brokaw, you are already here, you're seated. Will you please state your full name, spell your last name and state your affiliation for the record, please.

MR. BROKAW: Yes, Mr. Hearing Officer and Members of the Hearing Panel. My name is Barry Brokaw, B-R-O-K-A-W, I am the President of Sacramento Advocates, Inc. I am here today as a consultant testifying solely in behalf of my client, Kraft Foods Group.

HEARING OFFICER SUTHER: Thank you.

Whereupon,

BARRY BROKAW

Was duly sworn.

HEARING OFFICER SUTHER: You have presented us with some written statements here; do you want those entered into the record at this time?

MR. BROKAW: Yes I would, sir, please.

HEARING OFFICER SUTHER: These will be entered in as Exhibit number 40.

(Exhibit 40 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. BROKAW: Thank you. Mr. Hearing Officer and Members:

Kraft Foods operates a dairy plant in Tulare, California where they manufacture Parmesan and other hard Italian cheeses, as well as cultured products including sour cream and cottage cheese under the Knudsen brand. This facility also produces dry sweet whey powder, both food grade and animal grade. Kraft employs 265 people at this facility and processes several million pounds of milk per day. This milk is purchased from farmer cooperatives in California. The Tulare plant is one of Kraft's 40 manufacturing facilities in North America, 9 of which are cheese plants. The Kraft customer base includes customers in the retail foodservice and wholesale segments, nationwide. The cheese that Kraft produces in Tulare is then transported to the Midwest, where it is aged, processed and then packaged. The packaged, finished goods are then shipped nationwide, including approximately ten million pounds shipped back to California to be distributed. This back-and-forth shipping adds significant cost to the cheese, which is why higher cost milk due to whey will create an uncompetitive market situation for cheese makers.

I am here today to testify in strong opposition to the producers' proposal - we can call it formally the Western United Dairymen/Milk Producers Council/California Dairy Campaign proposal - that would value whey in the 4b milk pricing formula at a value similar to the Federal Class III value, for a term of up to two years. I am also here to testify in support of the Dairy Institute alternative proposal that replaces the current dry whey schedule with a schedule driven by the price of WPC34 and a term of no longer than six months.

In our view, whey processing in general falls into four tiers:

1. The largest plants in California manufacture whey protein concentrate, WPC34 or WPC50, and even lactose and dry whey permeate;

2. The next tier manufactures whey protein concentrate but does not further process the permeate, creating a cost to dispose of the permeate; and

3. The third tier recovers some value from selling liquid whey concentrate, when possible, and pays to dispose of liquid whey concentrate when there is either a quality issue or there is no buyer. Transportation cost also has to be paid on these loads, further eroding that value.

4. The fourth tier is full disposal. Two-thirds of California's cheese plants are too small to recover any of their whey from cheese processing and must instead pay to transport and dispose of the liquid whey that they generate. Please note that these plants have no ability to sell their whey to someone that does have a whey drying capability, and those companies that can dry whey are either fully utilized or want to be paid to toll the product, and oftentimes the tolling fee is higher than the value that would ultimately be realized anyway.

Currently, Kraft handles whey generated through their manufacturing process in Tulare in several ways: they sell a small amount as liquid condensed whey and they dry the rest into sweet whey powder. The sweet whey powder is then marketed by a third party to both food customers and feed customers, as applicable. Occasionally, due to processing issues, the sweet whey powder generated has to be sold as animal feed instead of as a food grade product, for a fraction of the price of a food grade product. Kraft does recover value from the whey stream that it generates because it only runs a sweet whey drying operation versus a value-added whey drying operation like WPC34, WPC80 or WPI. But Kraft is not able to process 100 percent of the whey into food grade product and the value is minimal and sometimes is an expense on a net basis. Kraft has calculated the cost of converting the current whey drying operation into a value-added whey drying operation like WPC34, WPC80 or WPI, but the amount of capital investment required does not have a payback that is even close to being financially feasible. Kraft does not generate enough volume in its one California plant to justify a value-added whey drying operation, and transporting whey generated by Kraft plants located elsewhere is extremely cost prohibitive. So the value that the Kraft Tulare facility garners from sweet whey processing is minimal, and even at that minimal level is still higher than what many of the cheese makers in California are spending to dispose of their whey.

Any increase in the cost of 4b milk like the one being proposed by the producers will negatively impact Kraft's margins. Cheese processor margins are small, as retail cheese is a commodity business - meaning that on-shelf prices for branded products need to be close enough to the prices for store-branded products in order to be attractive to consumers. The costs of manufacturing, storage, transportation, sales and marketing are inflationary and inelastic, and when combined with potential increases in costs of raw materials like milk in this case, there's only one place that these potential increased costs can come from and that's the margin. Kraft's business is rational -- excuse me, it's rational too but it's national and it can't charge the customer more in general or in any region just because some percentage of its cheese is made in a particular geography like California at a higher cost. Higher cost raw materials like milk can't be funded out of trade spending either. If Kraft reduced trade spending in general or in key accounts just because some percentage of its cheese was made in a particular region at a higher cost, retailers would choose to promote their private label products over Kraft branded products because private label products don't carry the heavy marketing expenses that branded products do. Kraft would lose volume and share and eventually become desisted from retailers' refrigerator cases. After that, the business would have a lack of viability.

So the Dairy Institute's proposal addresses the concerns of the majority of California cheese makers, including those that are too small to afford a whey operation of any kind. The proposal does represent a value that can be recovered by plants that process whey in the state of California because it is based on liquid whey value, which is realistic. And the proposal includes a cap on contribution that is at a low enough level to allow the smaller plants without whey processing to be minimally impacted. In light of this, and in light of the fact that the producers' proposal does not take basic supply/demand/

profitability fundamentals into consideration, Kraft is in support of the Dairy Institute proposal.

So let me conclude; I know you're looking forward to that. California as a dairy producing region has a lot of positives: generally temperate weather, scale in numbers of cows on the farm, scale in processing infrastructure and price leverage by having milk prices creating a total cost of ownership of finished goods that is in line with other regions in the United States. Until now the only negative has been the drought situation and the resultant reduction in year-over-year milk production, but that is to be expected based on the ebbs and flows of milk volumes in a normal marketplace. Now, the additional negative caused by the continued squeeze on margins resulting from recurrent temporary price relief and other short-term fixes in the current California dairy pricing system is beginning to result in cheese manufacturers leaving California for other regions and a lack of growth of manufacturing assets in California. California's labor rates, energy costs and water costs are higher than many other regions and the cost of transportation from California to other areas in the U.S. is prohibitive. For example, sending Italian cheese from California to the Midwest for aging and processing, then back to California for distribution. Therefore, something has to give to return the California milk industry's balance to equilibrium. A longer-term fix to the California milk pricing system, which is better for producers and processors alike, should be the ultimate goal. However, instituting temporary "fixes" resulting in higher milk costs for producers while waiting for longer term price reform is short-sighted. Raising milk prices due to whey won't really accomplish anything other than increasing costs and decreasing margins, and impacting California cheese manufacturing viability. If manufacturers can operate more profitably in regions other than California, then justification for new plant and processing investments will be easier in those other regions, and manufacturing capacity and therefore milk supply will grow in those other regions. The financial viability of cheese manufacturing in regions that don't have such far-reaching water and energy challenges that California does will support further investment in those regions and California dairy processing infrastructure will begin to erode. Kraft owns dairy plants in Wisconsin, Illinois, New York and Minnesota, and Kraft has an extensive supplier base that reaches many other states around the U.S. Kraft regularly performs financial analyses and comparisons of product line and plant profitability as well as overhead comparisons between plants. California has been long trending towards higher milk prices and any additional increases coming out of this hearing will only serve to decrease California's viability for growing cheesemaking infrastructure.

So to reiterate, Kraft is strongly opposed to the producer proposal as it does not allow the pricing in the 4b formula for whey to accurately reflect the actual market conditions. Additionally, having a "temporary" price fix in place for two years is hardly temporary. If only manufacturers and retailers could have that kind of value and price certainty, it would be ideal, except we can't, as we are at the mercy of the elasticity of supply and demand, which is the true market clearing mechanism. Conditions can completely change within a six month period, which is why that should be the imposed time limit of any price changes.

Kraft supports the Dairy Institute proposal, and while it might not be the most ideal solution, for a company like Kraft who does process some whey into end-use products, it certainly captures the true market conditions a bit more fairly to the majority of cheese producers in the state and it has a reasonable duration. This is the best proposal to accomplish the goal of balancing the needs of the entire industry by creating a more relevant whey-based pricing for milk used in cheese making, while offering more income to the pool in higher whey markets. Isn't it the goal of the collective dairy industry in California to expand capability and capacity and create demand for California dairy products by fostering an environment where value drives innovation, and innovation drives investment, and investment drives profitability? Profitability has to work for both the producer and the processor, and the producer proposal fails to acknowledge the economic fundamentals that processors are bound by from cow to consumer.

This concludes my testimony. Thank you for your time and attention. I would like to have the opportunity to file a post-hearing brief if necessary.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Are there any questions from the panel?

MR. EASTMAN: I just have a couple of questions. On the first page of your testimony you mention that Kraft ships its cheese to the Midwest, I think, to age it and then ships it back in order to distribute it.

MR. BROKAW: Correct.

MR. EASTMAN: Is there a particular reason why that happens? Is there a lack of aging facilities here in California?

MR. BROKAW: It is my understanding that's where our, that's where our facilities are for doing those latter tasks and that's why it's done that way.

MR. EASTMAN: Okay. And then in two places you talk about how you would view the impact to smaller cheese processors of any of the proposals. You mention the four tiers of cheese processors. You mention the fourth group, which is about two-thirds of cheese plants and then you also sort of mention at about page three how smaller cheese plants might be affected by the Dairy Institute's alternative proposal. Do you as a consultant work with other cheese plants or what knowledge or experience do you have with some of those processing facilities in California to make that statement?

MR. BROKAW: I don't work with other cheese processing plants. Our experts helped prepare the remarks and I'd like to have them get back on that point, if you'd like, in the post-filing brief.

MR. EASTMAN: Okay. And then obviously in your testimony you mention that you do support the Dairy Institute alternative proposal, even though their proposal is based on WPC34 and Kraft actually makes dry whey. Do you feel that there is enough correlation between those two finished commodities that allow you to support that alternative proposal or do you think it's just that the values that they are proposing fall in line with what you can absorb?

MR. BROKAW: All I can say at this moment is that's the position that we have taken. We have reviewed the alternative proposal by the Dairy Institute and we are comfortable supporting it, even though the great benefit doesn't extend to us.

MR. EASTMAN: Okay. And then the final question I had is you mention that there is some limitation that Kraft has that causes some of their dry whey to not be of human grade or have to be marketed to animal feed-type purposes? Do you know what the limitation or what causes that to occur?

MR. BROKAW: Well specifically I can't say at this moment if it goes beyond the processing itself that sometimes leaves it in capacity. But we can get back to you on that as well.

MR. EASTMAN: Okay. If you could do that, that would be great, in the post-hearing brief so we get the sense of that.

MR. BROKAW: Thank you.

MR. SHIPPELHOUTE: A follow-up question on the small plant subject. You mentioned that two-thirds of the small plants -- plants are too small. Do you have any sense of the percentage of volume that that covers?

MR. BROKAW: No I don't, sir.

MR. SHIPPELHOUTE: And you mentioned that Kraft has nine cheese plants in total. Do you know if there's other plants that make the same type of cheese products that you are doing here in Tulare?

MR. BROKAW: I can't answer that specifically. We do most of the Parmesan cheeses in California but we have a variety of cheese brands and there may be some duplication. Because they compete within plant for product lines and costs determine who produces what.

MR. SHIPPELHOUTE: Do you have any sense of the cost of milk for those other eight plants outside of California compared to the California plant?

MR. BROKAW: I can't respond authoritatively to that.

MR. SHIPPELHOUTE: That's all the questions I had.

HEARING OFFICER SUTHER: Any follow-up questions from the panel?

Thank you for your testimony, Mr. Brokaw.

MR. BROKAW: Thank you for your time.

HEARING OFFICER SUTHER: We now have Mr. Cardenas.

MR. DE CARDENAS: Good morning. I brought an illustrative very large exhibit, actually. It is something proprietary to our business and I'll just kind of use it for an illustrative purpose. Is this something I would have to leave with the committee or can I take it home with me.

HEARING OFFICER SUTHER: You would need to leave it to be entered as an exhibit.

MR. DE CARDENAS: Okay. But I can use it for an illustration?

HEARING OFFICER SUTHER: Yes.

MR. DE CARDENAS: In non-exhibit form?

HEARING OFFICER SUTHER: Yes.

MR. DE CARDENAS: We will win for the largest illustration of the day.

(Laughter.)

MR. EASTMAN: Well the day is still early so you better watch out.

MR. DE CARDENAS: Yes, that's true. You see, this is the perfect carry-on on Southwest.

MR. EASTMAN: I see. But that's not what the illustration illustrates, I hope.

MR. DE CARDENAS: Correct.

MR. EASTMAN: Okay, that's good.

MR. DE CARDENAS: Nice. Thank you, appreciate it.

HEARING OFFICER SUTHER: Mr. Cardenas, could you please state your full name, spell your last name and state your affiliation for the record, please.

MR. DE CARDENAS: Certainly. My name is Antonio de Cardenas, A-N-T-O-N-I-O, separate word D-E, C-A-R-D-E-N-A-S. And I am here as a business owner representing our family business, Cacique, C-A-C-I-Q-U-E, Incorporated. Thank you.

Whereupon,

ANTONIO DE CARDENAS

Was duly sworn.

HEARING OFFICER SUTHER: Mr. de Cardenas, do you have any other written statements that you want entered into the record?

MR. DE CARDENAS: At this time, no, I am just going to present orally.

HEARING OFFICER SUTHER: Thank you. You may proceed.

MR. DE CARDENAS: Thank you very much. I am here today -- and than you for this opportunity to share the story of our family business.

My parents immigrated from Latin America in 1971. In 1973 they had a fabulous start-up idea except there wasn't private equity or venture capital; there was hard work and there was hard work. And with $800 borrowed and raised they started our family business.

Today we are America's most popular brand of Hispanic dairy products as measured by nationally recognized auditors such as IRI and Nielsen.

We have grown from the immigrants of my newly immigrated parents with two suitcases and three small children and one on the way, me, with big, big dreams to succeed in America's promise that hard work, integrity and earnest effort will be met with fair and just rules of governing. Every day we are thankful for these proven truths.

Our beginnings were humble. We produced high-quality cheese and creams. Yet typical of the time we suffered low efficiencies with little byproducts to sell. Essentially we made cheese, cream and whey. At that time whey was simply an expense and it had no practical use. It could not be flushed with the wastewater.

As we were then, and now, an urban cheesemaker in Southern California, we have no fallow farm field dumps nor did we have eager buyers. However, we did make a bargain with a pig farmer to take the whey off our hands many, many years ago.

Certainly times have changed. With modern technologies and expanding markets of opportunities we have managed to capture many of the elements that once flowed into our whey. Even so, today's whey market for Cacique remains very difficult and the expense is very difficult to manage. Although in the practice formula of milk pricing whey is given a value for determination of what we pay for milk, it is the net cost, not gain, for us.

There are machines that can concentrate and dry whey for sale that would cost us millions to install and operate for a few pennies profits with an unlimited amount of time to pay that back. We concentrate whey into WPC and sell our market rates. A byproduct of our WPC process is liquid lactose that has no home other than zero-gain feed and it, in fact, is significant capital expense every year to dispose of.

Overall, on average we consume about a million pounds of milk per day. About 45 to 50 percent of our products leave the state of California. We compete directly with regional manufacturers that aggressively defend their markets. Most of the competitors are in the Upper Midwest. While milk prices may be higher the operating costs are considerably lower. No great surprise. Costs such as electrical wastewater, legal exposure, workers comp and others are considerably lower; in some cases half as low as ours. State and local taxes are far lower and these states are all friendlier to business, unfortunately, than California.

Now I'd like to turn your attention to our handy-dandy map here. This is kind of an indication over the last 90 days where consumers have purchased Cacique products. And you'll see we manufacture our dairy items here in the state of California. And as we move further east it becomes more expensive for us to sell our products.

In fact, if you take into consideration the cost of doing business in California, although we do have a different price model here for milk, I think it's a zero sum game realistically. If we instantaneously have a significant price increase our growth and -- we push our growth east of the Mississippi. Those markets in New York and Washington and Florida, they don't become 3,000 miles they become 9,000 miles because we are far less competitive, which means we have less volume and we are buying less milk. And realistically, we want to buy milk. We want to drive the category, we want to grow our business. However, it is somewhat of an unsustainable model to take such an extraordinary cost and be able to compete in the furthest markets.

Simultaneously, such a cost is exactly what our out-of-state competitors want because it opens an opportunity for them to come to California because they do have costs, operating costs that are significantly lower. So in the overall scheme, our family business would have to take a national price increase, our competitors wouldn't. So that is an impediment that presents risk to our family business.

You know, it's really important that you recognize that we are in this together and we feel we are the ambassadors - an ambassador I should say - for milk in California. It's not so secret our number one cost of good is milk and we exceedingly want to buy more California milk.

So with that being said I thank you for your time and we do, in fact, support the Dairy Institute's proposals.

Thank you.

MR. SHIPPELHOUTE: A quick question on your graphic.

MR. DE CARDENAS: Yes, sir.

MR. SHIPPELHOUTE: Is there any indication of volume there or is that just a transaction somewhere in New York generates a dot?

MR. DE CARDENAS: Those are just -- back -- in that part of the market there's overlapping dots.

MR. SHIPPELHOUTE: Okay.

MR. DE CARDENAS: So I would say we are pushing our, the strength of the growth is east of the Mississippi, which has always been the most challenging for us because of distance, freight and additional costs.

MR. SHIPPELHOUTE: Do you have a sense for what your competitors in other states are paying for the milk that thy use to make cheese?

MR. DE CARDENAS: Well, I assume they are participating in the federal system. I don't know to what extent they are opting out, you know. So based upon market conditions it is pretty clear that there are certain markets where probably some of our larger competitors have opted out of the federal system. You can just see. It's really straightforward, you see it in the pricing. So it's just a price competitive market.

MR. SHIPPELHOUTE: No other questions.

MR. EASTMAN: Do you have any sort of data information to support your statement that the cost of making cheese, you sort of mentioned the Upper Midwest is cheaper or their costs are lower. You mentioned tax rates, business climate, things of that nature. Do you have any sort of information to corroborate that?

MR. DE CARDENAS: Sure. California's workers compensation rate is 188 percent more expensive than the national mean. So that means for a California employer, we're putting about $3.75 into the workers compensation system for every $100 of pay; the federal system is at about a $1.80. The electricity is significantly more expensive in California, water is more expensive, higher regulation. Some of this is no secret.

But the issues that we are really are impacted is, you know, we have a -- another one is cost of living in California. You know, we have over 200 employees here in California so it's definitively something that -- you know, we don't pay minimum wage, we are above minimum wage, we are not a minimum wage bearer. Does that answer your question?

MR. EASTMAN: Yes. If it's possible for you to provide any documentation of that, say in a post-hearing brief, that would be beneficial, if you'd like to do that.

MR. DE CARDENAS: Sure, I'd be thrilled to.

MR. EASTMAN: I realize that you didn't come prepared with a lot of written statements, per se, but if you have such information to corroborate that statement and you are able to provide it in a post-hearing brief that would fine.

MR. DE CARDENAS: I confess I've come with my training wheels today, this is my first time.

MR. EASTMAN: Understandable.

MR. DE CARDENAS: Do I would be thrilled to.

MR. EASTMAN: Okay.

MR. DE CARDENAS: Thank you very much. Any additional questions?

MR. LEE: Yes, I have one. In terms of your total volume of sales, how much of it would you say is in-state as compared to your out-of-state sales?

MR. DE CARDENAS: It's about 53/47, 53 in the state.

MR. LEE: Fifty-three of your volume is in California.

MR. DE CARDENAS: Correct.

MR. LEE: Forty-seven outside.

MR. DE CARDENAS: That's correct, sir.

MR. LEE: Thank you.

MR. DE CARDENAS: Thank you.

HEARING OFFICER SUTHER: Mr. de Cardenas, thank you for your testimony. And your request to file a post-hearing brief is granted.

MR. DE CARDENAS: Thank you very much, have a pleasant day.

HEARING OFFICER SUTHER: Mr. Paris. Mr. Paris, will you please state your full name, spell your last name and state your affiliation for the record, please.

MR. PARIS: My name is Joe E. Paris, P-A-R-I-S, and I am here representing Joseph Gallo Farms. And the testimony I will give has been reviewed and added to by Mr. Mike Gallo, who is the CEO of Joseph Gallo Farms and also co-owner.

Whereupon,

JOE E. PARIS

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other written statements other than the ones you have presented?

MR. PARIS: No, sir.

HEARING OFFICER SUTHER: Would you like this to be marked as an exhibit?

MR. PARIS: Yes.

HEARING OFFICER SUTHER: Your exhibit will be Exhibit number 41.

(Exhibit 41 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed, sir.

MR. PARIS: Mr. Hearing Officer and Members of the Hearing Panel:

My name is Joe E. Paris. I am a dairy consultant representing Joseph Gallo Farms. I am responsible for the milk and cream into and out of Gallo Farms. I also work with the Farm Service Agency for Gallo's farming operations and I provide market information and other pertinent information to the senior management of Gallo on a daily basis.

Joseph Gallo Farms is located at 10561 West Highway 140 in Atwater, California. At this location we have the Gallo Cottonwood Dairy and the Gallo cheese plant as well as Gallo Global Nutrition, a whey processing plant. Two miles east of the Gallo cheese plant is the Gallo Santa Rita Dairy. Between the two dairies Gallo milks approximately 8,000 cows. We also farm several thousand acres to provide feed for those cows.

Joseph E. Gallo started farming in 1946. In 1983 he hired a Wisconsin cheese maker to help him realize his childhood dream to make and market cheese. He and the cheese maker built the Gallo cheese plant. Since that time that plant has been improved and expanded several times. The cheese plant plans to process close to 500 million pounds of milk this year into various cheese varieties including cheddars, Monterey Jack, mozzarella blocks and pasta filata. At this time, 70 percent of the milk that Gallo processes is bought from outside suppliers. We concentrate our whey from our own plant and are a market for whey protein concentrates from other small plants in the area. The WPC is processed and dried into whey protein isolate at the Gallo Global Nutrition plant, part of the Gallo complex.

Domestically we sell packaged cheese under the brand of Joseph Farms Cheese. Most of this cheese is found in grocery chains or stores like Walmart and Costco. We also export cheese into Mexico, both branded and unbranded. About 40 percent of our cheese is sold as commercial blocks or for food service.

Gallo has always tried to invest in ways to not only improve our efficiency, but in a way to protect our environment. The Gallo methane digester provides electricity to operate the plant. Waste water from the plant is used to flush the Cottonwood Dairy lanes to a separator where the solids are taken out before the liquid goes into the digester. Solids then are composted and used to fertilize the land. The system cost millions of dollars to build and maintain. Gallo Global Protein is another huge investment where we process WPC from our cheese plant and from other small cheese plants. Until recently, much of the whey was being dumped or fed to cows.

If Gallo had been required to pay the 4b price that would result by the producer proposal, none of these improvements could have taken place. Gallo is a small plant when compared to other national companies in California and we would not have been able to generate the type of profits to invest in these long-term sustainable projects. Without profits there is no investment.

As mentioned earlier, Gallo milks 8,000 cows in two facilities. We certainly understand the plight of dairymen in the state of California. We know what the cost of production is on our dairy farms because we experience it every day. We know that in some years the cheese plant helps to subsidize the losses on our dairies and in some years the dairy helps subsidize the cheese plant's losses. Some years they both make money and some years they both lose money. Both as dairy producers and cheese plant operators we are at the mercy of the marketplace. Volatility can be the enemy of both producer and processors. Long-term planning and investment is needed in order to grow both the producer segment and the processor segment of the dairy industry. If the proponent's proposal is adopted as written it is our opinion that the cheese sector will stagnate almost immediately. Medium and small plants will no longer be able to sustain their processing plants. The producers will find themselves with fewer markets. The

California market will find itself in a pre-1985 position of having mostly a butter-powder industry.

How would we respond at Joseph Gallo Farms? One scenario would be to eliminate all outside suppliers of milk and reduce our cheese sales to only our Joseph Farms packaged cheese. We might need a few more cows and would take advantage of the higher milk prices. Our branded product prices would have to be increased in order to maintain overall profitability. We could also look at diversifying our operation by planting more permanent crops. At the very least, we would have to eliminate any premiums or handling charges we currently pay our suppliers.

Producers have a tendency to look at the Midwest or the East Coast and feel that are being deprived of a fair price. These producers serve an entirely different market than we have in California. Because of their location, these areas serve the vast population that runs from the Midwest to the East Coast and from Maine to Florida. Because of transportation costs they can demand higher prices for that products. Much of California's production services not only the West Coast population but also Mexico and the export market. These export market sales, including Mexico, cannot pay the prices that would be needed to offset the increased cost of this whey factor. Even in the emerging markets, income will not allow any chance for profit or growth. We know that any time the market price of cheese is greater than $1.90 per pound, cheese sales to Mexico come almost to a standstill. Over $2.00 cheese eliminates the market in Mexico and slows sales of our cheese here in the West. What we hear about the growth in the middle class in many emerging countries to which we export cheese does not mean they have the same ability to purchase as the middle class in this country.

In the Federal Milk Marketing Orders, plants are allowed to depool and there are no minimum pricing laws that require a minimum payment for depooled milk. Due to a large increase in milk production in other parts to the country it has been reported that milk has been purchased as much as $7.00 per hundredweight below the minimum regulated price. I heard somebody this morning say as much as $10. We know that this has been happening from various reports. In California it is unlawful to pay less than the regulated price unless the milk does not meet the Grade A standards of quality and the milk is degraded. Many of the plants in the Upper Midwest have much lower overhead costs due to regulations that have nothing to do with milk. Many of the plants are medium and small and process specialty cheeses. Some are able to buy manufacturing grade milk at a reduced cost on a regular basis. In the last several years we have seen large cooperative cheese plants close due to losses under our current pricing system here in California.

Joseph Gallo Farms is opposed to the producers' proposal as it is written. The sliding scale for the whey would eliminate any profits for investment into new technologies that would add value to the 4b milk. For some plants it would mean closure. For others, it might mean a complete change in the way they do business, including the amount of milk they could purchase. I know of cheese plants that have planned to add additional cheese-making equipment or whey processing equipment that would not be able to meet that plan due to dramatically increased milk costs. The cost of raw milk in a cheese plant can be as much as 95 percent of its total costs. Adding the average of the last 3 years of $1.44 per hundredweight to the current 4b price will make California processors greatly disadvantaged to cheese processors in surrounding states such as Washington, Oregon, Idaho and Utah. Idaho and Utah are not price regulated under any state or federal order. we support the principles of the Dairy Institute proposal and particularly the concept of moving the whey pricing from dry whey to whey protein concentrate, WPC, a much more market-oriented price. It is our understanding that there is only one plant in California that is currently drying whey. Most of the whey product pricing is related to the WPC price rather than the dry whey market. It is the opinion of Gallo that the scale used in the Dairy Institute's proposal is still too high for small to medium cheese plants, although it may be all right for a few -- very few larger, newer, efficient plants. Gallo is concerned that the implementation of the producers' proposal will force closure of several small to medium size cheese plants, including Gallo's. This will result in less processing capacity in the state and more producer milk seeking a market. Over the years we have had many "temporary" adjustments that make it difficult to make long-term plans in processing.

State or federally regulated milk prices should be minimum prices based on the best market-oriented criteria and should not be changed every few years. Producers have the right to negotiate higher prices than the state minimums based on an individual plant's ability to pay above the regulated price.

This concludes my testimony and I would like the ability to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Any questions from the panel?

MR. SHIPPELHOUTE: A similar question to what we asked the last person and that is, you make reference to the cost of manufacturing in other states. Do you have any information that we could look at to verify or get a sense for the difference between the cost of manufacturing in California versus the Upper Midwest or other areas?

MR. PARIS: Is that where I talked about other costs were lower in other states?

HEARING OFFICER SUTHER: That's correct.

MR. PARIS: Well, just the regulations we have here in California in manufacturing is extremely high. Other states don't have those kinds of regulations. They allow things to happen differently than we do here. And that's the reason we don't see a lot of expansion in cheese plants in the state of California. There's other places where you can go and put in a cheese plant and it's a whole lot less costly to you. As some person said once, here we roll out the red tape, there they roll out the red carpet.

MR. SHIPPELHOUTE: But you don't have a sense of how much of a difference there is in the cost?

MR. PARIS: In the cost of producing the cheese?

MR. SHIPPELHOUTE: Yes.

MR. PARIS: No. But I could find out and address that in a post-hearing brief.

MR. SHIPPELHOUTE: If you could, please.

MR. PARIS: Yes.

MR. LEE: I have a question.

MR. PARIS: Okay.

MR. LEE: When you've finished your writing.

Regarding Joseph Gallo's cheese sales. How much of your sales would be in California as compared to outside of California?

MR. PARIS: I'm guessing it would be at least 50 percent, it may be higher than that. I know our cheese going to Mexico is about 30 percent and we do service some other areas in the West, but our product mainly is in California. We are a large farmstead cheese operator.

MR. LEE: So let me get this straight. So how much would it be in terms of your -- 30 percent outside of California?

MR. PARIS: Thirty percent is about what goes into Mexico when the prices are right. When that price hit $2 last year, sales in Mexico died. I mean, it was just very difficult to get anything done there. We do have a little bit up in the Pacific Northwest but not a significant amount. Most of it is right here in California so 50 to 60 percent, somewhere.

MR. LEE: Thank you.

MR. EASTMAN: I have a question. You mention that you do support the proposal of the Dairy Institute. If the Department were to implement a change that were to extend beyond six months how would you view that impacting your operation?

MR. PARIS: It will have a significant impact on our operation in the increased cost, even the Dairy Institute's proposal. We think it's too high, the scale is too high in it. We prefer the status quo.

MR. EASTMAN: That's it.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Paris.

Dr. Erba, you are up next.

Dr. Erba, could you please state your full name, spell your last name and state your affiliation for the record, please.

DR. ERBA: Dr. Eric M. Erba, the last name is E-R-B-A, and I am representing California Dairies, Inc.

Whereupon,

ERIC ERBA

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other written statements other than the ones you brought up that you would like entered as an exhibit?

DR. ERBA: I do not. You have the one that I have.

HEARING OFFICER SUTHER: Thank you. Dr. Erba's exhibit will be Exhibit number 42.

(Exhibit 42 was entered into the record.)

HEARING OFFICER SUTHER: You may 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 and Chief Strategy Officer for California Dairies, Inc., whom I am here representing today. California Dairies is a full-service milk processing cooperative owned by 400 producer-members located throughout California and collectively producing 18 billion pounds of milk per year, or 45 percent of the milk produced in California. Our producer-members have invested over $500 million in large processing plants at six locations in California, which will produce approximately 385 million pounds of butter and 785 million pounds of powdered milk products in 2015. The Board of Directors for California Dairies approved the concepts contained in my testimony that I will be presenting today at their May 26, 2015 board meeting.

We thank the Secretary for calling this hearing on her own motion and keeping the relevant topics narrowly defined such that only alternative methods for valuing whey in the Class 4b milk pricing formula are being considered. Over the past four years, we have pointed out that the disparity between the whey valuation in federal milk marketing orders and in California remains too large to ignore and continues to have far too great of an impact on our member-owners' milk price. The effect on our member owners of the undervaluing of whey has been addressed several times in hearings similar to today's proceedings but the same old inequities continue to persist. And the reason is simple; the glaring problem in the Class 4b pricing formula has not yet been corrected.

Today's hearing affords us the opportunity to show our support for an improved means to value the whey portion of the Class 4b pricing formula. California Dairies fully supports the alternative proposal submitted by Western United Dairymen, Milk Producers Council and California Dairy Campaign to modify the sliding scale within the Class 4b milk pricing formula that generates values for dry whey.

While it is outside the scope of the hearing today, California Dairies also supports the regular review of manufacturing cost allowances relative to the Department's annual manufacturing cost exhibits.

I will speak now to the alternative proposal from Western United Dairymen, Milk Producers Council and California Dairy Campaign.

The milk pricing proposal that California Dairies supports has a foundation based on economics, logic and consistency with the California federal milk marketing order effort that is being actively pursued. The proposal is meant to address the singular issue of fair compensation to dairy producers for milk and its components purchased by processors. The current means for valuing whey in the Class 4b formula has been in palace since August 1, 2012. It is clear that it fails to track within a reasonable range of the benchmark for whey valuation as established by the federal Class III pricing formula. In fact, since January 2012, the California Class 4b pricing formula has averaged $1.95 per hundredweight less than the federal Class III price, almost entirely because of the inferior mechanism being used to capture the value of whey. The proposal from the three producer trade associations corrects the deficiency by implementing an expanded dry whey value look-up table that mirrors the whey values achieved in federal milk marketing orders. Within the current operating range of market prices for dry whey, the proposed changes would have a large impact on producer milk prices. At dry whey prices of $.40 per pound, the Class 4b price would be $1.25 per hundredweight higher. And likewise, at dry whey prices of $.60 per pound the Class 4b price would be $2.50 per hundredweight higher. A graphical comparison of the proposed look-up table and the current look-up table are shown in the document submitted into the hearing record.

An acceptable level of price difference exists for most of the classes of milk when comparing California milk prices to federal order milk prices. The exception is Class 4b and it is past the time for the appropriate adjustment to occur. We believe a modification to the method for valuing whey in the Class 4b formula would not only restore equity in what our manufacturers pay for milk relative to comparable manufacturers around the country, but would also generate much-needed additional revenue for dairy farmers, who are facing some of the lowest milk prices seen since 2010.

The California dairy industry is the leading agriculture industry in California and milk and dairy products have generated the most value of any of the agricultural commodities produced in California - over $6 billion in each of the last five years and a record of nearly $10 billion in sales in 2014. In 2015 the California Milk Advisory Board study of the economic impact of the dairy industry estimates that $65 billion in direct and indirect sales is attributable to the dairy industry, as are 190,000 jobs statewide.

However, as hard as it may be to comprehend given the dairy industry's legendary status in California, there are signs that the producer side is not faring well at all. Simply, the billions of dollars cited in milk sales do not translate directly to dairy farm profitability, and the lack of profitability has a predictable effect on dairy farm operations. Over 480 dairies have exited the dairy industry since 2007. From California Dairies' own perspective, we now have 165 fewer dairies in operation than we did in 2007. That trend has not abated but has continued into 2013, 2014 and 2015. Over the last two years, the past 24 months, California dairies has lost more than 50 dairy farms that were producing a combined 2.7 million pounds of milk per day. Most of these dairies were sold at auction and are completely out of production today.

The direction that the industry is headed is not sustainable without suffering widespread consequences. Banks, vendors, suppliers, feed companies, milk hauling companies, and milk processing plants are mindful of the conditions being faced by their dairy customers. They also know the dairy industry well enough to understand what it means when dairy farms exit the industry. These affiliated business partners are dependent on the health of dairy farming operations, and a collapse on the milk production side of the dairy industry has grave consequences for the survivability of their own operations.

The regions of the state where the dairy industry has flourished have also been the leading areas of unemployment. These counties have been reporting high unemployment numbers relative to the state average for the last several years. Further increases in unemployment rates can be expected as dairies continue to exit the business.

And I will run through some of these. These are based on April 2015 information obtained from the U.S. Bureau of Labor Statistics. The California average for unemployment is 6.5 percent, Fresno County, 11.2 percent, Kern County, 11.1 percent, Kings County, 11.9 percent, Madera County, 11.5 percent, Merced County, 12.9 percent, Stanislaus County, 10.4 percent. And the leading dairy county in California, Tulare County, 13.2 percent. That's April 2015 information.

It is well-known that California is facing the worst drought in over a century. Calendar year 2014 was California's driest year dating back to the 1800s and four consecutive dry years have left millions of acre-feet of empty space in reservoirs across California. On April 1, 2015 California Governor Brown directed the first ever statewide mandatory water reductions. Not surprisingly, the drought has had and will continue to have significant implications for dairy farms in California.

To chronicle the negative impact of the drought, I have asked members of California Dairies about their decisions for growing feed for their dairies. I am including just three of these in my testimony today as substantiation of the impact of the California drought on dairy farming.

Dairy 1 farms 780 acres. In a year with normal rainfall, the dairy grows 120 acres of alfalfa and 660 acres of corn. However, the drought has altered the planting decision to include zero acres of alfalfa, 320 acres of corn and 460 acres of sorghum. Alfalfa and corn take substantial amounts of water and cannot tolerate stress well. While sorghum takes less water than corn and is more stress-tolerant, sorghum does not have the same nutritional qualities of corn, which will force Dairy 1, as well as all other similarly situated dairy producers, to buy supplemental feed for their dairy rations.

Dairy 2 farms 1,200 acres. In a year with normal rainfall, the dairy grows 300 acres of alfalfa, 400 acres of corn and 500 acres of sorghum. This year, the dairy will farm zero acres of alfalfa and 900 acres of sorghum. The remaining 300 acres will be unfarmed.

My last example, Dairy 3, farms 1,300 acres. In a year with normal rainfall, the dairy grows 300 acres of alfalfa, 700 acres of corn and 300 acres of sorghum. This year, the dairy will farm, again as the other ones did, zero acres of alfalfa, 250 acres of corn and 400 acres of sorghum. There will be 650 acres left unfarmed on Dairy 3.

Many of our dairymen are reducing the amount of corn silage used in their dairy rations. They typically supplement the rations with more alfalfa hay, which must be brought in from out of state. The Department's *Cost of Milk Production 2014 Annual* verifies that dairy-quality alfalfa hay is an expensive supplemental feed and averaged over $300 per ton in 2014. Current prices in 2015 are no different; delivered costs range between $300 and $325 per ton for dairy-quality alfalfa hay.

We recognize that attempting to establish a milk price high enough to erase the historical financial losses sustained by producers as a result of years of inappropriate whey valuation is problematic. As stated in my testimony, the proposal that we support is meant to address the singular issue of fair compensation to dairy producers for the milk and its components provided to processors. Said another way, producers are entitled to be compensated fairly for the product they produce.

I am going to answer a question that Mr. Eastman asked earlier in my testimony, which I was very pleased about, by the way.

There seems to be a common theme underlying past hearing decisions by the Department, and that is to say, if there is sufficient milk supply to service milk processing plants then there is no need to increase the milk price. A corollary to this basic notion is that establishing a higher minimum price will only lead to more milk production. It does not take much of an analyst or a historian to conclude that managing the state's milk supply by adjusting minimum pricing formulas only occasionally is ineffective and inefficient. All of the major cooperative and some of the proprietary plants arrived at that same conclusion years ago and adopted programs that allocate milk production shares to producers based on the ability of the entity to handle its milk supply. These programs are actively managed and can adjust with market condition much faster than the Department can call hearings and institute milk pricing changes.

California Dairies supports the whey valuation proposal submitted by Western United Dairymen, Milk Producers Council and California Dairy Campaign. It is logical, has an economic basis and is consistent with the producer-led effort to pursue a federal milk marketing order in California. We urge the Department to adopt the proposal as a means to bridge the financial gap from where California milk prices are today and where they need to be to prevent further attrition on the producer side of the California dairy industry.

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

HEARING OFFICER SUTHER: Dr. Erba, your request to file a post-hearing brief has been accepted.

Any questions from the panel?

MR. EASTMAN: I guess I'm back first again.

On page four of your testimony you talked a little bit about the drought's effect on a few dairy farms that grow some of their own feed. Do you have any sense of the cost comparison between them having to buy supplemental feed, sort of the transition from farming their own or a portion of their own feed to what it will cost to have to buy supplemental feed or whatever change that they are going to make?

DR. ERBA: I would just -- I will estimate - I'll have to verify this and get back to you - but a 20 to 25 percent higher cost to purchase and bring in from out-of-state -- kind of the kicker there is it doesn't grow locally.

MR. EASTMAN: Right.

DR. ERBA: Compared to what they could do if they had the resources themselves. It's clearly better for them to be able to grow their own forages. And I think you probably know that California dairy farmers get into real trouble when they can't produce enough forage to feed their own dairies. When they have to bring in forage from out-of-state it gets to be very expensive very quickly. So I'll check on that but 20 to 25 percent is about what I would say.

MR. EASTMAN: Great. If you could just provide some information to sort of illustrate that sort of cost comparison that would be great.

And then I had a question regarding the answer to the question I didn't have to ask you so I appreciate that, saves us a minute or so.

DR. ERBA: And we are all about saving time.

MR. EASTMAN: I had a question

DR. ERBA: We're all about saving time.

MR. EASTMAN: That's great. So you mentioned how the cooperatives have their production basis and can utilize that to respond to whatever milk supply balance there is with regards to plant capacity. How do you view that changing under sort of a hypothetical situation? Already we have received some testimony, we might hear more, that would suggest that any increases to the 4b price could inevitably cause some small or medium sized cheese plants to go out of business, which would represent some portion of the milk supply. What that is, probably neither one of us know.

But if that were to actually happen and that represents 1, 2, 3 percent of the state's milk supply, do you view that you, as the cooperatives who handle most of the milk supply, you would be able to handle that within just the scope of your production basis? Would you feel you would ship some milk out of state? Is there any sort of concern about that happening, sort of in the current framework with which we are operating right now?

DR. ERBA: I think it would be callous and careless to say that we don't care about the industry beyond our own members. We absolutely do and we would absolutely do anything to prevent that from happening. But I will give you a flip side, Mr. Eastman, and that is: we have lost a lot of dairies over the past few years and that doesn't seem to get a lot of recognition or attention; but that continues to happen even today. Even last year when we had extraordinary milk prices and extremely high margins we still lost dairies. Obviously not as many but we did lose dairies. So we are concerned about the general health of the dairy industry but we want that balance and that's why we are supporting the proposal that we are.

As far as the milk supply and how you might allocate that. Our view is that the milk supply -- and you heard it earlier today from some of the other witnesses. The milk supply, the pressure to produce more milk in this environment is extraordinary. There are so many factors at work against increasing milk supply today we didn't have five years ago or ten years ago. I just can't see that we would ever return to those levels and stay there. There's a lot of competing competition for the resources that dairy farms use. Land and water are huge ones now. It would be very difficult to say that the dairy industry is going to return to those golden years that we have had in the past, I just don't see that happening.

I think the likelihood of milk supply going down is much higher than it going up, and how you allocate that milk among the buyers is going to be a challenge in the coming years. Now I'm not saying that it doesn't matter if we lose a few processors. Again, we very much care about the health of the overall dairy industry, but I am not so sure that that is going to be a problem that we are going to have difficulty managing. We will pull milk out of our own plants if we have to. That's the advantage we have for having the setup we have with six processing plants.

MR. EASTMAN: So in summary, you would argue that over the last five to ten years, per se, besides the regulatory milk pricing sort of issues that we have been continually talking about for a number of years now, you view that currently the other sort of factors that affect milk production like you mention, but it's water, land use, competition, regulatory costs and implications of those. Even if the proposal from the trade associations were to be adopted, you would still think that those other factors would impede us from getting back to sort what we experienced maybe 5, 10, 15 years ago. Was that an accurate statement?

DR. ERBA: I think so. We have maintained our own supply management program, capacity allocation program is a better way of saying it from our point of view. That has been in place since 2008 and we have never taken it out of place. The last time we had to charge back our members was three years ago. I think the days of that being a major concern are probably past us.

MR. EASTMAN: Thank you. I think that's what I had.

MR. SHIPPELHOUTE: In your reading you mentioned the hay prices for 2015. Could you repeat those for me, please?

DR. ERBA: Sure. I actually just talked with one of our folks this morning and asked what the current price was and he quoted me $300 to $325 a ton delivered.

MR. SHIPPELHOUTE: And that's for supreme?

DR. ERBA: Yes, dairy-quality.

MR. SHIPPELHOUTE: No more questions.

MR. LEE: Regarding the proposal by the Dairy Institute using the different way of determining the whey factor? Do you have an opinion as to the new methodology?

DR. ERBA: Actually, Dr. Schiek and I talked about this before the hearing was called. We were actually in good conversation about this idea of bringing something other than dry whey as the basing point for determining the whey price and there is some validity for that, I don't argue that one bit.

The area where we departed in agreement, unfortunately, Dr. Schiek, was the price levels. So no matter how you determine, no matter what you use to determine the price level, that's where we found there is a deficiency. Whether it's dry whey, WPC or some other product. If the price level is right I don't think we would really have much of an argument for why you should or should not use WPC relative to dry whey. Our main concern is the price level.

MR. LEE: Do you think the concept, the recognition in California particularly, the concept of using that pricing mechanism, would that be more -- I don't want to say it would be better but more reflective of what goes on in California?

DR. ERBA: Even in the days when I was here working at the Department we had difficulty getting information on dry whey. It just isn't really done here so I do not argue that that's necessarily the best way. Then again, you could look at all of the commodities we have for each one of those milk prices and say, is that really the best commodity to be used to set the milk price? I think it's all, it's all debatable.

We produce a lot of Italian-type cheeses in California. That doesn't appear anywhere in the formula. Is that really -- the way we do it with cheddar cheese, is that really the best way? I don't know. I think you could make an argument that says, maybe there are different ways of doing it. But no matter what the methods are, the price level to me is what's the most critical and I think that's where we have a departure of agreement on. It is not necessarily the methods, it's where you end up price-wise.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Any other questions from the panel?

Thank you for your testimony, Dr. Erba.

Mr. Dryer, you are up next.

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

MR. DRYER: Actually my full name is Ray Gregory Dryer. My father insisted I be named after him and then my mother made sure I was never known by any name other than the one that she chose, which is Greg, so it's Greg Dryer.

(Laughter.)

MR. EASTMAN: We'll call you "Greg" then.

HEARING OFFICER SUTHER: Could you state your affiliation, please.

MR. DRYER: The last name is Dryer, D-R-Y-E-R.

HEARING OFFICER SUTHER: Can you state your affiliation too, please, for us.

MR. DRYER: I work for Saputo Cheese USA,

Incorporated.
Whereupon,
GREG DRYER
Was duly sworn.
HEARING OFFICER SUTHER: Do you have any other written statements other than the ones you've brought up to us today?
MR. DRYER: No I don't.
HEARING OFFICER SUTHER: Okay. They will be marked as Exhibits 43 and 44.
(Exhibits 43 and 44 were entered into the record.)
HEARING OFFICER SUTHER: You may now proceed.
MR. DRYER: Mr. Hearing Officer and Members of the Hearing Panel:
My name is Greg Dryer. I am Senior Vice President of Industry and Government Relations for Saputo Cheese USA Inc. Our company, Saputo, operates seven facilities in the state of California. We employ more than 1,500 people here and purchase a substantial portion of the state's milk production both directly from farmers and from farmer cooperatives. We are very familiar with conditions in other regions from our experience operating 21 facilities in ten other states.
I am here to testify in support of the Dairy Institute of California's proposal to temporarily replace

the current whey factor in the Class 4b formula with one based on the value of liquid WPC.

Why cheesemilk is lower priced in California.

Regional market variations.

Contrary to popular myths, the California 4b milk price is not a discounted price. It is built from the ground up. The 4b price is based on the value of California commodities FOB California, less the state's average cost of their manufacture. It is independent of other regions and other circumstances.

There is no shortage of precedent for substantial regional variation among commodity costs and prices. The April 2015 USDA All Milk Price showed California to be the lowest among the 23 major dairy-producing states. This is due in part to low Class I utilization and the relatively low value of butter and powder in the month. Also, 16 of the 23 states had a higher fat content in their milk than California. If these prices were adjusted to a 3.5 percent butterfat equivalent and we excluded Florida and Virginia which have 83 percent and 65 percent Class I utilization respectively, the price range would be $3.24 or 18.5 percent off the high price. To compare, in March, the most recent month on record, California grapefruit sold for 24 to 26 percent less than that of Texas and Florida. April wheat prices by state ranged by 29 percent from $4.31 to $6.62 per bushel. Hay prices ranged by 186 percent from $86 to $246 per ton. When I was last here, I filled my tank with $3.50 gas. The Midwest price at the time was $2.50 a gallon. Those commodities all varied more by region than California's milk price did. The point is that it is normal for commodity prices to vary widely by region. The market for milk is regional, not national. Conditions in California impacting California's market price for milk are unique to California.

California's milk supply.

According to USDA NASS in its February 2015 Milk Production Report which includes the 2014 annual milk production and farm numbers, California milk production increased more than any other state in 2014. In fact, it accounted for 22.4 percent of the entire nation's increase.

Milk production here has more than doubled since 1991. The California milk pricing system has enabled farms and processing plants to grow significantly. That would not have happened if the system was detrimental to the participants. Market share has been captured and milk is being exported in the form of dairy products to other state and other countries. There is little local competition for milk, because supplies have been more than adequate to fill existing capacity.

California's cost of production.

According to USDA, on average, California farms produce 7.6 times the amount of milk that the average dairy farm in the rest of the country produces. They produce 10.6 times the amount of milk an average Wisconsin farm produces. That enormous scale gives producers a substantial cost advantage. Milk production cost studies almost exclusively compare farms that are similar in size. The USDA ERS Milk Cost of Production Estimates by State Report takes into account all farms regardless of size. The May 1, 2015 report shows California as the second lowest cost state at $3.71 per hundredweight below the All States average and $8.36 per hundredweight before Wisconsin's cost. As long as the price of milk exceeds their variable cost of production, farmers are motivated to produce more milk.

California's processor margins.

The percentage in reduction in dairy farm numbers here from 2013 to 2014 ranked 34th of the 50 states. California lost just 3.3 percent of its farms but it lost 9.4 percent of its cheese plants, that's according to the USDA's NASS Dairy Products 2014 Summary. Available processing capacity has continually been stressed to keep pace with the growing supply of milk. This has led to the construction of very large plants producing bulk commodity products capable of accommodating the ever-increasing milk flow. Just three of those plants account for 56.4 percent of the milk used in Class 4b. Bulk products command lower margins than those of the smaller specialty plants that operate in other key cheese producing areas such as Wisconsin, Minnesota, New York, Pennsylvania and Vermont. In other areas of the West where larger plants are more common, the industry is either completely unregulated or most of the manufacturing is dominated by cooperatives, which have pooling and pricing flexibility to adjust to the changing market conditions.

Because California milk production has grown so dramatically, it vastly exceeds the demand for local dairy products. As a result, most of the cheese produced in the state is exported to other population centers across the United States.

There exists a Freight Market Intelligence Consortium that provides strategic freight market intelligence, benchmarking and comparative analysis to its members in a private forum. That organization indicates that it currently costs approximately $.11 per pound to ship cheese from central California to Chicago and $.165 per pound to New York. California cheese must compete in those markets on a delivered basis. $.165 per pound of cheese equates to $1.67 per hundredweight according to the Class 4b formula. There are a myriad of other factors which also contribute to a lower cheesemilk value in California. Among them are higher siting and operating costs and a higher cost of regulatory compliance. Statewide Environmental and Cap and Trade regulation impedes the ability to pay a higher price for the milk.

Class 4b History and Federal Milk Market Orders.

The California 4b price had no whey factor prior to 2003. When it was introduced it was very similar to the Federal Order whey factor. In 2007, a crisis arose when the dry whey price surged to unprecedented levels, completely out of proportion to the value derived from whey products made by most of the cheese plants in California.

That placed a number of California cheesemakers in serious financial jeopardy. An emergency hearing was held and the problem was solved with an arbitrary fixed value for whey. That fixed value resulted in higher milk prices for producers than the previous formula for 17 of the first 19 months after its implementation. As dry whey prices began again to steadily increase after 2009, the opposite has been the case.

A variable whey value table was introduced in 2011 and then subsequently increased in 2012.

In all that time since 2007, USDA did nothing to address the dry whey over-valuation problem in the Federal Order areas. The Federal Order process had become so cumbersome and unwieldy that participants resigned themselves to accept their fate rather than undertake the Federal Order hearing process once again. Many plants didn't survive. Wisconsin's American cheese plants dropped from 90 to 60 in the past 20 years, nonfat dry milk plants have virtually disappeared, 91 of the remaining 127 cheese plants in Wisconsin now produce specialty cheese. By diversifying away from commodity products, squeezing whatever value they can from their liquid whey byproduct and taking advantage of under-class prices for surplus milk, they have somehow managed to survive. The Class III whey factor based on dry whey prices, however, continues to keep them under enormous pressure. Two large Midwestern cooperatives published large losses in 2014. AMPI reported a loss of $10 million on sales of $2.2 billion and Foremost Farms lost $16 million on sales of $2 billion.

The fact that California addressed the whey problem and USDA did not led to large price disparities between the two systems as dry whey prices gradually climbed back to very high levels. That disparity doesn't mean, however, that California milk was underpriced. On the contrary, it meant that Federal Order regulated prices were significantly overpriced.

The Wisconsin Cheesemakers Association addressed this issue on April 13, 2015 with Comments Filed on the 610 Review of Federal Milk Marketing Orders - Docket ID: AMS-DA-

09-0065 and I have attached a copy of that document with my testimony.

In it, they make the case that dry sweet whey is not an appropriate basis for the valuation of other solids in the Federal Order Class III price. Less than 6 percent of the U.S. cheese plants produce dry whey and human production has declined more than 20 percent since 2000. There are too few processors of dry whey and limited dry whey production results in prices that can be wildly out of proportion with other whey products. The answer for California is not to attempt to mirror the antiquated and failed Federal Order system. This is especially true because plants operating in FMMOs can operate outside the pool as non-pool plants, and as such are not subject to the minimum regulated prices under the orders. Cooperatives are free to resell their milk for whatever price they can command. Last week, sales in the Midwest were reported at $7 to $10 below the Class price. in California, plants must pay minimum prices for all the Grade A milk they buy, whether it is in or out of the pool. Again, conditions in California are unique to California.

It appears that California producers do not necessarily want a Federal Order, they want a higher price for their milk. A sustainable higher price whether in California, or a Federal Order region, will only come from increased demand.

Regulatory Intervention.

While it might be tempting for CDFA in sympathy for producers to mandate a much higher 4b milk price, setting a price above the market will not achieve its intended purpose. An unintended consequence of such a change is likely to be reduced market demand for the milk. If that occurs, producers' incomes could actually decline as producers and co-ops try to find new outlets for milk in today's market, where milk capacity is stressed in key areas of the country. Efforts to circumvent a California market-driven price for milk, one that balances supply with milk demand and clears the market, are fruitless in the long run.

2014 was the all-time record year for milk prices across the U.S. and it was the result of increased demand from a burgeoning world market and not from any form of price intervention. The continual threat of CDFA intervention in milk pricing leads to uncertainty. Uncertainty is the enemy of investment. An environment where the constant threat that regulation can radically alter what comprises 80 to 90 percent of a cheesemaker's cost inhibits investment. Given the magnitude of cheese milk cost relative to any potential margin, 10 to 20 times as much or more, a small increase in the regulated price can translate to a devastating change to a cheesemaker's bottom line. That price difference might be enough to eliminate his incentive to buy the milk in the first place. It is very unlikely that milk price increases can be passed on to customers in the current market environment. The relationship of milk cost to profit margin helps explain cheesemakers' sensitivity to regulatory changes in the price of 4b milk. In contrast, regulatory stability and growth in dairy product demand stimulate plant investment and will lead to more milk demand and higher prices for producers.

Alternative Proposal.

The other proposal submitted for the hearing today is simply a rehash from the one that was submitted and rejected in 2012. It attempts to take us back to 2003 once again but has been increased further to mirror the Federal Order Class III whey factor. The only differences are that it is based on the Dairy Market News West Whey Market rather than the AMS NDPSR survey price for dry whey and it introduces a price floor and a price ceiling. This proposal would radically raise milk prices and comes on the heels of the highest year of milk prices in recorded history and one in which cheese plants across the country experienced very challenging economic times. Further, cheese byproduct revenues in general this year, with the exception of dry whey, have been slashed by about half from last year's high.

This is in response to a major reduction in the world market price level. It has been driven by a number of factors which include the over-production of milk and decreased demand from China. To adopt such a proposal in light of the state's mandatory application of regulated minimum prices would instantly render the state's cheese industry uncompetitive with the rest of the country. It would result in disorderly if not chaotic marketing conditions and should be rejected out of hand.

Dairy Institute Proposal.

The consensus of the U.S. Dairy Industry recognizes that our economic future depends heavily on exports to meet the growing demand from developing countries. There is no state better situated to meet that demand than the state of California. Maintaining regulated prices at levels that still allow the market to work will result in increased investment, more competition and ultimately higher prices for California producers. In the interim, California should lead the way with a whey table utilizing the value of liquid whey based on the WPC34 market. It will result in a moderately higher price for producers, is more reflective of the state's processors' products and could serve as a model for the USDA as it considers necessary changes to Federal Order pricing. That table is encompassed in the proposal presented by the Dairy Institute of California which we are here to support. The

Dairy Institute proposal is for a temporary adjustment not to exceed six months. In those months, the industry should continue to work cooperatively toward a permanent and more market-oriented solution than what we currently have.

That concludes my testimony. Thank you to the Secretary and the Hearing Panel for the opportunity to testify and I would ask for your approval to file a post-hearing brief if warranted.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Questions from the panel?

MR. EASTMAN: I have a couple of questions. In about the fourth page of your testimony under the subheading "California's cost of production" you mention that California farms produce 7.6 times the amount of milk and on average a lot greater. Are you talking because California farms, on average, are larger? The total quantity of milk they just greater than smaller farms.

MR. DRYER: Yes, I'm just -- Yes, I'm just excerpting from the USDA's annual milk production report where they include farm numbers and milk production per farm.

MR. EASTMAN: Okay. That's what I assumed, I just wanted to verify that.

On the next page of your testimony, I guess it's before you get to the history of Class 4b and Federal Orders. You mention that you receive information regarding freight costs as, I assume, a member of this consortium. is there a way for you to support some of that by showing some of the information or data on freight costs, possibly in the post-hearing brief?

MR. DRYER: I could share that.

MR. EASTMAN: Or would that --

MR. DRYER: Yes.

MR. EASTMAN: That wouldn't go against the ground rules of the consortium or anything?

MR. DRYER: No, I don't think so.

MR. EASTMAN: Okay. That would be great so we could get that on the record.

The other question I had was towards the end of your testimony you support the Dairy Institute proposal but you mention that the industry should collaborate and find cooperatively solutions to the long-term issues that we have been discussing. Is there some sort of form or method or way that you view that could be successful?

Last year the industry through the Secretary's task force attempted to do that and in the end it didn't come out with a solution that was implemented. Do you feel that is the best method? Is there some other way or some other fashion in which that could occur that might lead to success? Because some people might -- I think a lot of people would agree there needs to be collaboration but I guess we have been unsuccessful in the past.

MR. DRYER: I think one possibility could be informally a couple of major players on either side of the issue get together and brainstorm and come up with an idea that they come back and sell to the rest of the industry could be an expedient way to approach something like that. Rather than introducing a lot of players in the beginning all at once, there tends to be too much contention. Whereas if you narrow that down to a limited number of people, if they were able to come up with a good viable idea, then you go back and try to sell that to the rest of the industry. That might be an effective way to approach that.

MR. EASTMAN: Okay. Do you view that some of the issues confronting the industry on both sides of the fence are long-term in nature in the sense that they do require some sort of collaborative, long-term structural change? Do you think that's an underlying cause or do you think that is not quite as important at this juncture? I guess, how much importance do you place on that right now in terms of solving what might be the barriers in the industry today.

MR. DRYER: Well, I think it's hugely important. Obviously it is very important to producers, they need a viable price in the long run, processing plants need a price that they are able to compete with in the marketplace. So coming up with a pricing mechanism that works is hugely important. My point of my testimony was, though, that fiddling - constant micro-management trying to go one direction or another doesn't really play out. We need something that is flexible in response to changing market conditions quickly.

MR. EASTMAN: And then the last question I had is, how do you view Saputo's operation would be impacted by say the Dairy Institute proposal that you support?

MR. DRYER: We are a public company so, you know, I can't provide information that hasn't first been disclosed to the market. But obviously it would, yeah, adversely impact our costs substantially with what was proposed with the MPC and Western United and the California Dairy Campaign's proposal would be a significant cost increase to our plants here.

MR. LEE: Would you clarify that as to what significant change would occur if it is implemented. Do you have an opinion on that?

MR. DRYER: Like I said, I can't disclose detailed financial information but we buy -- I mean, it's simple math to take the price increase per hundredweight times -- for us it's a significant volume of milk. It's a big cost. Enough to impact the business in total. I mean, it's a big potential cost so one we are concerned about.

MR. LEE: Would you move some of your production out of state then?

MR. DRYER: You know, when I look at things I don't -- I don't expect anything knee-jerk. Obviously in business you make objective decisions based on comparisons and analyses and then over time, things tend to happen over time. So I could see over time, you know, having an impact on decisions being made.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Mr. Dryer, thank you for your testimony.

Ms. McBride.

Ms. McBride, will you please state your full name, spell your last name and state your affiliation for the record, please.

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

Whereupon,

LYNNE McBRIDE

Was duly sworn.

HEARING OFFICER SUTHER: And do you have any other testimony other than what you provided here?

MS. McBRIDE: No.

HEARING OFFICER SUTHER: We will mark this as

Exhibit number 45.

(Exhibit 45 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

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 grassroots organization representing dairy farm families throughout California. The testimony I will present today is based on positions adopted by the CDC Board of Directors.

I would like to begin by thanking California Department of Food and Agriculture Secretary Karen Ross for holding this hearing today to consider adjustments to the whey factor in the 4b price formula. We join with Milk Producers Council and Western United Dairymen in calling for an increase in the 4b whey scale to better reflect the whey value in the federal milk marketing order system. We support the testimony that Annie AcMoody presented earlier outlining the details and justifications for an increase in the whey factor in the 4b formula. We consider this increase to be a compromise position due to the fact that the scope of today's hearing is limited to the whey factor in the 4b formula and would sunset in 24 months. However, we strongly support all efforts to increase California minimum prices so that they are closer to a reasonable and sound economic relationship with prices paid in other states.

We believe economic conditions warrant an adjustment.

The California Department of Food and Agriculture Annual Review for 2014 indicated that there are 1,470 dairies remaining in the state. Despite record high dairy producer prices, 26 dairies went out of business in California last year. The economic conditions faced by dairy farmers in our state have led to the loss of now more than 500 dairy farms since 2006. We believe a significant reason for the decline in the number of dairies in California is largely due to the fact that dairy producers in our state are paid significantly less than dairy producers in the federal milk marketing order system. Our organization strongly supports efforts underway by California Dairies, Inc., Dairy Farmers of America, and Land O'Lakes to establish a federal order for California to bring our state dairy producer pricing and the process of setting dairy producer prices in line with the rest of the federal order system.

Although dairy producer prices improved in 2014, they dropped substantially beginning in December of last year and continue to be well below production costs today. It is important to recognize that although prices did improve last year, higher prices did not last long enough to make up for the tremendous losses that dairy producers have incurred in recent years.

Over the last six years, California diary farmers experienced a substantial net loss in income based on CDFA cost comparison summaries. As we all know, 2009 was the worst year by far with average income losses throughout the state of more than $5 per hundredweight. Conditions improved in 2010 with the net loss narrowing to $.75 per hundredweight on average and in 2011 dairy producers earned an average net profit of $.71 per hundredweight. The situation deteriorated dramatically in 2012 as dairy farmers lost more than $2 per hundredweight. In 2013 income for dairy producers in California on average did not cover expenses, falling short roughly $.06. And in 2014, income did exceed expenses by $3.29 per hundredweight on average; however, higher prices in 2014 just simply did not last long enough to make up for years and years of chronic losses.

As the last available cost of production report from CDFA indicates, the average cost to produce milk in California now totals $20.09 per hundredweight; but since late last year, prices paid to dairy producers have not come close to covering those costs. Mailbox prices in California totaled $15.11 in January and $14.49 in February while the blend price in May was just $14.60 per hundredweight, all well below average production costs.

Dairies Continue to Close

A number of our dairy producer members have closed their dairy operations since CDFA held its last hearing in 2013 to consider adjustments to the 4b pricing formula. We believe it is important to recognize the factors that contributed to the decision by these dairy producers to close their dairies and how it relates to the minimum pricing formulas established by CDFA. I would like to briefly discuss the factors that led up to the closure of three dairies of various sizes, both above and below the statewide herd average, because we consider these closures to be representative of the challenges confronting dairy producers in our state due to the fact that California dairy producers receive some of the lowest prices in the nation.

The first dairy I would like to mention was a 350 cow dairy in the Oakdale area of the Central Valley. This was a dairy that was in operation for more than 20 years. The husband was primarily responsible for managing the dairy and his wife had a full-time job in order to sustain the dairy operation. These dairy owners endured considerable scrutiny from state regulators over the years despite the fact that this dairy was in full compliance with all state and federal environmental regulations. The owner of this dairy made sure that the milkers on his operation had days off, but he rarely, if ever, took days off while he managed his dairy operation. After the crisis that all dairy farmers in California faced due to a substantial rise in feed costs and depressed producer prices in 2012, the owner of this dairy decided to sell the operation. In the end the dairy was sold and converted into an almond orchard. This practice has become so common that now a new name has been created to describe these dairies. Dairies that are torn down to plant trees are frequently called "grind up dairies." These grind up dairies are literally leveled in order to make room for orchards - and in the case of this dairy - an almond orchard.

The second dairy I would like to discuss was a roughly 1,000 cow dairy in the Tulare area. The owner of this dairy was a leader in our organization for many, many years. Due to the high cost to produce milk in California and the low prices he was receiving on his dairy he put his dairy up for sale. He received a generous offer to purchase his dairy and it became another grind up dairy that was replaced with walnut, almond and pistachio trees. He relocated to Oregon and he considers it one of the best decisions he has ever made. As a result of the sale of his dairy he was able to retire millions in debt he had accumulated operating a dairy in California over time. Besides the higher income he was receiving in Oregon, the other major difference he found was the marked difference in the approach of regulators to dairy operators in that state. In California regulators impose fines and penalties when environmental issues occur, he said. In Oregon he found that regulators approached dairy operators and asked how they could help them fix problems in order to achieve regulatory compliance. I spoke with him recently and he confirmed that he receives an income that is well over the federal order minimum prices, demonstrating that dairy producers on the West Coast can be paid well above the minimums and plants can remain profitable. It was difficult for him to leave family and friends behind in California, but he said in the end that the many benefits of operating a dairy in Oregon were well worth the sacrifice.

The final example I would like to mention is the closure of a dairy by another leader in our organization who was renting a dairy with the option to buy that operation. This dairy was a 1,500 cow free stall organic dairy in the Oakdale area. But doe to the fact that the owner of the dairy facility received a substantial offer to purchase the land from an almond grower, the lease-to-own option was canceled and this dairy operator was forced to move his cows to another rental facility. The original dairy that he hoped to purchase became yet another "grind up" dairy. Despite the higher prices he received producing organic milk, this dairy producer could not compete with the amount of money a major almond grower was offering to buy the land. This dairy producer was able to move his cows to another location and is continuing in the dairy industry, but the pressure that he and other dairy producers face due to the profitability of other crops, particularly almonds in this case, creates great uncertainty about the future of his and other dairy operations. Given this pressure it is more important now than ever that CDFA uphold the standard in the Food and Ag Code that requires California prices to be in reasonable and sound relationship with other states.

We would not continue to see so many of these dairies go out of business if our California pricing system had paid dairy producers a price that was in line with the federal milk marketing order system. Reports we have received from livestock sales in the Turlock area indicate that approximately half of the heifers are leaving the state during special heifer sales and a significant percentage of cows are leaving the state in all sales. It is well documented that milk production has been on the decline each month of this year and this trend is likely to continue.

The disparity between our 4b price and the equivalent federal order Class III price is a significant reason for the decline in milk production in our state. We appreciate and again thank CDFA Secretary Karen Ross for limiting the call of today's hearing to the 4b price because it is and has been the source of the greatest difference between California and federal order prices. The average difference between the California 4b price and the equivalent federal order Class III price totaled on average $1.80 per hundredweight over the last year as the analysis for today's hearing confirms. The gap between the Class III and California 4b is wide and longstanding and is a threat to the future of the dairy industry in our state.

California Producer Prices Fail to Cover Production Costs.

As CDFA determines whether to grant an adjustment in the 4b pricing formula, the income received by dairy producers relative to production costs is an important indicator to assess whether economic conditions merit an increase. The latest cost of production data available from CDFA again is from the fourth quarter of 2014, which reports the cost to produce milk in the state amounted to $20.09 per hundredweight. In past hearings the Department has indicated that the mailbox price is a more transparent price in regards to the income received by producers. Again, the California mailbox price for February was $14.49 per hundredweight, indicating that income that month was more than 25 percent below average production costs. Since then, prices paid to producers have continued to remain substantially below production costs. According to the section which we have all named before, 62062 of the Food and Ag Code, the secretary shall, "consider the cost of management and a reasonable return on necessary capital investment" when establishing prices. The current pricing formulas do not result in a price that is adequate to cover production costs proving that a minimum price increase is more than justified.

The ongoing statewide drought is creating even greater challenges for dairy producers. One dairy producer I spoke with the other day indicated that he had just spent half of his income that month on his feed bill. He grows all his own forage crops so that was just the grain bill that took up half of his income. He indicated that if anything were to happen to one of his wells, he would be in real trouble. He used a lot more colorful language than that but that was his point. The uncertainty about feed availability will exist far into the future given the ramification of the historic and ongoing statewide drought. The prices that dairy farmers will be required to pay for alfalfa hay are far more uncertain and unpredictable than during the last hearing CDFA held in September 2013 to consider an adjustment in the 4b price. The drought has worsened exponentially since the last hearing and the feed and water situation is far more dire.

A recent California Milk Advisory report conducted by UC Davis which has been mentioned previously in this hearing states, "The economic health of the California dairy industry depends crucially on a healthy local forage industry to sustain silage, hay and other forages that are too bulky to economically haul long distances." It goes on to explain that, "California dairy farms use mainly California-produced forage feeds and grains and high-protein food shipped into the state from elsewhere." Dairy producers are undoubtedly going to pay more for forages this year and in years to come and it is critical that minimum prices in our state take into account these and other increases in production costs relating to the drought and other factors. The study estimates - and this has been mentioned before, I'll repeat it - the direct dairy farm employment totaled 30,000 workers in 2014 and produced $9.4 billion of milk output. The stakes are high in this decision today about whether to raise the 4b price because of the tremendous economic impact of milk production in our state.

The fact that our state system underpays dairy producers compared to other states has caused California dairy farmers to be paid on average $1 per hundredweight less than dairy farmers in the federal milk marketing order system leading to a more than $1.2 million loss in income for the average size dairy since 2011 and that number has only grown. Had our state dairy system paid California dairy producers prices that were in line with prices paid in other states, the losses dairies suffered would not have been as great and more California dairies would be in operation today. The closure of dairies causes irreparable harm to the local and regional economy and the social fabric of the affected communities.

California mailbox prices are consistently some of the lowest of any regulated state in the nation. Again, the most significant difference is the inequity in the 4b pricing formula that fails to reflect the current value of whey in the marketplace. According to the latest Diary Market News, the mailbox price in California -- I mentioned these numbers before. Again, in January it was $15.11, February $14.49. In contrast, if you look at the average mailbox price in all federal orders those numbers for January $17.71 and $16.91 respectively, again showing that difference.

As has been said many times during these hearings, the California Food and Ag Code requires the Secretary to set prices that are in reasonable and sound economic relationship with the national value of manufactured milk products. A gap of $1.80 per hundredweight between the 4b and the equivalent federal order price over the last five years demonstrates that the current 4b pricing formula fails to meet the standard set out in the code. By comparison the gap between the 4a price and the equivalent federal order Class IV price totaled approximately $.23 during the last five years. We along with other producer organizations have called for an end to this price disparity, however, up until now the department has failed to restore equity to our dairy pricing system.

Despite the challenges faced by California dairy producers, California continues to be the nation's leading milk producing state, yet dairy producers here are not able to find markets if they want to change to a new buyer. Due to the consolidation and concentration that exists and the lack of competition in the marketplace, the minimum prices established by CDFA are more critical than in other parts of the country where more buyers of milk exist. Minimum prices are more important than at any other time in our state's history because of the number of dairies that have exited and those that are likely to exit unless our state prices are brought in alignment with prices paid in other states. The unprecedented statewide drought continues to put additional stress on dairy producers due to a decrease in water availability that is decreasing the acreage planted for feed crops. Given those factors, again it is critical that CDFA adhere to each standard set out in the Food and Ag

Code so that minimum prices here are fair and equitable.

In addition, the new dairy margin insurance program established in the last farm bill is based on the "All Milk" price which is significantly higher than the California mailbox price. During the sign-up period for the DMPP last fall, information circulated by UC Davis estimated that the California mailbox price was $1.92 per hundredweight lower than the "All Milk" price used in the new program. Now under the new arm bill, dairy producers in California are at a greater disadvantage due to the fact that prices in our state are significantly below prices paid in other states resulting in far less of an effective safety net for dairy producers here when margins decline.

Dairy operations cannot continue to sustain chronic losses while there is considerable profitability experienced further up the food chain. As we have testified at previous hearings. CDC believes the only way to restore equity to our state dairy pricing system is to join the federal order system which would improve the outlook for dairies across the state and enable the next generation of dairy producers to have a brighter future than the one that exists today.

The proposal we join with MPC and Western United in proposing to CDFA today would, again, bring our 4b prices in closer relationship with federal order prices and make it more responsive to changes in the whey market. Again, it would narrow the gap significantly from the current $1.80 to a far more reasonable $.34 per hundredweight. Because it is limited in scope to 24 months instead of a permanent change to the pricing formula in the end it falls short of restoring equity to our pricing system but it would move our 4b price closer to the national value of cheesemilk.

We are opposed to the proposal put forward by the Dairy Institute that would incorporate a sliding scale based on whey protein concentrate values. Under the Dairy Institute proposal the whey value would increase just $.06 based on today's WPC price. Demand continues to grow both domestically and overseas for whey products. Given how much the market for whey products has matured over the last five years, we do not agree that dairy producers should be paid a value based on the WPC price according to the scale they have included which does not reflect the growth in the whey market that has and continues to occur. The Dairy Institute proposal would maintain a significant gap between the 4b and Class III prices and we urge CDFA to reject that proposal.

And again, given the long list of challenges dairy producers face today, we do not agree that any adjustment should be limited to six months. We think that any increase should be for the entire 24 months and if necessary, at a later date, that could be possibly reviewed.

And in conclusion, the increase called for in our joint proposal will provide much needed additional revenue that is well deserved by dairy producers who have continued to lose substantial income since prices dropped dramatically late last year. Our proposal is a compromise position that would increase the 4b price, a step that is long overdue. Adoption of the producer price increases that we have called for today will provide, again, much needed and well deserved revenue to dairy producers across the state who continue to struggle to remain in operation under continued difficult circumstances.

CDC would like to thank the Department for the opportunity to present our testimony today and we would like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Questions from the panel?

MR. SHIPPELHOUTE: You spent quite a bit of time talking about "grind-up dairies." Certainly over the time that I have been with the Department we have had instances where a lot of dairies in Southern California were ground up for houses; in the North Bay a lot of dairies were converted to vineyards. I'm just curious if you could speak to your thoughts on using the minimum price to ensure that a parcel stays in dairy as opposed to some other competing land use.

MS. McBRIDE: I bring that up just because I think when you hear of those, you know, story after story after story of dairies, again, just literally being leveled to plant other crops, and you have a minimum price system here in California, again, some of the lowest mailbox prices in the nation, and you see this continuing gap between the 4b and the Federal Order Class III. I mean, I just think the stakes are a lot higher than they would be if all our prices were in alignment with prices paid in the other parts of the country. I think it just makes the decision so much more critical and that's why we thought it was important to raise today. And with the drought and the water situation it's becoming even more prevalent.

MR. SHIPPELHOUTE: So do you think if we were to adopt this proposal that it would prevent or -- would it make dairying more competitive or able to pay more than the almond growers that are bidding for that same land?

MS. McBRIDE: I think there is going to continue to be pressure from other crops certainly, but the adoption of this proposal just to ensure again that our prices are equitable compared to what is being paid for milk in other states. And I think it would put farmers in our state on much better footing than they are today, again, given that they are competing against farms that are paid those minimums. And again in the case of the one farm I mentioned in Oregon on the West Coast, well above the minimums. We need at least an effective minimum price system here in California, which we don't think we currently have.

MR. SHIPPELHOUTE: On page 6 of your testimony you talk about the development of the whey markets internationally and the growth of those whey markets. Is that growth in sweet whey or WPC? Do you have any information on what types of whey products?

MS. McBRIDE: That's something I could definitely submit as part of a post-hearing brief.

MR. SHIPPELHOUTE: And your opposition to using the whey protein that was recommended by the Institute, is that just because of price level or because of the commodity that they are using?

MS. McBRIDE: Well, we think it is really important for our prices to be brought in alignment with Federal Order prices, and by switching to a WPC price when the rest of the country isn't doing that, we have concerns along those lines. But also just the fact that it would maintain that substantial gap between the 4b and the Class III, that's really the primary reason why we oppose it.

MR. SHIPPELHOUTE: Okay. That was it.

HEARING OFFICER SUTHER: Thank you for your testimony.

At this time let's take a one hour break. We will reconvene at 1:00 o'clock. Mr. Zolin, you will be the first to testify at 1:00 o'clock.

We are now off the record.

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

(On the record at 1:05 p.m.)

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

1:05 p.m.

HEARING OFFICER SUTHER: I would like to go back on the record. It is 1:05.

Again I would like to announce the opportunity to submit a post-hearing brief amplifying, explaining or withdrawing your testimony is granted for all witnesses who request a post-hearing brief period. In order for the brief to be considered the Department must receive the brief by Monday, June 8, by 4:00 p.m. The brief may be e-mailed to dairy@cdfa.ca.gov or submitted to the Department's branch office located at 2800 Gateway Oaks Drive, Sacramento, California, 95833. And the brief may also be faxed to area code 916-900-5341.

We will now proceed with the public testimony.

Mr. Zolin, would you please state your full name, spell your last name and state your affiliation for the record, please.

MR. ZOLIN: My name is Alan Zolin, Z-O-L-I-N, I am a consultant and I am here testifying on behalf of Pacific Cheese Company.

Whereupon,

ALAN ZOLIN

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other statements, written statements other than the one you have presented that you would like entered into the record?

MR. ZOLIN: I do not.

HEARING OFFICER SUTHER: You will be Exhibit number 46.

(Exhibit 46 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. ZOLIN: Mr. Hearing Officer and members of the Hearing Panel:

My name is Al Zolin and I am here today representing Pacific Cheese Company, located at 21090 Cabot Boulevard in Hayward, California. Pacific Cheese Company was founded in 1970 by Ray and June Gaddis and was the West Coast's first broad line cheese supplier. As industry pioneers, Pacific Cheese was instrumental in the expansion of the California cheese industry and laid the groundwork for the company's growth into one of the country's leading suppliers of premier-quality, natural cheeses. Today, a second generation of the Gaddis family oversees the company's success and industry leadership. Pacific Cheese has had a long history of working directly with individual dairy farm families, dairy cooperatives and proprietary cheese makers to build a high quality cheese industry that has greatly expanded the demand for California milk.

Pacific Cheese delivers a variety of cheeses for foodservice and retail environments. The company handles private labels and also offers its own brands, such as Cheswick, North Beach, Pacific Blue and California Select Farms, among others. Pacific Cheese also supplies cheese products for ingredient use in food manufacturing and is a supplier to the international marketplace, delivering through the Port of Oakland for direct shipments to South America, Southeast Asia and the Middle East.

Pacific Cheese is in the business of procuring high quality cheese from excellent suppliers and adding value through our cut and wrap facilities in Reno, Nevada and Amarillo, Texas, our supply chain expertise and customer service. We are a national and international supplier of cheese; we source cheeses from a variety of suppliers in multiple locations. We have historically and continue to procure a large quantity of cheese from suppliers in California. So we very concerned about proposals which would significantly increase the cost of milk to our cheese suppliers and the cost of the products that we source in the state.

Our business is a very competitive one. We began in California and have had a long history of procuring cheese in the state. However, there are many high quality and excellent suppliers of cheese in other states besides California. In recent years competitors have emerged throughout the western states. If a large increase in the regulated milk price paid by cheese makers were to translate into an increase in the price that we have to pay to procure cheese, and we see that as a likely outcome of at least one of the proposals (the producer trade association proposal) under consideration at today's hearing, the competitive nature of our business would cause us to, in all likelihood, reduce our purchases of California cheese and increase purchases from high quality suppliers in other states.

Procurement decision aren't only about price. Quality, service and supplier relationships are important as well. But in today's environment where there are many quality suppliers throughout the country, a company such as ours has choices, and we will need to give these choices serious consideration if our California cheese suppliers become less competitive on a price basis.

While we understand that the drought in California has created a lot of uncertainty and that the Department has concerns about the challenges facing dairy farmers in the state, pricing policy decisions have impacts beyond the farm gate, and some of those impacts may not be in the best interests of the state's producers if demand for California products and California milk is negatively impacted as a result. We ask the Secretary to take these issues into consideration.

Thank you for the opportunity to testify here today and I would request the opportunity to file a post-hearing brief. Thank you.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Any questions from the panel?

MR. EASTMAN: I have a question. In your testimony you don't necessarily support either of the two alternative proposals. Is your baseline -- Is your baseline testimony that you would prefer no change at all, and if there is change something very small? Is that what I am reading here?

MR. ZOLIN: Pacific Cheese is a member of the Dairy Institute of California and we do support their proposal.

MR. EASTMAN: Okay.

MR. LEE: Just one quick question. Pacific Cheese Company, do they process cheese themselves?

MR. ZOLIN: The word "process" has a number of definitions. They do make processed cheese, so they will buy cheese that is made as a natural cheese and then further process it into a processed cheese. American singles, for example, or a low-type cheese. Primarily they are a cut and wrap operation where they buy natural cheese, shred it or chunk it and move it into the retail sector or foodservice sector.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Zolin.

MR. ZOLIN: Thank you.

HEARING OFFICER SUTHER: Mr. Hofferber.

After Mr. Hofferber we will do the three minute testimonies, right around 1:30. So if you have not signed up in the back of the room please sign up for those.

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

MS. HOFFERBER: Yes. I am Scott Hofferber, spelled H-O-F-F-E-R-B-E-R, and I am the Chief Financial Officer of Farmdale Creamery.

Whereupon,

SCOTT HOFFERBER

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other statements, written statements that you would like to enter as an exhibit?

MS. HOFFERBER: No.

HEARING OFFICER SUTHER: Your testimony will be Exhibit number 47.

(Exhibit 47 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MS. HOFFERBER: Thank you. Good afternoon Hearing Officer and members of the Hearing Panel. I am Scott Hofferber, the Chief Financial Officer of Farmdale Creamery and I am here at the direction and on the authority of our Board of Directors. Farmdale is a third-generation family-owned and operated dairy processing facility in Southern California. With over 90 employees, Farmdale is processing an average 28 million pounds of milk and cream per month, 120 loads a week, into cheese, sour cream, WPC80 powder and buttermilk. We are grateful for this opportunity to provide Farmdale's perspective on the matters before the panel.

We are here to advocate for the proposal proffered by the Dairy Institute of California at this hearing to try and bring a true and honest minimum value of the whey stream as a starting point for end-product-based value determinations.

The Disconnect

To paraphrase the outcry from the producer community: "We want what our Federal Order brothers and sisters are getting in their Class III milk because it would be fair", which would be an untruth. This is a "loaded statement" - one with false, disputed. or question-begging presuppositions. But anyone who knows the California and Federal Order systems knows this absolute truth: federal orders do not mandate the minimum prices paid for milk going into anything but fluid usage. And that truth can be seen every month in the mailbox prices paid in orders where the industry is structured like California, mainly in the West, and where prices paid dairy farmers are within pennies of those paid in California.

Earlier testimony talked about the ability to go Grade B with California milk but in the regulations and the statutes that accompany that, it taints all the other products that come with it. For example, in our case we have WPC80 powder. Where if we were to make that powder from a Grade B product it would severely damage the value of that in the marketplace. So it is not a simple as just saying, technically in California you can get away from the minimum regulated price. You're not talking about apples and apples.

Producers can choose to perpetuate their misinformation, but right now, the absolute truth is that in Wisconsin cheese plants can buy milk for $7 below Class III. A real disservice has been perpetrated on the California dairy producers and the industry by the promulgation of this fallacious and inflammatory outcry.

The producer proposal assumes that certain features of the Federal Orders are directly applicable to our California regulatory model, industry conditions and underlying economics. Such an assumption has been made by producer advocates at nearly every hearing over the past 15 years and its accuracy has yet to be conclusively shown in any California hearing record. And we heard testimony earlier from Saputo that really reinforces that idea that the California construct is a ground-up build rather than a we want what they want -- what they've got. And of course it can't be because anything more than a cursory examination of the two systems shows clearly that is a false assumption. We aren't them, or they.

Who says the Federal Orders have the whey issue right in the first place? Not the Executive Director of the Wisconsin Cheese Makers Association, John Umhoefer. His article in the Cheese Reporter of May 8, 2015 describes the reality of valuing whey streams accurately. In speaking about the use of dry whey as the measurement for the value of the whey stream he states: "It's a fundamental flaw in federal milk marketing order milk pricing - a built-in discrimination against small and mid-sized cheese manufacturing businesses that cannot begin to afford the cost of dried whey manufacturing." Who else says that the federal orders have it right? Not Farmdale.

And to a question from Mr. Shippelhoute earlier: There is in the testimony record back in '07, I believe, there is a presentation by the Department that describes the cheese plants at about 65 of them, where we came in about fifty-second place, the largest to the smallest. And from 52 on down that collective group of smaller cheese makers at that point in time accounted for about 15 percent of the total milk being put into cheese. So if you are trying to equate the number of cheese plants to the amount of milk going it's about five-sixths or so of the plants are accounting for about 15 percent of the total milk going into cheese. It would scale fairly close to that if we were to update that particular study.

Farmdale, in response to the competitive environment in which we operate, took a hard look at our options, including going out of the cheese business altogether, and decided to take the risk. We bit the bullet and made the very significant investment in a whey processing facility which has been in operation now for just under two years. This so-called upgrade to our ability to efficiently eliminate the waste whey stream comes with great risk. The required capital investment, market development, global demand and other factors make this course of action worthy of our retaining any marginal improvements gained by affecting this change. It remains to be seen whether or not we made the right choice.

The Reality

The last 18 months ending June of 2013 of our old animal feed roller drying operation resulted in a negative outcome of about $.0125 a pound of cheese produced, a cost which was and is absorbed by the cheese operation. In the final six months ending June 2013 of that same operation the result was a negative outcome of $.0250 a pound of cheese produced. This increased negative outcome was directly attributable to the higher Class 4b price contribution from the increased whey scale in combination with higher market prices for dry whey. It got worse as time went along for us in the animal feed world, is the point of all of that.

Since the conversion to the new process, in the most recent 18 months ending April 2015 of our WPC80 powder operation we resulted in a positive outcome of $.03 a pound of cheese produced, an improvement of $.0425 a pound of cheese produced over the similar 18-month period in the old process. In the final six months ending April of 2015 of that same operation, however, the result was a negative outcome of $.0225 per pound of cheese produced, an improvement of only $.0025 a pound of cheese produced over the same old process' time frame, to compare the last six months of those two different processes.

A few important observations about these data:

The improvement of $.0425 a pound of cheese produced roughly represents the ROI necessary to service the debt incurred on making the necessary investment for the change in the first place.

Secondly, the improvement of $.0425 per pound of cheese produced could only remotely justify an increase in the value of the whey stream of $.3845 per hundredweight of 4b milk at an 11 percent yield, and that's if you believe the producers are entitled to the entire improvement ion performance. In no way can an increase of $1.46 a hundredweight, or so, be justified. We also have concerns about the Dairy Institute's proposal indicating an increase of $.41 a hundredweight but are hopeful that, by changing the underlying driver to WPC34, the movement in milk cots will track more closely with our WPC80 market.

Third, the dramatic downturn in the market prices of WPC80, earlier testified to as having been cut in half and we will verify that that is the case, in the last six months, resulting in the aforementioned negative outcome of $.0225 per pound of cheese produced in our new operation, amplifies our earlier points regarding the risk we have undertaken to stay afloat in the cheese business. The inability of the pricing system to appropriately track the value of WPC80 markets and translate that into milk pricing is obvious and not accounted for in the WUD proposal or the CA/FMMO systems. If the WUD proposal, or anything close to it, is adopted, we would face another even more catastrophic eventuality, that of being driven out of the cheese business without ever having had the opportunity to recover the debt incurred.

Fourth, we are, at least, just as impacted by lower prices as the producers when it comes to the whey business. The whey value in 4b milk over that same six months has fallen from $.6875 a hundredweight to $.50 a hundredweight in the 4b formula. In the metrics we use, this indicates a reduction in whey value to the producers of an average of $.01 a pound of cheese produced, or $.0925 per hundredweight in the 4b milk price. It is clearly evident that the "ask" for an increase of $1.46 a hundredweight in 4b milk, or $.1325 a pound of cheese produced, is without comprehension of the realities of our business. We might be able to garner a few cents-per-pound more out of the marketplace but certainly not the full "ask" without getting clobbered by out-of-state cheese.

Fifth, to have a conversation about whey values in isolation of the inextricably related cheese production piece is dangerous. It should actually be taken up as a separate class of product if, in fact, we are going to go down this road, but that is not part of this hearing. The Department's own cost studies clearly indicate that cheese make allowances continue to run behind the actual costs in an ever-increasing amount. Processors have agreed to forestall pressing this point with the Department in an effort to cooperate with the tenor of the debate surrounding producer pricing. That "discount" from the processors to the producers has certainly been left out of the conversation but should not be forgotten. And this "discount" is a real, audited figure based on real cost factors in California, not an abstract and unsupported correlation between FMMO Class III theoretical price and the California mandated 4b price.

There was a question earlier from Mr. Lee regarding whether margins could support the kinds of increases we are talking about here today and I think by my previous numbers you can tell that they won't, at least in our operation.

The most recent weighted average manufacturing cost for cheese is $.2291 a pound, but the manufacturing allowance is stuck at $.1988 a pound, which was the weighted average cheese manufacturing cost in 2006, nine years ago. I have done the math on what that impact would be to us and it is just a big number. I didn't bring it with me but we've left a lot on the table as far as make allowances go.

In 2007, a variable whey factor nearly ruined the smaller cheese makers when dry whey prices went unexpectedly high. A hearing at that time returned the whey valuation to a reasonable flat rate of $.25 a hundredweight. However, as the economic model for dairy farming in California has continued to under-perform, mostly due to an oversupply of milk into the existing and un-incented-to-expand processing complex, the outcry from the producer community has been reduced to the unwarranted, unjustified and unproductive focus on the whey valuation in the 4b formula as a means to an end; that end being pure price enhancement.

"Fairness"

Another issue we have with the producers' outcry is the use of the term "fair". This has become such a politically and emotionally charged word in recent years as so-called "entitlement spending" by governments in the name of fairness has put cities into bankruptcy, including our own San Bernardino, and created so much political polarity that our leadership is at loggerheads leading to a near standstill in getting anything meaningful accomplished. Fairness is a fable these days. The better term is "appropriate".

Let's move the discussion away from this "I want what I want 'cause I want it" ranting to a more reasonable approach to determining the appropriate value of the whey stream.

First and foremost, producers have always had the ability to extract additional value out of the milk by affecting surcharges above the minimum regulated price. Why hasn't this been done is a mystery. Why this hasn't been done is a mystery. Producers and their representatives are certainly not lazy or unsophisticated so the answer must be the milk just isn't worth it.

It is the simplest of economic realities that since we need to run our plant in order to get an adequate return on our investment, there is demand for milk. If milk is scarce we would pay more for it, to a point, in order to keep our plant operating and afford the debt service on it.

Third, if milk is over-supplied, which has been the case more often than not in my 18-year tenure on the job, a high minimum price sends the wrong signal to the supply side; to wit, "make more milk". While milk production is down a bit this year, we have seen minor pullbacks in milk output before, only to be followed by new milk output records.

In earlier testimony the comment was made that the producers have no way to pass along costs. And I think but what I just said in that they have the ability to raise their premiums, that would kind of belie that statement.

And on this one I wanted to make the comment. It has been said a few times today, citing the number of dairy farms lost in the last five years. You know, there have been a couple of numbers thrown around, 400, 500 or so dairy farms. If this number is correct, and I am pretty sure it is, when the regulatory system came into being in the '30s there were somewhere around 17,000 dairy farms in California; we are down to 1,400. If you run a linear math on that that's 180 farms a year have disappeared over that entire length of time. So in five years that's what, 900 farms, which is a bigger number than the number actually thrown out here today. So it gets a little disconcerting to me that we get these statistics in isolation without real context. There is no argument that there has been difficult economic times, but the ongoing consolidation and change in business dynamics that go on needs to be separated from the debate about whether the 4b price is really the culprit in all this.

To run to the regulatory, legislative or judicial systems for "relief in the name of fairness" is not the answer. Just do business. But wait, there's a problem with that. The fact that many producers are also processors at some level masks the sometimes harsh realities of being in manufacturing. Since "re-blending" in co-ops can occur, a member producer doesn't necessarily see the impact of regulatory price changes on their combined total income. For a proprietary processor, we end up on the short end of that stick every time. We can't assess our producer/ suppliers to make up our business losses because we can't get below the minimum regulated price. The system is broken. Discussions surrounding reform have been unfruitful and even thwarted by this hearing.

Where we share the Secretary's concern for the welfare of the dairy industry entrusted to her care, we implore the Department to recognize the fragile nature of both sides of this coin, both producers and processors, and balance the needs of industry stakeholders. Let the marketplace determine the appropriate level of equilibrium in the price of 4b milk.

And with the respect to submit a post-hearing brief I respectfully submit my testimony.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Any questions from the panel?

MR. EASTMAN: I have a couple of questions. I'm missing what page this is on but you mention that - here we go - that there are certain areas of certain orders, mainly in the West, where producers/dairy farmers are paid within pennies of those paid in California. Are those specific federal orders or specific states or areas that you are referring to?

MS. HOFFERBER: Yeah, it's my understanding that whatever is in place in New Mexico is presenting mailbox prices very close to California's numbers. I can submit some additional breakdown on that that shows those comparisons.

MR. EASTMAN: Okay, that would be good. So it seems that your default position is really "no change." Is that --

MS. HOFFERBER: That would definitely be preferred as far as we are concerned. We need time to continue to develop this operation and the markets related to our WPC80 plant, you know, to get a handle and convince our banks we are going to be good to go for the next number of years it takes to pay that debt off.

MR. EASTMAN: If the Secretary were to decide to make some sort of change do you feel that a proposal like the Dairy Institute's proposal that bases pricing off of WPC34 is closer to your operation that produces WPC80 or is it just as different as dry whey or do you have any sense of how those correlate at all?

MS. HOFFERBER: Well, my sense and what our consultants are telling us is that we would track closer to 80, although there are disparities in those two prices. We don't really have a survey on the 80 so it's going to be somewhat, you know, a good guessing game. But we think it's a much better guessing game than what we've got with the whole dry whey market with nobody really making it and kind of an odd correlation between us and what's going on in Wisconsin, for crying out loud. It has nothing to do with our market.

MR. EASTMAN: And that was my second question, which you kind of answered. So you are not really aware of any public price discovery for --

MR. HOFFERBER: Not on the 80.

MR. EASTMAN: -- WPC80? Okay.

And then you sort of mention towards the end of your testimony that -- you made the statement that the system is broke; that you feel that there are certain issues that obviously need to be addressed. Do you consider those issues that need to be addressed within some sort of industry growth similar to what was happening last year? Do you think that's a bigger priority than what we are doing here today?

MS. HOFFERBER: Right. I have had the great privilege of serving on both the Whey Review Committee that followed up the 2007 adjustment and the Secretary's Dairy Future Task Force and I appreciated the opportunity to be part of both of those tables. The problem is that those exercises really were too broad in participation.

This really needs to be appointed to a very small focus of economic-based people that would come up with a construct that then we could present to the broader audience and debate that once some sort of construct was developed. We ended up doing an awful lot of good work and a lot of good ideas ended up on the table, but the end of the day in both of those committees we lined up just as we are lined up here today and we have to find a way to push past that.

My personal opinion in my experience is it would be a full deregulation in manufacturing milk and let us sit down across the table and negotiate a price on a local, vertical basis with the producers. I used numbers earlier, in the '30s or whatever we had about 17,000 farms and 625 processors. Today we are down to 1,400 farms and 120 or so processors. It seems to me with those changes in scale the necessity for these hearings becomes almost moot, where we could actually deal locally, regionally - when I say regionally I don't mean U.S., I mean up and down California - and come up with deals to where a group of producers would come to us and say, okay, here is our economic model, here is what we could make. Let's go together and get this done.

And I have been talking about this in both -- not so much the Whey Review Committee because I probably didn't know enough in those days but certainly with the Dairy Future Task Force. It became evident to me that that's where we need to go. But to get there is going to take another monumental effort, a real paradigm shift in why we -- the necessity of a regulated system at this point in time the way this economy is built and the number of players that are involved in it. That's my soapbox but, you know, you asked.

MR. EASTMAN: I did, okay.

Actually, I have one more question. You had made reference to a table that I think the Department had put together that showed cheese plants based on the amount of milk they procured and people have made comments about that. We have done that for this hearing again but would you think that based on the size of your operation that you are just not big enough in terms -- I assume you went through numbers to show how almost any price increase is definitely going to affect your bottom line. Do you feel that your size and below you just don't have the economies of scale based on your size to compete in the same way that maybe some of the larger cheese plants do based on your size?

MS. HOFFERBER: Yes. Over time we basically kind of described ourselves as the biggest of the smalls. Gallo is a little larger than us; Cacique is exactly our size, exactly roughly, if that makes any sense. But there's a lot of guys that are not nearly our volume that are looking for a way to do it. And Gallo described the fact that they are taking up whey streams around them and processing them. We're trying to work that out, it's not something that happens overnight. And a shock to the system like what is being proposed by the, by the producer community here would just completely trash any of that that we got going on. In my opinion.

MR. LEE: As a follow-up question to what Hyrum and yourself had regarding discussion over pricing. A few testimonies ago Saputo Cheese's Greg Dryer had indicated a means to which maybe to go forward is having a small group of folks getting together and coming up with a methodology and be sold to the rest of the industry. What are your opinions regarding that process?

MS. HOFFERBER: Yeah, and maybe that's what I was trying to describe when I kind of answered that question a little earlier on the tails of the Dairy Future Task Force involvement and all that stuff. It needs to be a smaller group of really smart people to just sit down and do exactly what you're describing. Or what Greg or Ray --

MR. LEE: Greg, Greg Dryer.

MR. HOFFERBER: No, Greg described.

MR. LEE: Greg Dryer.

MR. HOFFERBER: Just kidding.

(Laughter.)

MR. HOFFERBER: We had some fun with that at lunch.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. HOFFERBER: Thank you.

HEARING OFFICER SUTHER: Now we are going to take a little deviation. We are going to take some three-minute testimony so some producers can get back to work.

Peter van Warmerdam.

Mr. van Warmerdam, first off would you please state your name and spell your last name.

MR. VAN WARMERDAM: Peter van Warmerdam, last name V-A-N, W-A-R-M-E-R-D-A-M.

Whereupon,

PETER VAN WARMERDAM

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written statements you would like entered into the record?

MR. VAN WARMERDAM: No.

HEARING OFFICER SUTHER: Okay. You may proceed.

MR. VAN WARMERDAM: Good afternoon, Panel. I want to thank you for taking the time to listen to the dairy industry's testimony. My name is Peter van Warmerdam, I am a second generation dairy farmer in Galt, California. My family has been in the dairy business for over 60 years.

I am here today to speak to the long-term effects of our ever-decreasing dairy farms. Currently, California has the lowest price per hundredweight. I need each one of the panelists to think long and hard about the long-term sustainability of our industry. Our state has lost hundreds of dairy farms due to our current pricing system. Unless something dramatically changes, we will continue to lose valuable dairy farms that are essential to maintain our state's economic well-being.

Furthermore, all costs to run and operate a dairy farm in California has gone up significantly.

The competitiveness for the land that feeds our cows has changed drastically. Over the last five years in our area there have been hundreds of acres that have gone into grapes or trees.

Personally, I feel our state's milk price needs to change to what is being proposed by our dairy trade group today representing us here. We have been at a disadvantage for several years now that has cost dairy families millions of dollars. We are the nation's number one dairy state for milk production and quality; it is time we get paid for it. In CDFA's most current dairy review it showed California's mailbox price for February at $14.49, $3 less than the second-leading production state at $17.58.

In closing, please think about the sustainability of the dairy industry and make changes to our milk price that reflects the diligence, hard work and sacrifice that we all make to put out a quality product to feed our world. Thank you.

HEARING OFFICER SUTHER: Any questions?

MR. EASTMAN: I have a question. Do you have an land? Do you grow any of your own feed?

MR. VAN WARMERDAM: Yeah. We milk about 1,100 cows and farm about 800 acres. Probably 300 in alfalfa, 400 in corn silage and maybe 100 in grass. We have also diversified a little bit n the last few years with other crops and grapes and we put in some solar panels just to have some backup. We can't rely on one source of income anymore with what we have gone through in the last five to seven years so we have diversified. But our main income is from the dairy. That's what got us where we are today and that's what we have a passion for.

I'm a pretty hands-on dairy farmer. I start every morning at 5:00 o'clock. And the thing that probably saddens me the most is two or three years ago I went to a field trip, went on my son's field trip to a firehouse and one of the firemen asked him, "What do you want to be when you get older?" And he said right away, "I want to be a dairy farmer." And I am not so sure that I want him to go through what we are going through over the last 10 years. I think we are all very grateful for 2014, it got us back on our feet and built up some equity, but I sure don't hope -- I sure don't hope that the next five years is what was prior to 2014, otherwise this room would probably half full from what it is right now.

MR. EASTMAN: How has the drought affected your farming operation?

MR. VAN WARMERDAM: The drought hasn't really affected us that much yet. We are pulling all well water. I mean, we are in Sacramento County, 30 miles from here, so we have a reasonable amount of water. We have had to lower our wells a little bit last year.

But I think the biggest concern we have is I look around my farm and all I see is grapes. I go two or three miles down the road and they're putting in hundreds of acres of walnuts and almonds that are just -- you know, it's hard to see that when you have been a dairy farmer your whole life. Even though I put in grapes it's not really my passion but I have to do something that is going to give me a higher return per acre than the feed I grow for my dairy cows.

MR. EASTMAN: Thank you.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. van Warmerdam.

Mr. Avila.

MR. AVILA: Clarification. I signed up for the other one.

HEARING OFFICER SUTHER: Which one would you rather with?

MR. AVILA: Well, I tell you what, 20 minutes is too much and 3 minutes isn't enough so let's split somewhere in the difference.

HEARING OFFICER SUTHER: Well, then you will need to stay on the other list for the 20 minute one.

(Laughter.)

HEARING OFFICER SUTHER: Mr. Deniz.

Mr. Deniz, could you please state your full name, spell your last name and your affiliation for the record, please.

MR. DENIZ: Sure. My name is Lucas Deniz, D-E-N-I-Z. I am here today representing myself, Deniz Dairy, in Petaluma. I also would like to state that I am a member of the Western United Dairymen board, part of the people that put the petition together here today. Excuse me, I'm a little bit nervous.

I don't have anything really prepared to say but I just want to make some comments.

HEARING OFFICER SUTHER: Excuse me; could you hold on one second?

MR. DENIZ: Sure.

HEARING OFFICER SUTHER: I've got to finish up a little more business here.

Whereupon,

LUCAS DENIZ

Was duly sworn.

HEARING OFFICER SUTHER: Okay, thank you. And any statements you want entered into the record, any written statements?

MR. DENIZ: No.

HEARING OFFICER SUTHER: Okay. You may proceed.

MR. DENIZ: Like I said, I'm a dairy producer from Petaluma, third generation.

I'd like to talk a little bit about our pricing system here in California, the pooling system as we all know. It's not a perfect system but I believe it's a good system, I think it's a fair system. Sorry, Scott, for using "fair."

At its basic fundamental core I think it is designed to ensure stability and ensure that producers get a fair market price for the raw products that are made. And as we heard earlier from all the numbers, we don't feel that we are getting a fair -- the whey price is not an accurate market price, it is not representative of the value of that product.

And as a producer I have no way of passing on my costs of doing production at all. Many of the small cheese processors who we have heard from today -- and I would like to also state that I think all of us producers are very sensitive to their situation as well. I don't think any of us want to see processors struggle or go out of business or leave the state. We need them, no different than they need us. But unlike producers, we are unable to pass on our cost of doing business.

I know that many of the small processors are doing value-added products and are at least on some level, I don't know where that is, I don't have any numbers, at least some level are able to pass on some of their costs to the marketplace. Now I don't know what their costs have done. You know, the retail cost of their products have gone in the last year. I know as our prices have dropped by 30 to 40 percent in the last six to seven months -- I don't know but I speculate that their prices, their retail prices have probably not dropped quite that drastically.

Another thing that was failed to mention from many of the processors here today is in our current 4b formula we take the value for cheddar cheese. A majority of the cheese produced in this state is not cheddar cheese, it's cheeses that produce a much higher yield than cheddar, and so the processors are capturing that value as well as, I feel, not accurately accounting to the pool for the whey value.

Also another thing is we have been at this fixed whey price now for almost since December of 2001 -- excuse me, December of 2007. So we're going on, coming up on eight years that we have been in this situation in the industry. I find it somewhat difficult to see how two years of a different whey factor could so drastically and dramatically impact the processor community the way that we have been impacted, like I said, for almost eight years now.

So that's why I am here today to fully support the proposal submitted by the three producer groups, Western United, Milk Producers Council and California Dairy Campaign.

HEARING OFFICER SUTHER: Any questions from the panel?

Thank you for your testimony.

Mister -- I believe it's Corda.

MR. CORDA: Yes.

HEARING OFFICER SUTHER: And I apologize in advance if I butcher anybody's name.

MR. CORDA: You're fine.

HEARING OFFICER SUTHER: Mr. Corda, could you please state your full name, spell your last name and state your affiliation for the record, please.

MR. CORDA: My name is Jerry Corda, C-O-R-D-A, and I am a dairyman in Marin County and that's my affiliation.

Whereupon,

JERRY CORDA

Was duly sworn.

HEARING OFFICER SUTHER: Thank you. Do you have anything written you would like to enter as an exhibit?

MR. CORDA: No I don't at this time.

HEARING OFFICER SUTHER: Okay.

MR. CORDA: I want to thank you for this opportunity to speak before you today. I am a fourth generation dairyman and I am in partners with my mom and my brother. We have been in dairy since 1972. Prior to that all of my family was involved in the dairy industry.

I just want to let you know that I support the Western United, Milk Producers Council and California Dairy Campaign's proposal before you today.

I think all the facts and figures and numbers have been presented throughout the day whether through the processors and the producers so I think you've got all those numbers.

I just wanted to say that to keep the dairymen in business I think it's important that you support Western United's proposal. I don't think California can afford to lose another dairy family.

And with that I thank you for your time.

HEARING OFFICER SUTHER: Any questions?

Thank you for your testimony.

MR. CORDA: Thank you.

HEARING OFFICER SUTHER: Ms. Duarte.

MS. DUARTE: Good afternoon.

HEARING OFFICER SUTHER: Good afternoon. Please state your full name and spell your last name and state your affiliation for the record, please.

MS. DUARTE: My name is Antoinette Duarte, D-U-A-R-T-E, and I am a dairywoman in Elk Grove, California.

Whereupon,

ANTOINETTE DUARTE

Was duly sworn.

HEARING OFFICER SUTHER: Thank you. Do you have any written testimony you would like to have entered?

MS. DUARTE: No, I don't.

HEARING OFFICER SUTHER: You may proceed.

MS. DUARTE: Good afternoon, Hearing Panel. I would like to say thank you for allowing me the time to speak at this hearing on behalf of the dairy families here of California.

My family and I own and operate a 550 cow dairy in Sacramento County. We began our dairy on 160 acres on a farm in 1972 with 180 cows and $12,000 in our pocket. My grandfather, father and brothers also had a dairy, and unfortunately they sold their cows and facilities in May of 2013 and they were one of the circumstances of the falling milk prices. So as you can see, dairy farming is very important to me.

I am going to bring out some points and then I have a few things to say afterwards.

The dairy operations will feel the effects of the drought as feed supplies, and a portion of which is locally grown, represents our highest operating costs. For the losses of locally grown silage, hay and pasture could raise our feed costs significantly. California dairy producers on an average import 50 percent of the feeds during the non-drought years and in drought years these producers are expected to increase their feed imports 60 to 70 percent.

California dairy farms are likely to be more vulnerable during the drought in 2015 than they were in the previous years. Last year milk prices nationwide soared to high record prices, which shield California dairies from the drought effects on feed prices. With milk prices having plummeted nearly 40 percent from a year ago, California dairies will not likely be so lucky in 2015.

Some dairy producers who grow their own silage are converting some of this acreage to nut trees where the net returns are higher. Other producers are fallowing their acres due to water constraints, diverting water to other commodity crops or selling it to nearby farms. Dairies will have significant access to feed in 2015 but more of it may come from further distance at higher prices and some dairies may shift the composition of their feed rations. Changes in rations are likely to reduce protein content in dairy diets and lower milk output to some degree.

In the face of sharpening their end margins -

narrowing margins - California dairy operators have begun to shrink their herd sizes, culling less-productive cows and are moving cows outside of California. Some of the larger operators with the available capital are leasing land to gain extra water rights. Many smaller dairies, the 500 to 750 cow dairies such as mine, are contemplating their future in California. A few have sold off their herds in the past year and have sold their land to be planted into trees or vines.

If the drought continues through 2016 feed supplies will become more limited and more expensive. California dairies will decrease their milk production, putting a strain on the California dairy processor sector. And the approaching regulation of groundwater is likely to have a detrimental impact on long-term health of the California dairy industry. More consolidation of small and medium-size dairies is expected.

Not long ago in Elk Grove we had 22 dairy operations; presently we have 7. One is now currently for sale. And I understand it was sold last week and I'm hoping it's going to go to continue as a dairy. Of these dairies sold in the past three years, three are currently being planted with walnuts.

I have family and friends who live in Wisconsin, and of course, after we have discussed quickly about our family and our conversation of grandkids, the conversations go directly to the dairies, the water situation in California, feeds and milk prices. And of course the bottom line is they are making more money than what we are and their costs are much lower.

The last three months have been very difficult to cash flow. We are tapping once again into our valuable assets to borrow from our lender to keep up with the rising cost of producing because the low, extreme mailbox price that we are receiving does not pay the bills. The cycle of volatility is very difficult when the lenders are looking to our year-end finances and contemplating if they are going to renew our loans and how much more operating funds will be available when we make the call. This is all very trying on our health and our family life.

On a personal note also, we were with a bank for many, many years. We have been approached by many other banks because, like I said, we have been in business for many years, we have an older dairy and we only fix what needs to be fixed. But back to the lending, what I wanted to say was being with the bank that we were, I was seeing the volatility was getting longer and the cuts were deeper on us. And I was very concerned about how the bank was going to approach us if we decide to continue in the dairy business. I do have a son who is 42 and managing the dairy since my husband had a stroke five years ago.

And again, I was concerned if this bank was going to continue backing us. So I did change to another lender because I feel that they would be more -- not compassionate, of course, but more able to work with us if we choose to stay in this business. Two years from now, I don't know. I really am very concerned about the losses that we are undergoing.

I don't need $25 milk. I just want to continue to have a viable dairy operation to keep our valuable employees that we have had for over 25 years, to have a future for my son, possibly my grandchildren. I am encouraging them to get an education. And I am really -- as of last week I discourage them to come into the dairy with us. There is no life -- there is a life but there is no future. The volatility is tremendous and this is not a way to keep in business. Not knowing from three to four months ahead how we are going to pay the bills, much less trying to keep the business going with all the high water and standards that we have to have in place for the business to stay.

I thank you again for your time and I do want to say that I am in support of the proposal from Western United, California Dairy Campaign and Milk Producers Council.

HEARING OFFICER SUTHER: Any questions from the panel?

Seeing none, thank you for your testimony.

MS. DUARTE: Thank you.

HEARING OFFICER SUTHER: Mr. Barcellos.

Mr. Barcellos, would you please state your full name, spell your last name and state your affiliation for the record, please.

MR. BARCELLOS: Yes. Tom Barcellos, B as in boy, A-R-C-E-L-L-O-S. I am the owner of T-Bar Dairy and Barcellos Farms; I am a partner in White Gold Dairy with my daughter and son-in-law. I am also an owner of LGT Harvesting, which is a pistachio harvesting company.

Whereupon,

TOM BARCELLOS

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

MR. BARCELLOS: Mr. Hearing Officer and Panel, appreciate the opportunity to testify before you today and thanks to the Secretary for the call of the hearing.

I am in support of the Western United Dairymen proposal and the associated trade associations that are working with them and the co-ops that also support that.

I am going to give you a little bit different twist on what you have heard here today. Part of my farming operation business for the last 25 years has been operating long-reach excavators cleaning out dairy ponds. It's a service I have been providing.

Most recently we have been cleaning out ponds to decertify the dairy to get approval from the State Water Board to close the dairies up. We are currently decertifying two and both of them are owned by a conglomerate out of Singapore. I was told yesterday by the local manager that they are going to close escrow on another one in two weeks and that I would have more work. I never expected that that would be my primary source of income in that segment of the business when I started that 25 years ago. We talk about California Grown. Well, the trees that are being planted on these facilities will be California grown but they will not be California owned, which I think is something that needs to be taken into consideration.

There's four other dairies that I do work for, have for many years. They have young trees planted over the last two to three years and in three to four years they are going to make a determination based on the outcome of this hearing and the potential federal order that is going to be available in a couple of years on whether or not they are going to stay in the dairy business, or we'll decertify them as well and they'll plant the rest of it in trees.

My dairy, White Gold Dairy, that I am partners with my daughter and son-and-law, we are on a leased facility on that one. We have two years left on that lease and the owner is currently entertaining opportunities to sell that to tree growers, some out of the country, some in the country.

So the outcome here today also is going to have a bearing on my own business. Will we expand our home facility and move the herd over or will we just divest ourselves of that operation? Because there is a great risk in investment, as i heard here today. Do I spend $6 million and upgrade a facility? Or do I spend $4 million and plant trees myself. That's a determination that will have to be made.

If the Western United and associated member proposal goes through I'd be happy to pay the additional $.08 plus-or-minus for cheese at the store because that is the impact that it will have at the market. And I would be able to afford it because I would still have businesses that could sustain themselves.

So I thank you for the opportunity to testify today.

HEARING OFFICER SUTHER: Any questions from the panel?

Thank you for your testimony.

Mr. Mendoza (sic).

Mr. Mendoza, could you please state your full name, spell your last name and state your affiliation for the record.

MR. MENDONSA: My name is Frank Mendonsa, M-E-N-D-O-N-S-A. I am a dairyman, a farmer, I am current president of Western United Dairymen.

Whereupon,

FRANK MENDONSA

Was duly sworn.

HEARING OFFICER SUTHER: You may proceed.

MR. MENDONSA: I also want to thank Secretary Ross for calling this hearing. I just would say that I am here to support the producers' proposal. I want to thank CDC and Milk Producers Council for being with everybody and the three co-ops.

I am a second generation dairyman. I've got a real passion for what I do. I hope my kids can be the third generation. It's going to be tough. I would ask the question, you know, coming off such a great year, 2014, you have to really wonder why we are down production in the last five months. As you have heard here today, the land prices, the drought, there's a lot of things working against us. And I would say that the mindset of the California dairyman has changed since 2009.

So that's what I wanted to testify to. Thank you for this opportunity.

HEARING OFFICER SUTHER: Any questions from the panel?

MR. SHIPPELHOUTE: You were asking a hypothetical question, I just want to make sure, you have the opportunity to share from the producer perspective. You asked the question, why has production dropped off as quickly, and you alluded to the mindset having changed in the last couple of years. Can you expand on that a little bit just for my benefit?

MR. MENDONSA: Well, like I said, the mindset has changed. I have been on my own in the dairy business 30 years this month, or last month. It used to be that everybody thought about milking more cows and, you know, expanding for the kids. That's no longer the case. Too many dairymen, if they still have equity, are talking about planting trees or have planted trees and encouraging their kids to go do something else. It's just way too volatile.

The reason why we're down in production, there's a number of reasons. We are one of only two states that are down, the rest of the states are up. Why is that? Well, coming off of 2014 we knew 2015 was going to be a bad year. Too many dairymen said, not me. A lot of cows went to slaughter they were holding on to in 2014 to capture that higher price. Some dairymen have sold out and moved to other states or are considering it, I know a couple, and others just had to leave.

I would -- I would make a comment to the gentleman who stated that in the '30s there was 18,000 dairymen and so over the course of time that's about 180 dairies out per year. Well, in the '30s that represented one percent and today that would be over ten percent. I think, you now, that's not a very good argument on his part.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. MENDONSA: Thank you.

HEARING OFFICER SUTHER: Mr. Sanchez.

Mr. Sanchez, could you please state your full name and spell your last name and state your affiliation for the record, please.

MR. SANCHEZ: Adolfo Sanchez, S-A-N-C-H-E-Z, and I work for Los Altos Foods.

Whereupon,

ADOLFO SANCHEZ

Was duly sworn.

HEARING OFFICER SUTHER: Would you like these written statements entered into the record?

MR. SANCHEZ: Yes.

HEARING OFFICER SUTHER: They will be Exhibit numbers 48 and 49.

(Exhibits 48 and 49 were entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. SANCHEZ: Well, it's not good morning anymore but thank you for listening to me. My name is Adolfo Sanchez; I am here on behalf of Los Altos Food Products, a small cheese manufacturer in Southern California.

Eighty-five years ago milk pricing started to save the small dairies from going bankrupt and insure an adequate supply of milk to children and the general population. The other reason was because there were a few large, well organized processor-handlers who controlled the milk price negotiations. Farms were usually between 50 and 150 head of cattle. Eighty-five years later milk pricing controls continue but instead threaten small businesses like Los Altos while giving the regulatory advantage to large, well-organized co-ops.

DFA in 2013 had an adjusted net income of $61.3 million, net sales of $12.8 billion, which equates to a 6 percent increase over the prior year.

Land O'Lakes in 2014 had $5.1 billion in net sales just in dairy products and $15 billion in total sales. Their net earnings were $266,710,000. Their profits alone far exceeded our total gross revenues.

California Dairies produce approximately 18 billion pounds of milk products per year, 43 percent of California's milk. It is one of the nation's largest suppliers of butter and it also produces dry milk which is available in all 50 sates and in more than 50 countries.

A study from 2000 to 2006 showed that the number of dairy farms had declined but that the average size of a dairy farm had increased. Also at the same time the average milk production per farm had increased twelve-fold. During this same period of time the largest dairy farms had over 15,000 cows, but a more common size was 1,000 to 5,000 cows. The days of the 50 cow farms have long disappeared. "Large dairy farms account for most inventory and production in Western States." This study was made by the Economic Research Services of the USDA.

Everyone is talking about the number of dairy farms but we should be talking about the milk supply. In 2011 California produced 41.4 billion pounds of milk and in 2013, a very rough year for the milk farmer, it produced 41.2 billion pounds. On an average the supply of milk has not decreased very greatly.

Los Altos is truly a small family-owned business that produces fresh cheese with a 45 day shelf life. We are under the gun every single month. We do not know the price of milk until the month is over and most of our cheese has been sold. Then our customers require a 30 day notice, and sometimes more, on any price increase. We are no different than the small dairy farms. They are just at the beginning of the production while we are at the end.

Los Altos estimates that, as proposed, the whey cost would increase between $1.50 and $2.00 per hundredweight. That would cost us between $1.7 and $2.2 million, annualized. This is not a cost that Los Altos can readily absorb. It will cost jobs, decrease margins and threaten our economic viability.

Increasing the price should be a solution aimed at the viability of all of California's dairy industry. As it is, it supports only one single sector and will harm small processors like Los Altos. Los Altos urges you to limit the harm to small business, and if you must adopt a proposal, that you adopt the proposal set forth by the Dairy Institute.

Thank you very much and I'd be happy to answer any more questions and I would like the opportunity to put in a post-brief, a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Any questions from the panel?

MR. EASTMAN: I have a question. What exactly do you do with your whey stream?

MR. SANCHEZ: Most of it goes to cow feed. We pay for the transport and it is just given away as cow feed. Just a couple of months ago we started condensing it you might say. But it's a break-even proposition because we can't afford the equipment nor do we have the room to install the equipment to dry the whey.

MR. EASTMAN: So just to clarify, you pay to transport it to someone who takes it but you are not paid anything for your whey stream?

MR. SANCHEZ: For most of it, right. Like a said, in the last few months we have been selling somewhere around 30 to 34 percent condensed or concentrate. With the equipment that we have to use and stuff we are basically breaking even. So we save a little bit on the transport but that's about it. Overall it is still a cost factor to us because the majority of the whey is not sweet whey and they won't take salt.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. SANCHEZ: Thank you.

HEARING OFFICER SUTHER: Ms. Rooney.

Ms. Rooney, would you please state your full name, spell your last name and state your affiliation for the record.

MS. ROONEY: Yes. Emily Rooney, Agricultural Council of California. My last name is R-O-O-N-E-Y.

Whereupon,

EMILY ROONEY

Was duly sworn.

HEARING OFFICER SUTHER: Do you have anything else or would you like this statement, this document entered into the record?

MS. ROONEY: Please.

HEARING OFFICER SUTHER: It will be Exhibit number 49.

(Exhibit 49 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MS. ROONEY: Thank you Mr. Hearing Officer and members of the Panel. I appreciate the opportunity to testify today.

HEARING OFFICER SUTHER: Excuse me.

MS. ROONEY: Yes?

HEARING OFFICER SUTHER: It will be Exhibit number 50.

MS. ROONEY: I'm trying to be Annie AcMoody words-per-minute.

(Laughter.)

MR. EASTMAN: Can't wait.

HEARING OFFICER SUTHER: And I ruined it.

MS. ROONEY: My name is Emily Rooney and I am President of Agricultural Council of California.

Our dairy membership includes the three California cooperatives, California Dairies, Inc., Dairy Farmers of

America and Land O'Lakes. We collectively represent about 75 percent of the fluid milk in California. As highlighted in our letter of support, Ag Council supports the proposal submitted by California Dairy Campaign, Milk Producers Council and Western United Dairymen.

In 2014, production costs increased due to higher environmental and labor costs and increased regulatory costs. Additionally, impacts of the drought are increasing the economic burden for dairy farms as well. UC Davis recently projected that for the year 2015, the drought will decrease revenues for California dairies, potentially increase feed costs due to the lack of availability of locally grown hay and extra costs will be added with expenses such as additional groundwater pumping.

Just yesterday, the State Board of Food and Agriculture held a hearing here in this room on the continued impacts of the drought on California agriculture. UC Davis has released its preliminary findings for the drought in 2015 - increasing statewide losses due to the drought from $2.2 billion in 2014 to $2.7 billion in 2015. Total job losses are estimated in the range of 18,600 jobs lost in 2015.

Dairies may add $250 million in lost revenues for 2015 due to the drought alone. Additionally, farmers will follow approximately 564,000 acres, or about 7 percent of the irrigated farmland. Many of these fallowed acres are projected to be field crops such s alfalfa, cotton and grains, resulting in decreasing local feed supplies for California's dairies. Groundwater pumping costs are expected to increase by 31 percent to $595 million.

According to UC Davis faculty, these losses will be uneven. Specifically, greater losses will be experienced in the areas of the San Joaquin Valley with poor groundwater supplies such as Tulare, Kings and Kern Counties.

According to the US Bureau of Labor Statistics, in April 2015 the unemployment rates in these counties were as follows: Tulare County at 13.2 percent, Kings County at 11.9 percent and Kern County at 11.1 percent, which the statewide unemployment rate was 6.5 percent.

While on-farm costs are on the rise, milk prices are not responding similarly. Prices have decreased by approximately $8 to $9 per hundredweight since the peak of March 2014. California continues to be the most environmentally regulated state in the nation and we expect this trend to continue.

These factors contribute to the overall declining health of dairy farms in the state. While dairy is the leading sector in California agriculture, the number of dairy farms is decreasing. Since 2007, California has lost 480 dairies.

For these reasons we urge the Department to adopt the proposal submitted by the dairy producer groups for a period of 24 months. The whey sliding scale has been in place since August 2012 and is not tracking with the benchmark for whey within the federal Class III price. In previous hearing reports the Department has stated that it could update the sliding scale and therefore the proposal submitted by the producer groups is consistent with this mindset. This solution would modify the sliding scale that values dry whey within the Class 4b formula, bringing additional revenues to dairy farms during a very critical time for California's dairy families.

The short-term solution being offered by the producer groups improves price alignment with surrounding states and increases California dairy's mailbox price.

The proposal is also consistent with the cooperatives' efforts to bring California's 4b formula in alignment with the Federal Order Class III price. The cooperatives remain focused on this effort and have invested significant resources on that front. The trade associations' proposal fills a short-term gap that could provide immediate relief until a determination is made on the Federal Order.

In closing, we thank the Secretary for calling this hearing and urge the Department to adopt the proposal submitted by the producer groups. Thank you for your time and consideration of our comments. Additionally, I would like to request the ability to file a post-hearing brief if needed.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Any questions from the panel?

MR. EASTMAN: Actually, I do have a request. Would you mind submitting the UC Davis report that you cited in your testimony within your post-hearing brief so we can include that on the record?

MS. ROONEY: Absolutely.

HEARING OFFICER SUTHER: Thank you for your testimony.

MS. ROONEY: Thank you.

HEARING OFFICER SUTHER: Karen, is there any more three minute testimonies?

MS. DAPPER: (Shook head.)

HEARING OFFICER SUTHER: Okay. We will go back to the 20 minute testimony. Brian Murphy. Excuse me; Barry.

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

MR. MURPHY: It's Barry Murphy, M-U-R-P-H-Y, my affiliation is with BESTWHEY, LLC. It's a consulting firm for small cheese plants and whey protein plants.

HEARING OFFICER SUTHER: Thank you.

Whereupon,

BARRY MURPHY

Was duly sworn.

HEARING OFFICER SUTHER: Do you wish to have this statement entered into the record?

MR. MURPHY: Yes.

HEARING OFFICER SUTHER: Exhibit number 51.

(Exhibit 51 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. MURPHY: Mr. Hearing Officer and Members of the Hearing Panel.

My name is Barry Murphy and I have worked in California's dairy industry for the past 25 years, first in the senior management corporate environment and for the past 15 years as a consultant under BESTWHEY, LLC, to smaller cheese plants with specialty cheeses and whey handling and disposal needs. My background includes Dairy Science and Business post-graduate degrees, technical and operations management, sales and marketing management and green field project development and financing. I live in San Francisco, California.

My position on the proposal and the alternate proposal: BESTWHEY, LLC opposes the proposal from the three producer trade associations, CDC, MPC and WUD, and strongly believes that these measures will destroy California's cheese industry and eliminate most small cheese companies. BESTWHEY, LLC supports the Dairy Institute of California's alternate proposal, but believes that the current 4b whey factor should remain as is and to allow the market forces to determine the 4b milk price premiums.

Whey Powder and Whey Protein Concentrate.

Of the 57 cheese plants in California, one plant manufactures whey powder, that's Kraft Cheese in Tulare, and the next three major cheese companies, Leprino, Saputo and Hilmar, process most of the whey solids into products other than sweet whey that is the factor for the current Class 4b whey valuation and for which the current whey are weak. Ten other cheese companies process a liquid reverse osmosis whey or ultra-filtered whey for sale as liquid to animal feed, to other whey processors, and in four of these plants, as dried whey protein. All ten of these companies dispose of greater than 85 percent of the whey solids as animal feed at little or no value.

Facts:

Thirteen of the 57 cheese plants in California can process whey to some degree per most recent CDFA data.

2. Using whey powder market value in the 4b pricing formula does not make sense and assumes that all

plants utilize 100 percent of whey solids, when in fact one plant in the state can achieve this and a handful of additional plants can capture the value from the bulk of the whey solids, while the vast majority have minimal or no recovery of whey solids.

3. Reverse osmosis whey solids are sold in liquid form two plants in the state and achieve 50 to 70 percent of the whey powder value minus freight costs.

4. WPC34 liquid solids are sold by three plants in the state to dryers at $.20 to $.30 cents under the WAOM, the Western Average of the Monthly WPC34 delivered. In other words, even though it's $.20 to $.30 over the freight needs to come out of that.

5. The small cheese companies, representing at least 70 percent of the 57 cheese plants in the state, have no ability nor the economies of scale to process whey and actually pay up to $1.00 a hundredweight to dispose of the whey.

Conclusions:

A. Using the Dairy Institute's proposal to index whey value in 4b milk to WPC34 market value makes more sense than using the whey powder market value since only one plant in the state can utilize 100 percent of whey solids. I have tested the Dairy Institute's data supporting its proposal and the data is accurate in terms of WPC34 yields, operational costs, sales value, transportation costs for those plants able to recover whey value through concentration and sale of liquid whey.

B. Adopting the three producer trade associations proposal will wipe out the smaller cheese plants and may result in reduced processing levels by the larger cheese plants, since they have the ability to move some cheese volume to other states.

The cheese business is a tough, low-margin business, and for the smaller cheese companies without the ability to create value from the whey it is even tougher. For the large plants, a few cents margin from cheese sales value, less milk cost and operating cost, combined with very large scale operations, may at best result in a break even business and whey processing can add value to create an overall fair return on investment.

For the smaller plants, even with higher margins on cheese sales value less milk and operating cost, e.g., an example of the target gross margin in the specialty cheese business might be something like $.50 per pound of cheese. But the relative overhead costs are so high that the struggle with smaller plants is that they don't have the economies of scale to cover the base overhead comfortably most of the time. The proposed 4b milk price increase by the producer trade associations would be $1.61 per hundredweight over the past three years. This would be $.16 per pound of cheese value and would likely wipe out more than half of the smaller cheese plants this $.16 per pound of cheese increase in costs would eliminate a large percentage of the already low profitability. The specialty cheese business competes with products from across the U.S. and many of these cheese businesses must be buying milk outside the federal pool since their cheese pricing does not match federal order class III pricing in many cases. Of course, we know that many of these federal order mechanisms have a depooling option to ensure milk clearing below federal order pricing. California cooperatives can pay minimum mandated pricing to dairies but then can assess losses back to the dairies while the cheese business milk buyers do not have such an option. I guess what I am saying there is in 2014 the nonfat milk powder market went from $2 in January to $1 in December or something of that magnitude, so it was a disastrous year for the big cooperatives in the nonfat dry milk business. But surely they can absorb -- this included all the cooperatives in California as well as -- actually all across the U.S., all across the world. But the co-ops had the ability to assess some of those losses back to the dairies. The cheese plants just don't have this ability. This is clearly not fair and provides for no mechanism to clear milk with respect to the cheese plants.

Cooperatives versus the Private Cheese Companies

Whey-derived markets have collapsed in recent times as have nonfat dry milk powder markets. In the case of nonfat dry milk powder, the co-ops lost tens of millions of dollars in 2014 then assessed the producers to pay for these losses. The private cheese industry cannot assess losses to producers and therefore absorbs these losses. DFA and Land O'Lakes have one cheese plant each in California. Both sell liquid WPC below market to private cheese plant dryers. Why has DFA and Land O'Lakes not invested in WPC dryers, not to mention lactose or whey permeate handling dryer systems? One reason is the tens of millions of dollars required for investment in whey processing. If the three producer trade association proposal is adopted, then DFA and Land O'Lakes cheese plants will lose money or break-even at best. Why have the California dairy cooperatives sold or closed down their large California cheese plants and not developed their remaining cheese making operations? Examples are the Corona cheese plant. Which, you know, in 1984 was touted as the largest cheese plant in the world. We have the Petaluma cheese plant that was sold by DFA to Petaluma Creamery. We have the Willows cheese plant that was sold by DFA to Sierra Nevada Cheese. The Gustine cheese plant which is now basically abandoned, sold by Land O'Lakes to a private entity. We have the massive plant in Tulare on

Page avenue that was developed by Land O'Lakes and Mitsui and it got sold to Saputo. Why? Because it wasn't making any money. Yet now, producers and the cooperatives are proposing an increase that would force cheese plants to pay more for Class 4b milk, despite the fact that when cooperatives were operating these cheese plants they could not operate them at a profit. The math simply does not work. There is only so much money available with which to pay for a cheese plant, run a cheese making operation, pay dairy farmers for milk and remain competitive with other cheese suppliers in the market. The producers' proposed formula will simply increase the milk price too much for many cheese plants.

And my final conclusions:

Many of California's smaller cheese plants will be forced out of business should a federal order type milk pricing proposal be adopted, which is further compounded by the inability to depool milk to clear markets. Several of the cheese plants that I have consulted for over the past several years will be forced out of business. The larger cheese plants may reduce milk levels as they have the ability to move some cheese production out of state. If a very small percentage of cheese manufacturing is moved out of state or disappears due to plant closure, this will provide for an oversupply of milk in California with no ability to sell below the minimum mandated pricing to clear the market.

BESTWHEY, LLC supports the Dairy Institute of California's alternative proposal with respect to the 4b factor and opposed the WUD/MPC/CDC proposal, but believes that the current 4b whey factor should remain as is and allow the market forces to determine the 4b milk price premiums. Thank you.

And I'd like the opportunity to provide a post-hearing brief.

HEARING OFFICER SUTHER: Your request for a post-hearing brief is granted.

Any questions from the panel?

MR. SHIPPELHOUTE: On the first page you state that the whey factor should remain as is and allow the market to determine the 4b price and the premiums; you also make reference to the Dairy Institute proposal. So I take from that that your preference would be status quo, but if a change is made to go with the Dairy Institute?

MR. MURPHY: Yes, I support the Dairy Institute's proposal. I prefer that it stay the way it is and let the market -- let the milk price premiums drive everything.

MR. SHIPPELHOUTE: And when you were describing the various plants the cooperatives have sold off over time. Obviously this covers quite an extensive period of time.

But you make the statement that their math simply does not work. Could you maybe expand on why their math doesn't work but a proprietary operation may?

MR. MURPHY: I think what has gone on here is a battle between the Class 4a and the Class 4b milk, is the way I see it. You've got the cooperatives, Land O'Lakes, DFA and CDI, all are managing -- you know, in addition to selling Class 1 milk and other classes of milk they are processing nonfat dry milk and butter, so it's all Class 4a.

They had the opportunity over the years, you know, going back to -- you know, like I mentioned the Corona plant. Which I remember in 1984 was -- this was on the global news as the largest cheese plant in the world. So it was owned by DFA. LOL has sold Gustine. They still have Orland but they don't process the whey fully, they just make liquid WPC. Exactly the same thing is happening with DFA in Turlock, it makes liquid WPC. It doesn't take the WPC further to other value products.

So at the end of the day what you have is the three co-ops on a 4 -- everything they do is on a 4a basis. Unfortunately what's happened is that the 4b side of things is private industry, so the three big guys, Leprino, Saputo, Hilmar, and then it's all the other 54. well Kraft I guess is in there. Kraft not being that big, I don't believe, it's only 2 million pounds of milk a day. But then the other 53 or so cheese plants are all privately held -- I'm sorry, the other 51, two of them are co-ops. So DFA Turlock, Land O'Lakes Orland, that's all we've got.

And I guess the question I'm raising is why hasn't -- you know, if the whey premiums are so good and the profit margins are so good in the cheese business, why hasn't the cooperative side with their massive resources kind of diversified into that region? They have just focused 100 percent on the 4a market.

MR. SHIPPELHOUTE: Thank you.

MR. EASTMAN: I have a question. On the second page of your testimony, the number 4 at the top. You mentioned a Western mostly series. Is that different than the Dairy Market News Western Mostly Series that covers Western and Central?

MR. MURPHY: No, that's the same number.

MR. EASTMAN: Okay, it's the same one.

MR. MURPHY: It's all out of the -- I think it's the USDA office in Madison. It's the AMS.

MR. EASTMAN: Okay. And then in your testimony you allude to the fact that size is important, economies of scale come in with regards to really being able to try and capture some sort of full value for the whey product. Where do you draw that line?

MR. MURPHY: You know --

MR. EASTMAN: Where do you see --

MR. MURPHY: In past --

MR. EASTMAN: How big do you need to be?

MR. MURPHY: Yeah. In past testimony -- you know, we have had a run-up in the markets over the past five years, in kind of all the markets, I believe, all the powder markets. In the last 12 months we have a serious downturn, very, very serious, so obviously nonfat is impacted, whey powder is impacted, anything dry is impacted. On a global scale it's apparently related to a strong dollar and just poor purchases out of Asia. Asia has gone away because -- I believe it all comes back to the dollar, the strength of the dollar. I'm sorry, to get back to your -- so what was your question?

MR. EASTMAN: Who is buried in Grant's Tomb?

(Laughter.)

MR. EASTMAN: No. With regards to economies of scale how big do you need to be?

MR. MURPHY: Oh, yeah. In past testimonies here I used to say about a million pounds of whey per day, or say 20 loads of milk a day would do it. I think today you can do it for about a half a million, for half a million pounds. So in other words, ten truckloads of milk a day.

I think you have the opportunity to at least put in a reverse osmosis, perhaps even a UF. The problem with putting in a -- Putting in an RO kind of concentrates the whey so it gives you a product that is more like a whey powder except it's got 20 percent solids or something. Putting in a UF just gives you protein so you still have solids to dump and have shipped out. Could you put in a dryer at a half-million pounds? I don't think so. No, you just partially process.

MR. EASTMAN: So at a half-million you partially process and then at a million per day --

MR. MURPHY: Then maybe at a million pounds a day, kind of similar to the size of Joseph Gallo or Farmdale Creamery. Now you can afford to put in the dryer, possibly. But of course, as Scott Hofferber testified, it hasn't worked out terribly well for them. Because, you know, whey markets have collapsed as well as nonfat powdered milk pricing.

MR. EASTMAN: Thank you.

MR. LEE: Do you think that if the producers' proposal is adopted -- what do you think would happen in the whey market? Would it go further down? How would it be affected, do you think?

MR. MURPHY: I don't think it will have any impact on the whey market. I think it will just put cheese, smaller cheese companies out of business.

MR. LEE: Thank you.

MR. SHIPPELHOUTE: And one other question. You indicated you had tested the numbers in the Institute's proposal. But at number 4, page 2 of your testimony you mention the sales at $.20 to $.30 below the WAOM number and I believe the Institute's proposal uses $.15.

MR. MURPHY: Yes. Actually, I negotiate some of these -- some of these numbers are -- yes, so I think -- I think the Dairy Institute has been conservative on the side of the -- on the side of the original proposal. I have bought liquid WPC, I buy actually a fair percentage to send to South American for a client of mine and yes, the pricing has ranged in those ranges, $.20 to $.30 under. I know what you're saying the Dairy Institute is proposing $.15. That's a fair number.

I think it depends on what's happening with that. If it is going into a processing plant and there is some divergence between the 34 market and say the WPC80 or the WPI market - in other words, you can add some value to it - then I think people wold even be prepared to pay market for that. But over, just going back over the last five, six, seven years that I have been involved in these purchases, the price has been in that range. So if it's going in and deriving value in a dryer, then that's one thing. But if it's going into a -- let's say it's going into animal feed, into a calf milk replacer, then that's -- the $.20 or $.30

is probably more accurate for the animal feed side.

MR. SHIPPELHOUTE: Thank you.

HEARING OFFICER SUTHER: Any further questions from the panel?

Thank you for your testimony.

Mr. Ahlem and Mr. Jeter.

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

MR. AHLEM: David Ahlem, the last name A-H-L-E-M, and I am with Hilmar Cheese Company.

HEARING OFFICER SUTHER: Mr. Jeter, will you please state your full name and spell your last name.

MR. JETER: John Jeter, J-E-T-E-R, and I am with Hilmar Cheese Company.

Whereupon,

DAVID AHLEM

JOHN JETER

Were duly sworn.

HEARING OFFICER SUTHER: You have this written statement. Would you like this entered into the record?

MR. AHLEM: Yes.

HEARING OFFICER SUTHER: It will be Exhibit number 52.

(Exhibit 52 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. AHLEM: Thank you. My name is David Ahlem. I am the Chief Operating Officer for Hilmar Cheese Company, Inc. I am accompanied today by John Jeter, our President and CEO, who will complete the latter part of our testimony.

Hilmar Cheese Company is a cheese and whey products manufacturer with locations in California and Texas. In California, Hilmar Cheese Company, purchases milk from over 200 dairies processing about 12 percent of the milk produced in California each day. We employ nearly 1,000 people at our facilities in California and sell finished products to over 50 countries around the globe.

Hilmar Cheese Company was formed in 1984 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.

We are here today to represent Hilmar Cheese Company and our dairy producer owners. Hilmar Cheese Company supports the Dairy Institute of California alternative proposal to value whey and does not believe economical conditions warrant additional increases in 4b minimum milk prices as proposed by Western United, California Dairy Campaign and Milk Producers. Furthermore, we believe the California system is in desperate need of reform. Increases in minimum prices will do nothing to address our most basic problems. Instead, they will only further damage our industry by continuing to deter investment and delay necessary long-term reform.

Milk supply intervention will make things worse - let markets work.

Milk prices are falling because international demand has decreased. China is purchasing less and Russia has banned imports. Falling prices are a rational market response to decreased demand, especially after a period of supply resulting from the record high prices of 2014. In this type of environment we should expect prices to fall and milk supply to decrease.

Outside of the U.S. all major global exporters have already seen reductions in milk supply in response to falling prices. We are no different, but the U.S. price signals and response lag our international competitors because of our regulated pricing system which delays market signals. California's milk price and supply response to current market conditions mirror what is happening in the rest of the world.

in other regions of the country, of the U.S. that is, blended milk prices are falling more slowly because they are more strongly influenced by domestic cheese prices, more so than powder, which has already fallen to match global market values. Mailbox prices in those regions will eventually fall as domestic prices fall and deeply discounted surplus milk begins to impact mailbox pay prices. A recent Dairy Today article noted that production is exceeding dairy capacity in the Upper Midwest and the milk os "going for $3 to $5 under market to get somebody to take it." In New York it has been reported that Dairy Farmers of America asked some farmers to dump milk during the holidays and others have lost contracts with milk suppliers. Earlier this week there were reports that dairy producers were also dumping milk in Michigan. These are outcomes of oversupply in soft markets and not the type of environment in which we want to encourage supply by means of regulatory price enhancement.

It appears California milk production may have returned in 2013 levels and we may even exceed those 2012-13 average production levels for the remainder of the year, even if supply remains 2 percent below 2014. This is to be expected after a year of record profits when producers were incentivized to do all they could to squeeze additional milk supply from their herd. This year's falling prices, coupled with drought, means dairy producers will employ different strategies that result in less milk per cow, i.e., using rBST as a production enhancement. This also seems to be supported by the fact that cow numbers have not declined significantly year over year.

Our year - Hilmar Cheese - our year over year milk supply of milk has increased. We are not having trouble sourcing milk or fulfilling commitments in the current environment. We have maintained our non-summer contract caps.

Additionally, milk supply in California continues to meet or exceed state plant capacity in the spring. Again this year milk left the state because it could not find a home in California. Hilmar Cheese Company shipped nearly 400 loads out of state this spring because we were unable to find available processing capacity and willing buyers for milk in California.

The bottom line: while milk production has fallen in California this is not a crisis. It is a normal response to falling prices and is similar to what is occurring in every other major exporting region of the world. Regions in the U.S. that are growing rapidly, the Midwest, Michigan, New York, are dumping milk or selling it at deep discounts to class prices. Increasing minimum prices in this environment will encourage oversupply and drive prices lower. This will not help dairy products. It will only prolong and extend periods of low prices. Let markets work, don't intervene.

Increases threaten our global competitiveness.

Increasing milk prices will make us less competitive in an already difficult global marketplace. Nearly 30 percent of the California milk solids are exported, which means California processors and producers are highly dependant on maintaining global competitiveness. Hilmar is no exception. Last year Hilmar exported nearly 10 percent of its cheese, 50 percent of its whey protein concentrate and 95 percent of its lactose.

For the past year domestic cheese and whey prices have remained above international prices. This has led to reduced export sales. You see I have some exhibits there. Our export sales are down significantly year to date. Some of the export products have decreased by 50 percent year over year. To maintain some level of export sales in today's market we are selling some cheese and whey products below cost. These sales prices are not being captured in the product price surveys because they are export sales.

Economic conditions do not support the Department's decision to single out 4b as a target for price increases. Further increases in minimum prices will make us even more uncompetitive in the international markets we depend on encourage increased domestic supply. This will only compound the problem by leading to lower domestic prices as surplus product finds its way to the exchange. This will not benefit processors or diary producers.

Increases benefit our out-of-state competitors.

Increases in the minimum price put us at a competitive disadvantage to our primary competitors who are not subject to minimum prices. All of our major domestic competitors operate in regions where there is no minimum price regulation, Idaho, or the system is optional, Federal Milk Marketing Orders. None of our major global competitors, Oceania and the European Union, are subject to minimum regulated price provisions. As California minimum regulated prices increase, our ability to compete in both domestic and international markets is threatened.

CDFA data makes the case for lower, not higher, minimum prices.

Make allowance adjustments have not kept pace with plant costs. The 4b manufacturing allowance was last raised in 2007 to $.1988 per pound. The CDFA plant cost report for 2013 shows a weighted average cost of $.2291 per pound or 15 percent above the current 4b formula. In total, this discrepancy represents about $.31 per hundredweight.

The 4a formula is in a similar situation. Last raised in 2011 to $.1635 per pound for butter and $.1763 per pound for nonfat. The CDFA 2013 cost study shows weighted average costs of $.1724 a pound and $.1997 respectively. The shortfall for butter in the 4a formula was 5 percent and 13 percent for powder.

There are significant shortfalls for those who have chosen to remain in a state that is not conducive to investment. CDFA's own cost studies demonstrate 4a and 4b make allowance should be increased to keep pace with rising manufacturing costs.

Producer economics: we do not have a dairy crisis.

Last year was a record year for dairy producers in California. Producers deferred a record amount of income from 2014 into 2015. We estimate that producers in California deferred about $1 billion in income, which equates to more than $2 a hundredweight for every pound of milk produced in California for an entire year. This suggests there are ample cash reserves coming into 2015. This reality is not reflected in current mailbox prices.

2015 brings lower milk prices and lower feed prices. While milk prices are down considerably, largely due to weaker world demand and California's large exposure to powder markets, many key feed prices have also hit multi-year lows. USDA data shows California corn prices, one of the single largest feed costs and a bellwether for concentrate costs, are currently at their lowest level since 2010. Alfalfa prices have also moderated despite the drought and are at their lowest level since 2011. Compared to the last five year average, feed prices are looking favorable to date in California.

Compared to other dairy states, California producer net margins are reasonable. Hoard's Dairyman published an article in July 2014 that compared cost of production data from the accounting firm Genske, Mulder and Company for the year 2013. Of the 9 regions they analyzed, California's net profit per hundredweight ranked second. Furthermore, Hoard's commented, "profit per cow was significantly better than average" and California producers enjoyed "low costs for feed, fuel and oil, veterinary and breeding, labor and industry assessments ..." In addition, recently released 2014 margin data from Frazier also published in Hoard's shows California margins competitive with other western dairy states. Between the two studies, it shows California producer returns are very much in line with other regions in the West.

California dairy consolidation is not unique in the U.S. or the rest of the world. The number of dairy closures in California is often cited as a reason for the Department to intervene in the marketplace. Declining dairy farm numbers are not unique to California. In fact, every major dairy region in the world has seen the number of dairy farms decline while cow numbers are constant and/or growing. The E.U., Canada, Wisconsin and Oceania all have less dairy farms than they did last year. The decrease in the number of dairy farms is greater in Wisconsin than it is in

California.

The California story is not about contraction, it's about dairy consolidation, which is happening around the world. High cost producers are exiting the business and being replaced by more competitive low-cost producers around the globe. CDFA's farm cost survey clearly illustrates the wide variance in cost of production and margin. If you remove the high solids producers and organic dairies from the survey, the cost of production varies by well over $4 a hundredweight with some beyond those ranges. That's the reason we continue to see dairy consolidation in California.

Minimum prices do not tell the whole story.

Producer group's price comparisons often assume the processors pay and all producers receive the 4b minimum price. 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 buyers. Many processors pay premiums to producers above 4b prices.

Hilmar Cheese Company is one such example of a processor who pays market-driven premiums for protein, fat and quality. Since its inception we have consistently paid premiums to producers well above the 4b price. In the past several years we have paid over $120 million in market-driven premiums to our producers.

In addition, dairy producers also use risk management tools such as futures and options. Dairies that are engaged in risk management likely have different income than is reflected in mailbox or overbase prices. So far this year many of our producers participating in our risk management tools are on track to net over $5 million. This sum just represents a small portion of the risk management activity that we have visibility to. And although we don't have visibility to everything we know there is more occurring than there has been historically by settlement numbers.

Regulated minimum prices must be market clearing.

California minimum prices must remain below market levels. California processors cannot purchase milk from producers at less than minimum prices like other regions of the country. If minimum prices are set below market levels, too low, premiums will emerge. If minimum prices are set above market levels, too high, the industry will be damaged and capacity will leave the state. The regulatory system should be activated to clear the market, not create the market.

Cooperatives can charge more for milk.

While acknowledging weak commodity markets and drought pressures have created challenge in the producer community, we find the producer group's request to the CDFA to raise prices to be misplaced and misdirected. Many of the producer cooperative members, who control 85 percent of the milk in California, regularly negotiate supply agreements with buyers of 4b. 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 that responsibility to the California Department of Food and Agriculture. Why haven't they gone to their customers to ask for money? They have significant bargaining power and Capper Volstead gives them the ability to come together and set prices. 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 market price will drive premiums and establish a value for milk above the regulated price.

Increasing the 4b price takes money away from any of our producers.

Increasing minimum prices will not create more revenue or value for end products. It will only determine how revenue gets redistributed among producers in California. Increases in the minimum price will take money away from our producers who receive premiums and redistribute those dollars throughout the state to those who have not invested in cheese and whey processing facilities.

Many of our producers will lose revenue as their premiums get redistributed to other producers via the pool.

Producer-owned cooperatives, as we talked about today, have exited the cheese business or chosen not to invest in further whey processing. Why don't they invest? As long as we continue the revenue redistribution game in California this behavior will continue.

Inappropriate comparisons of Class III and 4b.

This hearing is not about the economical situation of producers, it is about the inappropriate comparison of Federal Class III and 4b prices. This is the only explanation for the Department's decision to target the whey price portion of the 4b formula. Comparing the prices is like apples and oranges.

There are very much different markets, just like we have different minimum wage in San Francisco and Tulare.

I am going to skip down here to this next section. There are different cost structures among states. And where Class III pricing is used it is always optional, not a mandatory price.

Dairy Market News regularly publishes milk prices being under class. Of the last 30 editions, 27 have cited examples of milk being sold at discounts to minimums, most of which were identified as Class III. As you can see in the appendix, milk sometimes is sold at $10 under minimum.

Hilmar Cheese Company operating in Dalhart, Texas, regularly purchases milk below the Class III despite there being transportation costs, processing costs and more competitive milk supplies. We have purchased thousands of loads below class prices this year alone. Many of those were at $4 to $5 under class. It is not legal for a processor to purchase milk under class from a dairy farmer or cooperative in California. This happens every day in the Federal Order.

Furthermore, processors around the U.S. regularly depool milk from federal orders. And I detail some of that depooling that is occurring in some of those charts.

I am going to skip down to this next point.

A Federal Order provides no guarantee that producers receive cost pricing. For example, New Mexico, which operates in the Southwest Federal Milk Marketing Order is probably the closest western comparison to California from a competitive standpoint; producers regularly receive less than class prices. It is illustrated by New Mexico mailbox price data in the chart included. When adjusted for solids this data reveals mailbox pay prices have been virtually identical to California the last couple of years.

There's many points of rehash here. The Class III not being a good value for -- a way to value whey. The Federal Order and some of the Wisconsin Cheese Maker data that was included in this, what they put together, so I am going to kind of breeze through that.

But we continue to believe dry whey is not an appropriate means to value milk. It doesn't represent what plants are actually producing. Probably the biggest thing: Over this last year, this breakdown has caused a situation where dry whey is greatly overvalued for cheesemakers receiving a WPC based price, if they receive value at all. The price relationship for dry whey and WPC/lactose of the past 8 months is the worst it has been in 15 years.

And the clear implication by the analysis is that dry whey is an extremely pool indicator of U.S. and international whey solids.

Finally, producer groups often claim the need to require Class III minimum prices to make risk management effective. But this just isn't true when you look at the data and I cite some of the correlations that are there.

With that, I think the other is just investment.

Frequent hearings just deter investment and send it elsewhere. The producer proposal. We have recently made a decision as a direct result of this hearing to delay another expansion in California, delay any expansion on cheese in California. Instead, we are going to go forward and invest in Texas later this year. And not only are future decisions delayed but current assets with a $1.50 in price increase would certainly be threatened as well.

And now I'll turn it over to John.

MR. JETER: So I just wanted to end with a few comments.

As a result of this, a lot of efforts are going on the state to reform this system, which I think we all agree is not working.

We have worked hard in, I think, many venues. But one of the questions is, why is it so hard to change this system? We hit the wall again and again and again.

And we really feel that the original policy, both federal and state, was designed to promote dairy cooperatives. At the time producers were very fragmented and had no power and so the federal and state systems were set up to really promote cooperatives and that means they incented them or favored them. So our policies have stayed that way since the '30s in the federal and the '60s in California and now 80 to 85 percent of our milk is controlled by cooperatives.

And the issue too is cooperatives in this favored status really of a milk handler. It's very difficult in federal orders to even purchase milk directly from a dairyman. And so if you want to buy milk you almost have to buy it from a cooperative, but that means they don't really have to process it; so they don't innovate, they don't invest, they don't update plants.

And we find ourselves in California with old plants that need updating badly and that is not happening because the cooperatives just don't have to do it. And in a global marketplace that puts dairymen in a really bad position, that we are not able to produce products that can compete on global markets.

So we would just encourage you. Let me skip to the last paragraph. I encourage the Secretary to step back from "fixing things." We feel this hearing really is an effort to just fix things through a regulatory process rather than incenting investment and innovation in badly needed and updated processing capabilities that would make us a global competitor. So we encourage the Secretary to step back from fixing things. Continue to encourage and even force us to truly reform the system that keeps the bar low currently. In a less price regulated market, all of us would be incentivized or even forced to invest, innovate and compete to the great benefit of dairymen.

That's our view. Thank you. We'd like the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Questions from the panel?

MR. EASTMAN: I have a couple of questions regarding investment. So in your testimony you mentioned that you were considering some sort of expansion on the cheese side. Is that an extra line going into an existing plant or was that going to be a whole new facility?

MR. AHLEM: We have considered both in California and neither of them make sense in the current environment with the instability. Current assets don't necessarily make sense with a $1.50 increase.

MR. EASTMAN: So you mentioned that you are considering or you are going to expand then in your other location.

MR. AHLEM: Correct.

MR. JETER: Yes.

MR. EASTMAN: And then a little while -- well actually in your testimony also you mentioned that you are considering expanding or building a new dry milk powder plant of some sort. Is that still going forward?

MR. AHLEM: Yes, we have a powder plant under construction in Turlock, California as well right now.

MR. EASTMAN: How do you anticipate that new plant is going to change the landscape of the California industry with regards to milk supply needs, how the milk supply is going to balance to plant capacity?

MR. AHLEM: Well it certainly creates capacity so we have a growing supply. As we illustrated that our milk supply is up and we have been trying to grow it in preparation for this new asset coming on. We still think fundamentally, long-term, good opportunity for U.S. dairy, good opportunity in global markets. We chose to invest in powder in California and not cheese, I think for obvious reasons. We are not having too many hearings threatening higher powder prices for some reason. Not higher 4a prices, only 4b, so it's a little safer plate, it feels like, in California right now. But we still think there is good dairy opportunity long-term.

We do think California needs to have more competition across all the products so producers get more because there is competing land use issues. So we need to go after and -- we really -- that plant is designed to meet export specs and we think it's one of the few in the U.S. so we're making that investment so we can generate some of that global value that we see out there and hopefully bring that back here.

MR. JETER: And I guess I would add to that. Because this is a big change for us; we have always been 100 percent cheese. I agree, Davis is absolutely right in terms of some of the basics. But we also saw opportunity because many, many of the U.S. powder plants are really utilizers of old technology.

I think in my testimony I talked about the new plants in the last - from 2012 to 2014 - that were 2 million pounds or more increases globally. I think there were 49 plants, 21 in the E.U., 16 in Asia and Oceania and only 6 in the U.S. And so the U.S. is just behind in terms of updating. Not just adding to capacity but we have old technology that is being used.

The Land O'Lakes plant that was shut down in Tulare, the old plant that they built in '79 is a great example of that in the late '70s. That plant really had the same equipment that it did in the '70s. And it wasn't a matter of not having enough milk, it was just old technology that couldn't produce what the market demanded. So in a sense we see the powder markets -- the U.S. has the milk, it needs to be converted appropriately.

And again I want to be careful with the way we say that in a sense because we're the new guys on the block and we've invested. We think it's a smart investment in new technology and capabilities. Because the U.S. should be doing and actually be the supplier of first choice, you know, rather than not. And so we see good opportunity in that area.

MR. EASTMAN: So the milk that you are going to procure for that new powder plant, are you hoping to be able to get that from your current shippers, are you going to have to buy spot milk on the market at all?

MR. AHLEM: Both are possibilities. So we have --

we have had contract caps on our producers as well. So there's a number of producers who want to grow and are waiting for those caps to be lifted so there's opportunity for growth so we have already begun that process of lifting some of those caps. We have others that are interested in working with us and we may very well reach out into the marketplace as well and see if other cooperatives or other players are interested in selling some milk.

MR. SHIPPELHOUTE: As you have started growing your milk supply has that contributed to the 400 loads that you mentioned that you had to ship out of state to find a home?

MR. AHLEM: Yes, I think this spring that did contribute to that some. I would say more so than the new plant. When we looked at the drought a year ago I sat here and looked at the numbers and thought we were going to see a decreased milk supply and I was very concerned about the drought and just really I've been wrong. It hasn't materialized that way.

MR. SHIPPELHOUTE: In your decision to invest in Texas you mentioned the conditions. Are some of those conditions the conditions you mentioned where there is competing interest for land. What has been mentioned over and over today is the competition for the nut market. So maybe a concern long-term about the ability for California to supply the milk that you need or that potential expansion?

MR. AHLEM: We still think milk supply is sustainable long-term in California and there's an opportunity. Is it going to grow rapidly? Probably not. Is there room for a stable milk supply out here? Absolutely. Does the industry need to reform, reinvest and get more value? Yes, definitely. So we pay premiums and think that is going to need to continue to retain existing milk supplies in California.

The Texas decision is there's an opportunity but it's a different deal. We talk about different markets so it's higher revenue, lower cost in Texas. So you're closer to market, that's what yields higher revenue. And then lower cost. Electricity, natural gas, labor, building, construction, it's all lower so that economic model makes sense. It also looks more attractive when we have a lot of hearings. If it's a $1.50 increase in California instantly it makes a lot more sense to make cheese out of Texas than it does in California.

MR. JETER: To the competing land use issue which has come up again and again. You know, that's a massive issue. We sat in the Secretary's meetings and we talked about that. We're competing for resources. And so in a sense the dairy guys really are coming up short.

And we think part of the problem is there is no investment really being made to increase the capability to convert that milk into world class products. You now, that's -- so the processing industry needs to grow in its capabilities and investment needs to be made. And I don't mean just by privates, I mean by cooperatives to chase value and increase revenue if we are really going to compete with the nut and the vineyards. We see it as critical.

MR. SHIPPELHOUTE: One other question I have. You make reference back to the 1930s and the producer community -- regulations were put in place to encourage co-ops. And suggesting that the producers didn't have any bargaining power at the time but once they were in a cooperative they have some power, more power in the marketing. Yet you're buying milk, you said about 1,000 loads this year, below market price. Could you tell me how those two comments, kind of reconcile those in my mind. If the producers now have power then why are they selling 1,000 loads to you at below minimum in the federal order?

MR. JETER: Well, okay. The comment about the 1930s really goes back to the start of federal orders. In the legislation, the first paragraph, to promote the formation of cooperatives. I mean, it was also the depression and the vast majority of the people in the U.S. or a larger proportion were production agriculture so a lot of the programs were designed to stimulate agriculture.

The stimulus programs of that era were really designed to stimulate agriculture and a big segment of that was, you know, a lot of dairy farmers. Very fragmented. And so there was this general policy goal to promote those people getting together in groups and marketing their product and getting their market price. That to me is a separate issue.

So then the issue is -- you're talking market clearing, I think. When you're saying we're buying loads below class in federal orders. Yes, that's just the function of clearing milk or any ag commodity, whether strawberries or cucumbers, they've got to sell at a price that clears the market. In a federal order that happens. A cooperative is not protected by a minimum price in a federal order so we could buy from a cooperative below the minimum price. In California we have to pay CDI the minimum price. We treat CDI like a 100 cow dairy, in a sense, they have different protections. But both of those systems really are designed to promote cooperatives. But when you're talking about clearing the market that's a different issue.

MR. SHIPPELHOUTE: Thank you.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. JETER: Thank you.

MR. AHLEM: Thank you.

HEARING OFFICER SUTHER: We will now take a five minute break. During this five minute break, anybody that has not signed up will need to sign up now, after the break we will not be taking any more people signing up.

(Off the record at 3:17 p.m.)

(On the record at 3:27 p.m.)

HEARING OFFICER SUTHER: Ladies and gentlemen, please take your seats.

Mr. Francesconi, you have a few more exhibits to enter into the record. Remember you are still under oath.

MR. FRANCESCONI: Okay, thank you very much. Mr. Hearing Officer, since the start of the hearing we have received a few correspondences since the hearing has started and I would like to enter those documents into the hearing record at this time.

The first correspondence I want to enter is a letter from Sierra Nevada Cheese Company dated June 2nd, 2015 and signed by Ben Gregerson, President; and I'd like to enter that as Exhibit number 53.

A second letter was received from Seifert Dairy, Limited Partnership, dated June 3rd, 2015 and signed by J. Seifert as Exhibit number 54.

Next is a letter from Marquez Brothers International, Inc., dated June 3rd, 2015 and submitted by

Jose T. Maldonado, Controller of Marquez Brothers International. And I am going to enter that as Exhibit number 55.

HEARING OFFICER SUTHER: Exhibits so entered.

(Exhibit 53, 54 and 55 were entered into the record.)

MR. FRANCESCONI: Okay.

HEARING OFFICER SUTHER: Mr. Hollon.

MR. HOLLON: Good afternoon.

HEARING OFFICER SUTHER: Good afternoon. Mr. Hollon, could you please state your full name, spell your last name and state your affiliation for the record.

MR. HOLLON: Elvin Hollon, E-L-V-I-N, H-O-L-L-O-N, and I am with Dairy Farmers of America. Copies of my statement are there for the panel and there are some in the back of the room.

Whereupon,

ELVIN HOLLON

Was duly sworn.

HEARING OFFICER SUTHER: And you would like your written testimony here entered as an exhibit?

MR. HOLLON: I would.

HEARING OFFICER SUTHER: We will be entering it as Exhibit number 56.

(Exhibit 56 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. HOLLON: Okay. Much of what has been said on page 1 has been said so I will let you read that at your leisure.

MR. EASTMAN: Appreciate that.

MR. HOLLON: And much of what is on page 2 has been said; I will -- three things. One is that Dairy Farmers of America is a part of the federal order hearing request and we continue to support that and our testimony today is in parallel with that.

We are supportive of the alternative proposal offered by Western United Dairies (sic), Dairy Campaign and Milk Producers Council and I will refer to that collectively as the producers in my statement.

I will start with the lower third or so of page 2 where it says "California Milk Production Data" which showed up on the screen.

It is without question that the California trend in milk production has veered from the rest of the country. The National Agricultural Statistics Service published monthly data on milk production for 23 states which make up more than 93 percent of the total US production. Quarterly and annually they publish production figures for all 50 states.

Map 1, which is on the screen, depicts the annual comparison for calendar year '14 versus calendar year '13 for the continental U.S. Of note is that as a whole the U.S. increased milk production 2.4 percent over 2013. Thirty-four states increased and 14 decreased. Inside each state depicted on the map is its total annual milk production, total pounds increased or decreased and percent of increase or decrease. States colored dark blue have increases of more than 3 percent; lighter blue, zero to 3 percent; lighter red, decreases of zero to 3 percent; and dark red, decreases of more than 3 percent. Generally speaking, the western states west of the north-south line from Louisiana to Minnesota are blue with most states showing dark blue. However, when updated to the first quarter of 2015, the trend begins to shift and several western states including California show a decrease in production. The trend continues when 23-state April data, Map 3, is presented and again California production shows a decrease. Note that the decreasing year over year trend in milk production is not the norm for the state. Since January 2000, only 27 out of 184 months have shown a decrease in the year over year comparison. This is the fifth consecutive month that the production trend has been negative. And only two times since 2000 has the consecutive streak of decreasing production happened for a longer period of time than now.

Table 1 - Comparison of All Milk Price, Western States and United States 2012 to 2015, compares the All Milk price as published by NASS for the western states that border California and for New Mexico. I didn't have that chart on the list but it's attached to the testimony. Dairy operations in these states are generally considered similar from the standpoint of quantities of milk produced. It would be DFA's experience that the largest sub-group of milk produced in these states originates from multi-thousand cow herds that would have similar economies of scale and production costs.

The All Milk price is constructed by summing all payments and deductions for quality, quantity and other premiums and excluding a deduction for hauling costs or hauling subsidies received by a farm in the month. It is an "at test" price, meaning the payments are not standardized for milk component composition. This price series has been published by NASS for many years and the price levels reported across states are considered a good proxy for the prices received by dairies as well as a good comparison for prices across states as the differences in component test would trend similarly over time. The All Milk Price is frequently used as a key measure for the success or failure of dairy policy and as a component in evaluating farm profitability.

California's All Milk Price consistently trails the list of its adjoining states. For the period August 2012, the month that the whey formula was last changed, the California hundredweight price averaged $19.38 or $1.57 below the average of the other five states. The minimum monthly difference was $.91 per hundredweight and the largest $2.38 and the median difference $1.50 per hundredweight. It appears that the factors that produce the California All Milk Price do not yield a comparable price with surrounding states. Note that Washington, Oregon, Arizona and New Mexico all have Federal Order prices as their base price. It is DFA'a experience that despite the elimination of the Federal Milk Marketing Order with the Idaho market in 2004, the Idaho manufacturers have now based their milk purchased on FMMO Class III price basis or have developed proprietary formulas that are designed to closely align with the Federal Order Class III. We suggest that this practice was determined to be necessary in order to maintain a viable production base to feed the state's processing plants with adequate milk supplies.

Table 2 - Total Cheese Production Volume Top 12 States 2011-2014, depicts the total volume of cheese produced in the U.S. in the 12 largest states in terms of total cheese production and the combined volume of the states as well as the compound annual growth rate of the

production volume for each of the 12 states and the combined compound annual growth rate for the entire group without California. Nine of the 11 non-California states show a positive compound annual growth rate. Collectively they produce 65 percent of the production of all types of cheeses. Additionally, they operate in states where the Federal Order Class III price is the minimum price for milk used to produce cheeses and whey products or where the major milk buyers have modeled their costs to track the Federal Order Class III price.

Plant Investments. The Secretary's California Dairy Future Task Force discussed intently the issue of attracting new capital investment in dairy processing facilities in California and we feel it is an important underlying factor in this hearing also. We are aware of the current milk powder facility under construction by the Hilmar Cheese Company and some expanded capacity at smaller facilities; but there has been limited interest in large scale plants for some time in the state.

As a part of DFA's ongoing business plans we monitor new investment in dairy processing as best we can as they represent potential opportunities to market members' milk as well as potential partners for processing opportunities. In the Central, Mideast, Southwest Federal Order and the Upper Midwest Order we are aware of 15 primarily cheese plants with just-completed ongoing or planned expansions that span 2014 to 2016. This new capacity will increase daily milk intakes by the respective plants from 100,000 pounds per day up to well over 1,000,000 pounds per day.

In the Northeast Order between 2010 and 2015 we are aware of 11 plants that manufacture Federal Order Class II, III and IV products that either have expanded their plant capacity or built new facilities. Two of these plants increased their milk intake capability by more than 1,000,000 pounds per day and one of the new constructions have a milk intake capacity of just 2,000,000 pounds per day.

All of the plants referenced operate in areas where Federal Order pricing is the basis for the minimum price and most, if not all, have some premium over that minimum price. Perhaps these plants desire a steady and expanding milk supply prior to committing capital for construction or expansion.

Comments about the Dairy Institute Proposal.

The alternative proposal offered by the Dairy Institute falls short of providing a needed adjustment to the Class 4b price as referenced by the Secretary in the Hearing Notice.

The use of a whey protein concentrate price as a benchmark commodity price series to be used in the pricing formula would be unique for the entire industry. that alone is not necessarily a reason to reject the concept. However, there is little regulatory or industry experience on which to draw for making conclusions in making this change at this time and possibly only for a short period. The use of a new benchmark commodity price in the manner suggested by the Dairy Institute may introduce more volatility than the current price factors and may not align with surrounding markets.

The published statistics of whey protein concentrate production offered by the Department noted that the production data covered more than just WPC with a 34 percent standardized protein level. The production data indicated the inclusion of other higher protein composition level products up to 89.9 percent in one table and to 100 percent in another table. The data on WPC prices are designated as only WPC34. Thus the production and price data series do not match and conclusions drawn from them may be incomplete.

But the demand for protein certainly causes some level of relationship between the demand for and the prices of whey, whey protein concentrate and the more concentrated whey protein products. And while the use of WPC and other higher level whey protein products as a benchmark commodity price may not be feasible for use by the industry at this time, several of the desired end results can still be achieved by the continued use of the whey price.

First, the Secretary has already determined that the bracket approach is a valid and usable method given the alternatives available to the Department. This approach is both flexible and responsive to market conditions. Over time it would seem that the price series across the whey protein spectrum has some relationship. The volume of available whey proteins are fixed by the volume of cheese production, however, the volume of whey products can vary depending on supply and demand factors.

As more WPC and other concentrated products are demanded, and prices and production volumes increase accordingly, there is less whey produced and the price of whey should increase accordingly in some fashion; thus offering milk producers to share in the whey value, as is the purpose of the product price formulas. The same logic holds for a decrease. So the whey formula will generally recognize these marketplace changes and transmit them through the milk price to producers. While not a perfect transmission this is a valid conclusion and supports the continued use of whey as a benchmark product.

Forward looking analysis.

The key decision that the Secretary will need to consider from the hearing is which proposal best meets the objective she set forth in the Hearing Notice. That decision, no matter how arrived at, will require some component of forward-looking analysis with regard to the operations of the two proposals. We offer the following objective and transparent analysis to demonstrate that the producers' proposal is the better alternative to meet her objective.

In order to have a forward-looking analysis the following steps were taken and presented in Table 3:

The CME futures prices for the period May 2015 - December 2016 for whey were used to project the results from the current formula and for the producers' proposal. This is the best publicly available projection of future prices for this commodity. We are well aware of other price projections available to the industry. However, they are not available for a public record as they are proprietary versus public products. That information is in Column 3 on Table 3.

The CME futures prices for the period May 2015 - December 2016 for nonfat dry milk and whey were used to project WPC prices. The prediction equation was derived from a regression equation using monthly USDA/AMS National Dairy Product Sales Report prices for whey, nonfat dry milk, and Central & Western WPC prices. The prediction equation is: WPC = -.00874 + (NFDM * 0.477107) + (WHEY * 1.227692). This equation has an r-square of .875 and is composed of 100 monthly observations. Those results are listed in Columns C, D and E of Table 3.

Whey contribution amounts to the Class 4b price were determined for the Current bracket and the Producers bracket using the futures prices and each bracket's methodology. That is displayed in Columns F and G.

The whey contribution originating from the WPC price for the Dairy Institute bracket was determined based on the equation described in step 2. That's in Column H.

The contribution to the producer price was calculated by multiplying each bracket's contribution value, Columns F, G and H, by the most recent 12 month average utilization for Class 4b of 46 percent. It's in Columns I, J and K.

The improvement or detraction from the Current bracket was calculated by subtracting the producer price contribution value of the current bracket from the respective newly calculated bracket. See Columns L and M.

And the net improvement generated by the Producers proposed bracket is displayed in Column N.

From Table 3 we can see that the whey and WPC prices have deteriorated noticeably in 2015. Increases in global milk production coupled with a significant reduction in demand from China, the largest whey importer - not imported - importer in the global trade network, are two factors suggested as primary causes. The low price trend is carried forward by the futures prices. Thus the Secretary's decision must be fashioned by a forward-looking price trend rather than a backward-looking one.

As to the use of CME prices in 2016, DFA has a significant risk management business unit. We provide risk management tools for our members, our own business units and will offer those services to our customers when mutually beneficial. Our group has some level of hedge business throughout calendar year 2016. Certainly at greater volumes for nearby months but some volumes are contracted for the final months also, indicating both a buyer and seller for the published prices and some validity in the prices reported.

Several conclusions can be drawn from this forward-looking analysis:

The Producers' proposal provides more price relief by way of a higher 4b price than the Current bracket and the Dairy Institute bracket in all months calculated.

Over the remainder of 2015 an 2016 the Current bracket will provide an estimated $.22 contribution to the 4b price, the Producers bracket $.60 and the Dairy Institute bracket, $.30.

Over the remainder of 2015 and 2016 the Current bracket will provide an estimated $.37 contribution to the producer price while the Dairy Institute bracket will only provide $.08.

Over the July to December 2015 period suggested by the Dairy Institute the contribution to the producer price offered by the Producers bracket would be $.35 per hundredweight versus $.05 per hundredweight from the Dairy Institute bracket. This result would not meet the Secretary's objective.

Summary.

We have offered data to support the Producers proposal by demonstrating that:

Milk production in California has declined in a manner not typical to state historical trends and in an opposite manner from trends in most other states where production is noticeably increasing.

Using the USDA All Milk price as a proxy for producer prices, the California producer price is noticeably lower than the prices of the nearby states.

Total cheese production is increasing in other regions of the U.S. at a steady pace.

Plant investment, generally slowed in the California market, is robust in other regions of the U.S.

Other regions explicitly or by reference are subject to the Federal Order Class III prices as their minimum price.

Using a forward-looking analysis, the Producers proposal provides significantly more revenue to meet the Secretary's hearing objective than does the Dairy Institute proposal.

It is almost obligatory but: As noted in the hearing announcement, proposals should reference and relate to Section 62062 of the California Ag Code, which requires:

"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."

The Producers proposal clearly relates closely to those requirements and best parallels those national values.

Application of the Producers proposal for 24 months.

It appears most likely that should a change be made as a result of the hearing it would be in effect on August 1 and apply to August milk production. Producers will have faced difficult margins as noted in earlier testimony since early 2015. It will take more than a few months to recover lost equity positions or replenish capital balances.

Operating loans and on-farm capital plans for 2016 will be developing in the fourth quarter. It would be a stabilizing effect on the production sector if the Secretary would implement the Producers proposal for the 24 months following the hearing announcement in August. While any decision that offers some level of price improvement is welcome, a short period does not aid farm business planning. The hearing process, while fairly swift in "regulatory proceeding time," still takes three to four months to complete. So if the Secretary's concerns remain after December there would again be a several month lag until dairy farms would be able to experience needed short-term price adjustments.

We note that the Producers bracket "floats" with whey markets and thus has a self-adjusting effect and would move quickly with changes in the market reflecting truer market values for the whey component to both milk buyers and sellers.

Again I would like to thank you for the opportunity to testify today. And I do request the opportunity to submit a post-hearing brief and I would be happy to answer whatever questions the panel may choose to ask. Thank you.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

We will now take questions from the panel.
MR. EASTMAN: On page 6 of your testimony you cite the results of your regression equation where you were trying to estimate what the future values of the WPC price could be.
MR. HOLLON: Right.
MR. EASTMAN: Is it possible for you to report the statistical significance of the coefficients that you have estimated in your equation?
MR. HOLLON: Yes.
MR. EASTMAN: You'd be willing to provide that in your post-hearing brief, I assume?
MR. HOLLON: Perhaps sooner than that.
MR. EASTMAN: Okay. Before you leave that seat? Is that sooner?
MR. HOLLON: I don't think I can do it before I leave the seat but I think before I leave today, or tomorrow.
MR. EASTMAN: Okay. Well go ahead and submit it in your post-hearing brief whenever that comes.
MR. HOLLON: Okay.
MR. EASTMAN: Okay. Then with regards to the changes in milk production that you have seen in the maps and also the underlying numbers that are indicated there. Do you believe that current milk prices in California are

the main reason for milk production decreases or do you think other factors that affect milk production on the dairy also contribute to that or do you have a sense of how those may balance or weigh against that?

MR. HOLLON: When you weigh the differences in the California prices and other prices you have to -- you have to allocate some of the causal to the lower price. When I talk to DFA members and other members in our group, the farm members, they speak of the same thing. You know, my ability to buy feed, to meet a loan commitment, to provide cash flow are constrained.

The nature of the California formulas respond down quicker and up quicker to changes in the underlying commodity prices. All those things hit sooner, lasted deeper. The historical view of the results of the formulas, it's pretty impossible to say that they don't result in a lower price so I think you would have to make some conclusion. Now drought is a factor. Drought adds costs. Costs are offset by prices/revenues. So I would say that the price scenario is key to some of that production drop.

MR. EASTMAN: I think that's what I have for right now.

MR. SHIPPELHOUTE: You talk about plant investment kind of stifled here in California. Earlier today somebody made reference to DFA's decision to build a plant in Nevada and kind of speculated as to the thought process behind that. I wonder if you could share DFA's thought process behind that.

MR. HOLLON: Some of that thought process, I can't share it all because it is not my part of the business. But a certain part of it was that the size and scale of the plant had been determined to be sort of a state of the art initial plant and that long-range planning in the company would involve additional drying facilities so that plant was by scale determined to be somewhat smaller.

Our member milk supply there and the ability for that supply to increase, given the production resources in that area, pretty much fit the scale of plant that we wanted. We do have, we do have business plans to have other facilities similar in other milk sheds. Business may be developed there and then farmed out to those locations as our business grows.

MR. SHIPPELHOUTE: No other questions.

MR. LEE: Regarding the methodology that has been presented by the Dairy Institute's proposal using WPC34. Do you have any opinions regarding adoption of the Dairy Institute's methodology?

MR. HOLLON: I did not -- I didn't see that until today; that's kind of the nature of these things. But I would say that the adoption of that methodology puts you guys in a pretty ticklish spot. Regulatory prices are generally built on stable factors that you can go out and find, that's the nature of them.

And so this $.15 off of some price. First of all, is that -- You know, the WPC price, that's pretty well given, that fits the regulatory environment. But that discount, does that fit and how do you find it? Even in your questioning back and forth it didn't last more than two or three hours that there were three or four answers to what that number ought to be. The 1.8 yield factor kind of matches what I can go out in literature and find so that kind of fits a regulatory environment.

But processing costs? Clearly -- I've been coming to these hearings for, well, I was part of the 2007 whey, I was on one of the committees. And so it's difficult to nail down some of those processing costs. So again, in terms of a regulatory environment that depends on discoverable costs, that's a somewhat difficult scenario. And I am not completely certain, given the diverse nature of WPC processing, that's going to fit, at least at this time.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Any further questions?

Thank you for your testimony.

MR. HOLLON: You're welcome.

HEARING OFFICER SUTHER: Mr. Vandenburg.

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

MR. VANDENBURG: Leonard Vandenburg. My last name is spelled V as in Victor, A-N-D-E-N-B-U-R-G and I represent Pacific Gold Milk Producers and also Pacific Gold Creamery.

Whereupon,

LEONARD VANDENBURG

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other written material other than what you have presented to us that you would like to enter?

MR. VANDENBURG: No, sir.

HEARING OFFICER SUTHER: This will be Exhibit number 57.

(Exhibit 57 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. VANDENBURG: Thank you. I want to thank Secretary Ross and the hearing officer and the panel for allowing us the opportunity to express our views and the facts.

I am here representing Pacific Gold Milk Producers, a cooperative, and Pacific Gold Creamery, which its owners consists of 30 producers which are Pacific Gold Milk Producer members, and several private investors, myself included. I have also been a National Dairy Director for the National Farmers Organization for three years and was their National Vice President for seven and a half years. I mention this because this will be useful in testimony later on in this brief.

Many of our producers since 2008 were told that there was no room for their milk, all the big co-ops denied these producers' cry for help. CDFA and dairy trade organizations told them to sell out because there was nothing that could do. And they were also told that the bigger producers could use their dairies to feed their heifers.

These producers were faced with selling at a depressed market, possibly losing everything they worked for over their lifetime. Not having the next generation to take over and the opportunity to have a career in the business that their families worked so hard for. Many producers faced with processor delinquent payments, or other processors terminating their contracts, and many of these producers joined Pacific Gold Milk Producers.

Most of these producers have decided to invest in their own future by starting a specialty cheese plant called Pacific Gold Creamery. They did not ask for a hearing to bail them out. No, they did it the old fashioned way, they took the risk, the investment, the debt, the guts, the vision and determination, the can-do attitude and decided to be market-oriented rather than be production-driven, and they took matters in their own hands through relentless effort.

Now that I have -- live, breathe and own part of a specialty cheese plant - it's kind of a PhD in hard knocks - I have developed a real appreciation for the remarkable challenge it takes every day to make and satisfy the consumer's demand for perfection. The increasing cost of higher quality standards and regulatory standards from every facet of our industry. These continued increase costs and demands from retailer, distributors, cut and wrap operations, brokers, FDA, USDA, local and state inspectors and above all the consumers. We as a specialty cheese plant embrace these quality requirements as we wish to protect our dairy food image for each other. If only one plant has a quality issue, everyone suffers the consequences. But there is a real increasing cost and what are these costs? It is in additional lab technicians, increased internal and third-party testing, upgrading equipment, upgrading the facility and the list goes on, to meet the every demanding requirements.

I have also learned to appreciate the challenge in trying to make money in the specialty cheese business in California. Pacific Gold Creamery has invested for nearly two years of losses, through the challenge of developing markets, to proving that we can make perfect a cheese every day over the year and the cost needed for equipment for every type of cheese. The specialty cheese does in fact have higher premiums, however, much of these premiums are absorbed through the higher cost. The additional cost comes from labor, not being a single type streamline cheese operation, additional packaging cost, additional handling and multiple days to make a single type cheese. The additional cost to make these cheeses is as much as $.20 a pound or more or $2.00 a hundredweight or more. the single largest reason we finally turned a profit is because of organic milk sales. If we were to make a profit in the conventional market, it would take another 18 months of investment. The other hidden fact in the cheese business is the start-up cost and the constant upgrading of cheesemaking equipment. In the ideal world under the reliable Van Slyke cheese formula, if we could capture 90 percent of the fat and 78 percent of the protein, we would lose $1.87 a hundredweight making cheddar cheese. And these numbers -- I've got an attachment in this brief. And I just took the California average butterfat, California average solids-not-fat and I used a 3.3 protein, which I think is pretty close but I don't have the documents for that. However, with used equipment we would be lucky to capture even 85 percent of the fat and possibly 75 percent of the protein, and your loss actually would be $2.50 per hundredweight. And you can find those Exhibits in A and B.

I think it was stated earlier by Hilmar Cheese that there was very little investment in cheese equipment or other equipment. And you're going to find the efficiencies at a lot of these plants has been diminished because of worn-out equipment and it costs a tremendous amount of money to get equipment. Just recently we quoted out a table, just a single cheese table, to be replaced. It was $137,000 and then we still have to install it. So, you know, this don't come cheap.

The core reason for the hearing is discussing whey values in California cheese plants. When I was managing the National Farmers Organization Dairy Department in the various federal orders it was very commonplace to pay anywhere from $1 to $2 under the Federal Order announced price. Most milk handling companies would share their pay prices and almost all the cooperatives paid under the announced price. In Exhibits C and D are the USDA facts regarding non-pooled milk in the federal orders. In the past 10 years the non-pooled pounds averaged over 28 billion pounds, to 14.83 percent of the year, and in 2014 the non-pooled pounds ended up being over 34 billion pounds or a little over 16.5 percent. The total Class III volumes in the federal exceeded a little over 57 billion pounds, so the non-pooled pounds end up being almost 49 percent of the Class III non-pooled pounds. The price difference between Federal Order Class III and California 4b for the past 10 years is $1.45 a hundredweight. That is completely unreasonable to try to compare the Federal Order Class III differential against the 4b when approximately 50 percent of the Federal Order Class III was severely underprice compared to the pool milk. Just in the last four to five months several thousand loads of milk was dumped and millions of pounds sold to cheese plants from $7 to $10 under the announced price. Just for clarification, I made a number of phone calls and had some discussions with people that they know for a fact that these loads were dumped. And in excess of 2,000 loads in the eastern part of the United States and milk being sold for $7 to $10 under. The $1.45 a hundredweight differential number is a very misleading figure, as nearly 15 percent of the lower price milk is not part of the equation.

Pacific Gold Creamery has turned our whey into ricotta. What most producers don't realize is that much of the cheese sold is sold at nearly a break-even price or a loss, depending on the type and volumes, while the dried whey products, and in our case ricotta, subsidizes the cheese sales. If it was not for our ricotta sales from whey, we would continue to lose money. To increase the whey value to producers equal to federal order pricing would be devastating to the cheese plants in California, especially smaller to mid-size plants such as ours. The other real concern and unfairness that faces cheese plants are the whey values are going down due to increased volumes entering the market. One other factor of unfairness is the consideration of carving out the income from California cheese plants from higher valued byproducts; however, this is ignored in the specialty dried powders other than whey powders. Why?

I am completely dumbfounded as to why we are here asking for a greater portion of the whey value when over 80 percent of the milk is represented by producer-controlled cooperatives in California. Over 95 percent of the producer milk pool in these cooperatives are not in the cheese business. If there is so much money in the cheese and whey, why are these same producer-controlled cooperatives not collecting 100 percent of the whey income by investing and risking for the rewards, rather than taking it away from those that earn it and the ones that risk for it.

The other factors in the market, our current domestic price is very strong compared to the global prices. The major plant constructions in the past 10 years have come in non-regulated areas. In the regulated areas we have witnessed plant closures and no major expansions due to poor potential economical returns. To increase prices would further jeopardize exports.

Instead of coming to CDFA and pleading their case, I strongly believe that the case should be confronted with the cooperative boards and management to revisit their own business plan and model.

Many producers have chosen to use rBST and it has given the public an image and a belief that milk is tainted with hormones. Some producers are using sex semen to increase herd size and production. When supply and demand gets our of balance, driving milk prices down then we all end up here at a milk hearing seeking relief. We as an industry need to take some responsibility and ownership.

We strongly support the need of dairymen to get a far price through meeting the consumers' marketing demands. We, however, oppose production-driven models that ultimately lowers prices and creates oversupply.

Pacific Gold Creamery and Pacific Gold Milk Producers do not support the proposed adjustment in the whey factor by Western United and California Dairy Campaign. We may be willing to support the Dairy Institute but I'd rather see that there is no adjustment at all. For all the reasons mentioned above in my testimony but also the proposals presented are not based on all the facts and all the factors are not considered fairly for the benefit of our industry as a whole. And I thank you for your time.

HEARING OFFICER SUTHER: Any questions from the panel?

MR. SHIPPELHOUTE: Mr. Vandenburg, you comment on a couple of thousand or several thousand loads of milk dumped. Do you have any way of documenting that?

MR. VANDENBURG: I think that could be documented. I would just have to get some written testimony from people that actually have dumped milk, processors. That can be done.

MR. SHIPPELHOUTE: I know there's been some weather issues around the country this winter. Did the weather issues contribute to some of that need to dump milk or was it --

MR. VANDENBURG: I think that was very minimal. I think most of it, it was just a glut of milk and no processing capabilities to handle all the increased volumes. I think what a lot of people don't realize, there's just -- you know, the eastern part of the U.S. is more of either fluid or specialty cheese plants and you don't see the bigger, large commodity-type cheese plants because economically it doesn't work.

MR. SHIPPELHOUTE: All right.

MR. EASTMAN: I have a question. On the table of milk that shows the milk that's produced, by producers on federal orders, et cetera. Did you get the figures for this table from, I assume the USDA website?

MR. VANDENBURG: I did.

MR. EASTMAN: Okay.

MR. VANDENBURG: And the gentleman that you see on the bottom, I did talk to him, discussed it with him, and that's where I got the information.

MR. EASTMAN: No, I didn't see that but I do now. Great, thank you.

HEARING OFFICER SUTHER: Thank you for your testimony, Mr. Vandenburg. Do you wish to request to file a post-hearing brief based on Mr. Shippelhoute's questions?

MR. VANDENBURG: Thank you for asking. Yes, I do.

HEARING OFFICER SUTHER: Thank you. Your request will be granted.

MR. VANDENBURG: Thank you.

Mr. Garbani.

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

MR. GARBANI: My name is Pete Garbani, spelled G-A-R-B-A-N-I, and I am a Vice President with Land O'Lakes, Inc.

Whereupon,

PETE GARBANI

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other documents other than what you presented to become an exhibit?

MR. GARBANI: No, I don't.

HEARING OFFICER SUTHER: It will be Exhibit number 58.

(Exhibit 58 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. GARBANI: Mr. Hearing Officer and Members of the Panel:

My name is Pete Garbani. I am here to testify on behalf of Federal Order, Inc. My business address is 400 South M Street, Tulare, California, 93274. My current title is Vice President, Member Relations.

Land O'Lakes would like to thank the Secretary and the Department for calling this hearing, on its own motion, to consider temporary amendments to the Marketing Plans. Specifically, we thank the Department for calling a hearing to consider adjustments to the current Class 4b pricing formula including adjustments to the whey factor. This hearing will address issues of critical importance to the future of both our California diary producer members and the entire California dairy industry.

Land O'Lakes is a dairy cooperative with 2,200 dairy farmer member-owners. Land O'Lakes has a national membership base, whose members are pooled on the California State Program and five different federal orders. Land O'Lakes members own several cheese, butter-powder and value-added plants in the Upper Midwest, East and California. Currently, our 200 California member-owners supply us with over 16 million pounds of milk per day that are primarily processed at our Tulare and Orland plants. We also operate a dairy dessert plant in Turlock.

Land O'Lakes supports the proposal submitted by the producer trade associations of Western United Dairymen, Milk Producers Council and California Dairy Campaign to modify the sliding scale that values dry whey within the Class 4b milk pricing formula. The proposed sliding scale closely approximates the whey formula incorporated into the joint proposal submitted to the USDA on behalf of Land O'Lakes, Dairy Farmers of American and California Dairies, requesting a hearing to consider a California federal milk marketing order.

Land O'Lakes supports this proposal be adopted for a period of no less than 24 months to provide much needed financial support to California dairy farm families who have recently experienced narrowing margins over feed costs. Land O'Lakes agrees the overall market conditions support this adjustment to the 4b pricing formula. We encourage the

Department to implement the proposed changes beginning as soon as possible.

First, I'd like to discuss the merits of using the whey sliding scale and making the proposed adjustments to it.

In the previous panel reports the CDFA has clearly affirmed that using the whey sliding scale is a viable option to value whey in the Class 4b formula. In the CDFA panel report discussing the hearing of June 30 and July 1, 2011, the panel stated that the sliding scale had merit for the following reasons:

Reason 1: The sliding scale would allow the whey value incorporated into the Class 4b formula to be market-driven so that the whey value would rise and fall as the price of the whey rises and falls in the market.

We agree that adopting the producer trade association proposal would be consistent with a market-driven approach.

Reason 2: The sliding scale could be updated.

We support this proposal that includes an updated scale which would better reflect whey's recent market value and more fairly incorporate the value into the Class 4b formula. The CDFA panel clearly envisioned the need for periodic updates as being one of the merits of this approach.

Additionally, since August 2012, which is the last time the Department updated the whey sliding scale, the market value of the whey has exceeded $.50 per pound in every month through December 2014. The market value exceeded $.55 per pound in 97 percent of the months.

More importantly, the whey factor in the 4b formula was capped at a $.75 cent ceiling in 13 of the 33 months from August 2012 through April 2015, representing nearly 40 percent of the months. This recent heightened market value of whey indicates the scale needs to be updated to allow additional sharing of these higher whey market values with the dairy farmers than producers are now receiving under the current whey sliding scale. This proposal provides that update.

Reason 3: The majority of producers favored using a sliding scale as a method to value whey.

As you know, the overwhelming majority of California producers support the trade association's proposal and continue to support the use of the sliding scale.

Since adopting the whey sliding scale, the CDFA anticipated the continued use of it as a method to value whey in the Class 4b formula and for these three reasons we strongly encourage the Department to adopt this proposal.

Next I would like to offer some observations about the market factors that support the temporary adjustments to the 4b formula. These factors include the recent market trends in milk production, farm milk prices and the financial conditions of California dairy farmers along with some comments about the impact that the chronic drought conditions have had on our dairy members.

California's Milk Production Has Slowed

California's milk production has slowed markedly from the growth rate experienced in the first half of 2014. In fact, since November 2014 when milk production posted a year over year increase of +2.4 percent, California's milk production has contracted for five straight months posting decreases of -0.1 percent, -2.6 percent, -3.5, -2.9 and -2.1 in December 2014, January, February, March and April of 2015, respectively. Most recently, the slowdown represents a milk production decrease of 2.5 million pounds or 50 fewer loads of milk per day during April of 2015 versus April of 2014.

By comparison, Land O'Lakes member milk production has decreased at even a faster rate. Similar to statewide production, Land O'Lakes milk production has decreased for five straight months since November 2014. The production has contracted by -2.1, -4.6, -5.3, -5.3 and -4.7 in December of 2014, January, February, March and April of 2015, respectively. For example, in April of this year, our member milk volumes decreased by roughly 850,000 pounds per day compared to our April 2014 production. Our members' milk production has appeared to be responding to the combination of rapidly decreasing milk prices and increasing production costs which have put many of our dairy farmers under extreme pressure as their margins have narrowed to unprofitable levels.

Financial Conditions Challenging California Dairy Farmers

By any price measure, California dairy farmers have received far less for their milk so far in 2015 than they received in 2014. For example:

The statewide blend price received by California diary farmers peaked at $23.67 per hundredweight in March of 2014 and has declined by $8.95 to $14.72 per hundredweight in February of 2015.

California mailbox prices have followed a similar path downward. The California mailbox price peaked in March of 2014 at $23.36 per hundredweight and has declined by $8.87 to $14.49 in February of 2015.

California's overbase peaked at $22.47 in March 2014 and has declined by $8.65 to $13.82 in March of 2015.

During the first four months of 2014, the overbase averaged $21.83 per hundredweight; this compares to an average overbase of $13.91 for the first four months of

2015, a decrease of $7.92.

These farm level price decreases ranging from $7.92 to $8.95 per hundredweight have had a huge impact on the cash flow position of our state's dairy farmers. These decreases effectively cut our dairy farmers' gross pay by one-third. Think how difficult it would be for anyone to experience that magnitude of a cut in their gross pay.

At this point, the CDFA has not released cost of milk production estimates for 2015. Based on the latest data available, milk production costs increased in 2014. Specifically, dry and wet roughage costs increased as prices paid for alfalfa hay, corn silage and other forages rose. Additionally, the drought impacted the quantity and the quality of the forage grown in 2014 and very likely resulted in the 11 percent increase in the prices for alfalfa to $294.16 per ton when compared to the 2013 alfalfa prices.

The drought conditions have not improved in 2015 and they appear to have worsened in light of the historically low levels of snow pack and lack of consistent spring rains. In all likelihood, forage quality will again suffer and the supply of forage may be further constrained this year resulting in higher costs for lower quality forage.

Hired labor costs increased 2.7 percent, operating expenses increased 3.9 percent and herd replacement costs increased 26.6 percent as the demand for replacement animals increased. Summing up all the costs previously listed, the CDFA estimated that the total cost of production for 2014 was $19.08 per hundredweight. From your own cost of production survey.

Comparing the latest farm level milk prices with the 2014 cost of milk production reveals how devastating the drastic fall in milk prices has been. The cost of milk production exceeded farm level milk prices by the following amounts:

California's mailbox price received by California dairy farmers was $14.49 in February of 2015. This was $4.59 lower than the $19.08 cost of production for 2014.

The statewide blend price received by California dairy farmers was $14.72 in March 2015, this was $4.36 lower than the $19.08 cost of production in 2014.

California's overbase averaged $13.91 for the first months of 2015. This was $5.17 lower than the $19.08 cost of milk production in 2014.

Income over feed costs represents a commonly referred to economic metric when considering the financial health of dairy farming. CDFA estimated that total feed costs averaged $11.05 per hundredweight in 2014. Assuming that feed costs have remained flat since then and using the average overbase price of $13.91 per hundredweight for the first four months of 2015 reveals that income over feed costs have been narrowed to $2.86 per hundredweight, clearly a catastrophic margin over feed level for California dairy farmers.

Recall that the 2014 Farm Bill created the dairy Margin Protection Program. This new risk management tool for dairy farmers uses an income over feed costs of $4 to represent the base insurance level that all dairy farmers can attain for no cost other than a $100 enrollment fee. This base level insurance is often referred to as catastrophic margin coverage. In developing the components of this program, the National Milk Producers Federation concluded that when margins over feed shrink to the $4 level, dairy farmers' equity is at risk. Recall the market conditions of 2009 when margins over feed shrank to below this catastrophic level. As stated earlier, the average margin for the four-month period for January 2015 to April 2015 is $2.86, this is $1.14 lower than the $4 level. If the current level of dairy farmer margins continue into future months, California dairy farmers' equity will again be at risk.

In light of the severe financial conditions of 2009, most California dairy farmers took the opportunity to enroll in the Margin Protection Program for 2015. The Farm Service Agency estimated that 69 percent of California's dairy farms enrolled in the Margin Protection Program. We estimated that 95 percent of our Land O'Lakes dairy farmer members in California enrolled.

Unfortunately, the negative California basis, meaning that the California all-milk price falls below the U.S. all-milk price, reduces the benefit to the California dairy farmers from participating in this program. As you know, the U.S. all-milk price represents the price used as the proxy for milk income in the calculation for the U.S. dairy margin in the Margin Protection Program. For example, the California all-milk price averaged $1.88 lower than the U.S. all-milk in the first four months of 2015, which was also the first four months of the Dairy Margin Protection Program. This means that when the U.S. income over feed or margin is at a $4 level, the California income over feed margin is $1.88 lower or $2.12 per hundredweight.

A significant portion of this negative California basis is attributable to the lower value for Class 4b milk and the lower value for Class 4b milk is directly attributable to the lower value of whey in the 4b formula. Thus, an additional benefit of the producer association's proposal is the narrowing of this negative basis. Closing the negative basis between the California all-milk price and the U.S. all-milk price could enhance the benefit to California dairies who have paid the premiums to help them manage their margin risk by enrolling in the Dairy Margin protection Program for 2015.

These types of challenging financial conditions have contributed to the 23 Land O'Lakes dairy members who exited the dairy business since August of 2012 and the 9 other members who sold their cows. Four other members chose to sell their milk to another buyer and one member moved his dairy to another state. In total, 37 Land O'Lakes members have changed their operations since August of 2012, representing a decline of nearly 20 percent of Land O'Lakes California dairy farmer members in 33 months, August 2012 through April 2015.

We are fully aware that some of our members are currently operating under negative margins and are considering exiting the business. While many members are evaluating their exit strategies some are getting pressure from their lenders to consider liquidation.

Adding to the challenging milk market is the chronic drought conditions. The drought has added considerable stress and cost to our dairy members. We know of many cases of dairy farmers idling cropland, drilling new, deeper wells or planting more drought tolerant crops such as sorghum as steps taken to manage their farms with less water.

In recent conversations with our dairy members we have been told that they have idled as little as 5 percent of their annual cropland acres to as high as 20 percent due to the lack of water. Some members have made major investments to secure water by drilling wells. These wells have cost from $250 to $375 per lineal foot with depths ranging from 600 to 1200 feet. this cost per foot does not include the lines needed to distribute the water to the crop acreage or the increased operating costs associated with pumping water from lower depths.

To close, we again want to thank the Secretary and the Department for calling an emergency hearing on its own motion. The California dairy farmers need this temporary increase in the whey factor of the 4b formula in light of the dire financial conditions they have weathered since late 2014 and the additional cost they must absorb due to the ongoing drought. This temporary increase has the potential to have a very positive financial impact on California's dairy farmers at a time when they need it the most.

Position on Alternative Proposals

We do not support the alternative proposal submitted by the Dairy Institute. The proposal is not consistent with the proposal submitted to the USDA to request a hearing on the adoption of a California federal milk marketing order.

As you are fully aware, the three major dairy co-ops operating in California, including Land O'Lakes, Dairy Farmers of America and California Dairies, submitted our joint proposal to the USDA in February and are awaiting USDA's decision regarding our request for hearing.

Once again, we thank the Secretary for calling this hearing. We thank the panel for your consideration and Land O'Lakes would like to request the opportunity to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted and we will now take questions from the panel.

MR. SHIPPELHOUTE: On page 4 of your testimony you are talking about the decrease in production of your member farms. Is that a comparison of farm to farm or is that your overall milk supply?

MR. GARBANI: It's our total milk supply year over year.

MR. SHIPPELHOUTE: That's all I have for now.

MR. EASTMAN: I had a question regarding that same thing. Why do you believe that the milk production decreases by your members are a lot greater than what you cite as the state average before then?

MR. GARBANI: Well, I think it's a combination of factors and most of them have been mentioned here today. I mean, I think that after 2009 and 2012, farmers are paying

-- dairy farmers are paying much more attention to market signals that are coming back to them. They are no longer willing to lose money on a per cow basis. They focus extremely hard on efficiency, which is really production per cow. So when things start to look, you know, kind of dreary outside they pull in the reins and they downsize and they try and weather the storm because who knows how long it will last and their livelihood is at stake.

MR. EASTMAN: So you believe that those actions then have been to a greater magnitude than the rest of the producers in the state? Because your members reacted more strongly maybe?

MR. GARBANI: Well, I would say that price is first. There are other factors like drought and, you know, return on investment and all those other things that have been mentioned here today. But first and foremost, I mean, nobody has an appetite to repeat a 2009 or a 2012 on their balance sheet or with their lender or any other circumstance that just continues to eat up equity.

MR. EASTMAN: Okay. That's all I had.

MR. LEE: I had asked this question of several of the cooperatives as well. Regarding the Dairy Institute's methodology of the whey, the WPC34 versus the current dry whey formula. Do you have any thoughts about their concept?

MR. GARBANI: I do. And I'll share a couple with you all right now but I think I'd like to address it more comprehensively in the post-hearing brief.

I truly believe in what Elvin just said about the formula that is used in the basis for that table that Dairy Institute has provided has some very subjective numbers in there. In years past we have used cost studies as a basis for make allowances and things of that nature, we're talking about drying costs, we're talking about transportation, none of which is verifiable or has not been substantiated at this point in time.

I would also say that it strikes me as uncommon that we are going to use a further processed product rather than the base commodity product to price what we do with the milk. So in other words, you know, we don't start with, you know, other products that are further processed; we start with the basic concepts. There's butter, there's cheese, you know, cheddar, there's nonfat dry milk in most of our indexes, right? Why are we jumping up to a WPC34 that already excludes some of the product that they won't get any value out of but the lactose and the other byproducts that come from that whey stream. Why not start with the whole whey stream?

You know, Eric said it earlier today, Mr. Erba from CDI. If you extract the right value from whatever index it is, in our opinion it is clearly lower than what it should be, then we get to the same spot.

It also strikes me as odd that we are now looking at a Central WPC index instead of just the West, which is a little bit different that what we have done in the past. So I would offer more comprehensive comments in my post-hearing brief but those are some factors that strike me.

MR. LEE: Thank you.

MR. SHIPPELHOUTE: You mentioned that four of your members chose to sell their milk to another buyer. Did they go to another cooperative, do you know, to a proprietary handler? Any idea what drove their decision?

MR. GARBANI: Proprietary.

MR. SHIPPELHOUTE: Proprietary.

MR. GARBANI: I mean, and on that basis we seem to have strayed from the basic concept of pooling in the state because now we are allowing different manufacturing options to keep more of the benefit and pay more for the milk just to their direct shippers and not have to share that through the state. Much like what co-ops had to do when butter and powder was being built and the infrastructure was built for that product. It was all contributed in the pool and we all shared in that equally. Whether you were shipping to a cheese plant or a butter-powder plant you got to benefit equally.

In most recent years what we have seen as a holdback from some of the value of the cheese operations so that we could, quote, get a return on investment and not have to share it with the pool, so it allows them more opportunity to pay more money for their milk directly and that's who we lose our producers to.

MR. SHIPPELHOUTE: You are marketing some of your member milk to proprietary cheese plants, are you not?

MR. GARBANI: Yes.

MR. SHIPPELHOUTE: And are you able to extract premiums above and beyond the class price?

MR. GARBANI: It's funny because when that negotiation happens the conversation usually heads towards, well go to the Department and get it.

MR. SHIPPELHOUTE: So I'll take that as a, no, you are not getting a premium?

MR. GARBANI: No, there -- there are premiums but it's not nearly what we think the milk is worth.

MR. SHIPPELHOUTE: And so what keeps you from getting what you think the milk is worth?

MR. GARBANI: Supply and demand.

MR. SHIPPELHOUTE: A follow-up on prior discussion or testimony and that was suggesting that the co-ops should consider processing some whey and capturing some of that value. Do you folks receive any whey from any plants for any processing?

MR. GARBANI: No. No, we don't.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. GARBANI: Thank you.

HEARING OFFICER SUTHER: Mr. Avila.

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

MR. AVILA: My name is Xavier Avila, A-V-I-L-A. I am a small dairy producer from Tulare. I am currently a Board of Director on Land O'Lakes co-op. This is about my 14th or 15th year coming to hearings. My first one was about 14, 15 years ago. Right after that I was Chairman of CDC for about three years from about 2002 to 2005.

Whereupon,

XAVIER AVILA

Was duly sworn.

HEARING OFFICER SUTHER: Okay. You may proceed.

MR. AVILA: Well, thank you for listening and thanks to Secretary Ross for calling the hearing. There was some talk for awhile about a few producers left in this state that wanted to call a hearing and me -- myself and a few other people put a lot of pressure on them not to do it. Quite frankly, we're pretty much done with this process and I am predicting this is the last hearing on these pooling issues we're ever going to have in the state. You know that the three co-ops have filed a petition with USDA to join the federal order. So everything that the processors are arguing here today, they are going to have to deal with this when we do go there. I think that's regrettable because I think the California system worked for awhile.

What's interesting is there was always a discount. You know, $.30, $.40 on the 4b. You guys know the numbers on why that -- you know, why that is now. But what's interesting is, you know, with the huge differences that there have been in a few years since whey value took off, you know, why can't -- when they could make it on that $.30 or $.40 difference why can't they do it today?

You know I hear a lot of accusations, very anti co-op and so I'm just going to take a few minutes and dispel some of those. But before I do that, you know, I'm not going to spend too much time talking about -- you've heard it plenty of times today. I'll just reaffirm that it's a dire situation with dairymen.

Also too I just want to note a few things. As far as I'm aware of, this is the first time the Secretary has ever called a hearing on her own, that I'm aware of. You know, I can't think of another time. I might be mistaken.

And secondly, you guys' line of questioning is kind of hopeful, actually. I have never heard questioning like that before of all the hearings that I've come, so it gives me a little bit of hope. But, you know, a lot of good questions about production and where we're going.

You know, listening to the processors today you would think that we have got it made and everything is great and they are going to hell in a hand basket, you know. And there seems to be this mentality of attacking the co-ops, you know. John Jeter today saying that co-ops were favored in all this. Well, you know, if you look at the price of the 4b versus the Class III I would say the cheese plants were favored in this, you know. I could tell you about why we sold our plant in Tulare. I know exactly why we sold it, you know. I could tell you a lot of stuff about that.

But back to the dairymen. The dairymen are fed up, their hearts are broken. You know, for people that love cows there is nothing that can replace the relationship you have with your herd. It's a multi-generational herd. Your milking the daughters and the granddaughters that your father and your grandfather milked. They're heartbroken.

But like Pete said, after 2009 and ongoing, you know, issues that we have had - and you heard a lot of other dairymen say it today - the competition. Where are you going to put your future? As good as trees are why are you still messing with cows? That's the mentality. And you saw that. We saw that when our prices crashed. You could go to the sales yards; I was there.

I don't live on my dairy. I have a partner and two families can't make a living so I sell semen. And that means I get around to a lot of dairymen on a daily basis and I hear it so I know their mentality. And their mentality is they can't go on losing equity, you know.

You know, it's what I tell them, watching the ceiling at night. They know exactly what I'm talking about. That means, when you go through those bad years you can't sleep because everything that you worked for and your father and your grandfather is about to go away. And you start asking yourself, what are you going to do?

And you think of your kids. You know, Frank Mendonsa was here earlier. He was hoping his kids would be a third generation, you know. But then you start thinking about trees and you get a little hope. And so after a while your mind starts to divorce yourself from being a dairyman, you know. Somebody told me they figured out milk would have to be $40 a hundredweight to be on the level with what the nuts are bringing. you think about that.

You saw -- I'm not humbled like the these guys you saw today come in here. My heart went out to all these dairymen that sat here, contrast with the processors. And I've got nothing against the processors, they're doing their job, but you saw some quiet, humble, hardworking people and they're coming to you guys for help because you guys are the government and you're supposed to be the referee.

And we have come here to these hearings over and over and over again and we are not going to give up. That's why, you know, a few years ago when this process started I was against it. I said, you're not going to get nothing out of the state, let's start the federal order process right now. We heard every excuse. The quota, the quota. Well, David Valadao, Congressman David Valadao fixed that with the last farm bill; now we are allowed to have a quota in the federal order system. So now that that trigger has been set, the mentality of the dairymen in the state now is, well let's wait and see what happens.

You know, leading up to this I ran into a lot of dairymen, hey, what's going on with the federal order. No one is asking me about the state; they didn't even know about this hearing. You know, we just had a hearing, you know, the listening session in Fresno and up and down the state, and "Tell me about it, Xavier." So I'm telling them about it and I go, "Oh by the way, next week we've got a hearing at CDFA" and you should hear the four-letter words come out of their mouth. They are done. They are finished, you know.

In dairymen's terms, when you do business with somebody and they get the better of you, you say, well, fool me once shame on you, fool me twice shame on me, and that's exactly how they feel. So, you know, we have plans to go to the federal order to fix that, keep hope alive.

But it's not about saving dairymen. You know, it's a little insensitive and some of the people in here today what I've heard them say, you know. We're not crying for more money. Or even the word "fair." somebody tried to redesign the word "fair." We are not coming here, we have never came here and asked for more. We have never, we have always asked for what was right, what was ours and nothing more. And so to have somebody try to redefine the word "fair" on a negative I find that kind of sad after all the equity that dairymen have.

So we are not -- us co-op people, we are not trying to get more money because we're greedy, we're trying to save the industry here, which is you guys' job. That's you guys' job to keep milk in the state.

So I don't have to go over all the reasons but if you drive around Tulare, Kings and Fresno Counties you see wells going out. I know my friends and I know the people there and I see wells, you know. I see rigs out there, emergency rigs pumping and a lot of stuff going. And there is a lot of ground fallow, there is a lot. Wells are slowing down, you now, they are not pumping as much.

So anyway, moving on. Land O'Lakes. A gentleman came in here earlier and really pounded, you know, the co-ops and Land O'Lakes and misstated - I'm sure he misstated - we made $200 million profit. Well we didn't make $200 million profit on the dairy side. We've got two divisions, we've got an ag, a seed division and we have the dairy division and the PL is separate on those.

But here is a good question because they keep asking, you know, why aren't they doing this? Do you want to know why we don't do what they said about getting more, you know, from the cooperative system as far as surcharge? Do you want to know why? We had -- I was at the last MAC meeting, we talked about that. And you know why we won't do it? And I almost feel they're daring us. Because we'll get sued. That's why they're so bold to throw that in our face. They'll sue us.

You've heard of CWT? Did you know CWT is being sued by Compassion Over Animals? It's a multi-million dollar lawsuit, we've been fighting it. The co-ops at national milk, we have been fighting it for years, you know. We are being accused of trying to manipulate the market from killing animals. So you don't think -- you don't think we'll be sued?

And here is what I tell our legal counsel. Well they can't win. And you know what comes back at us? Yeah, they can't win but it's going to cost millions of dollars to win and we can't afford that.

And by the way, the federal order that we talk about going to is going to cost Land O'Lakes $14 million a year, that means about $45 million a year to CDI, and yet we are for it. Why? Ask yourself why? Do you think our co-ops like to lose money? No.

A few years ago, three or four years ago we had Mary Ledman. Do you know who Mary Ledman is? She's well-known in the industry. She did an analysis of California and she basically said we are going to start going backwards. Our CEO of Land O'Lakes Chris Policinski asked, what can we do? We asked. Let's go to the federal order.

Will it make a difference? I think what we are asking for here today is pretty close to what we're getting. There are some benefits if we were to do this permanent, you know. We could keep our system that we have had and keep dairymen in the state, you know.

As far as the little cheese plants, my heart goes out to them. But we had AB 31 that they killed that gave them an exemption on a certain amount of milk. They didn't want that. In the federal order they're not going to get that exemption. And by the way, how many little cheese plants just like them are in Wisconsin paying $3 or $4 more a hundredweight for the milk, with no whey capturing. They have a dairy farmer come and get it and feed it to their heifers. There's hundreds of little cheese plants there.

The Ahlems, they talk about an advantage. John Jeter talking about an advantage to the co-ops. They're vertically integrated practically; did you guys know that? Those are rhetorical questions. In Texas they bought up all their former shippers' herds, dairy sites. They're insulated from the market. So are we creating a competitive advantage for them and favoring them now? I mean, think about that. They're insulated from the market. They're getting the whole whey value.

They're buying land, they're building dairies, they're expanding. They admitted it. They had to get rid of 400,000. They're building a plant where most people now are afraid to build a plant because they're not sure if the milk supply is going to be there. I've heard from plenty of processors, we won't build a plant now because we are not sure about milk production. But if you've got the cows and you've got the plant why wouldn't you?

I'm shocked that Pacific Gold, made up of some really good dairy farmers, now have shifted their idealogy. As soon as they own a cheese plant they just shifted. And shifted in a bad way, not even -- not even sensitive to how many dairy families have lost.

You know, you've heard all about the trees, it's true, you know, we've already been through all that.

January, Boca Raton, Florida. This innovation stuff, David Ahlem spoke. He was asked written questions from the crowd. A very good question: Can you explain how innovation will mean -- how it translates to better income for dairy farmers. He couldn't answer the question. It didn't make any sense. It was long and drawn out. It had so many twists and turns you didn't know what he was saying.

So this talk about innovation and saying the co-ops haven't. We've built -- CDI built a big plant in Visalia, you can see it when you drive by the 99. Land O'Lakes, we built a big cheese plant. And saying, not innovative. Our powder plant is state of the art. It makes all the powders that the world wants. CDI has built that too. Not all -- maybe there's more to do but we are innovative. So, you know, everything you hear here today, it overwhelmingly, you know, I say is smoke and mirrors.

Make sure I didn't forget nothing because this is the last hearing. I don't want to walk out and say, I forgot.

Oh, I wanted to explain the grinding, the grinder dairy. When Southern Cal -- those weren't grinder dairies those were bulldozer dairies. And they built houses and moved up north and built bigger dairies. They didn't go out of business, they didn't plant trees.

I can't really speak in Sonoma. Maybe wine grapes were just better, more attractive.

I'll define grinder dairies for you and it's sad when you drive by them. When you see a pile of rubble. The grinder dairy is where you've had it with the dairy business and you either sold -- mostly you sold and it's being -- the dairy is being ground out and it is going to be leveled over and trees are going to be planted on there. That's a grinder dairy. And that's something new, we have never seen that before.

Thank you for letting me testify today.

HEARING OFFICER SUTHER: Any questions from the panel?

Thank you for your testimony.

Mr. Rizo.

Mr. Rizo, could you please state your full name, spell your last name and state your affiliation for the record.

MR. RIZO: Ivan Rizo, R-I-Z-O, I am the CEO and co-owner of Rizo Lopez Foods in Modesto, California.

Whereupon,

IVAN RIZO

Was duly sworn.

HEARING OFFICER SUTHER: Would you like your written document entered as an exhibit?

MR. RIZO: Yes.

HEARING OFFICER SUTHER: It will be Exhibit number 59.

(Exhibit 59 was entered into the record.)

MR. RIZO: Mr. Hearing Officer and members of the Hearing Panel:

My name is Ivan Rizo and I am the CEO of Rizo Lopez Foods. Rizo Lopez Foods is located at 201 South McClure Road, Modesto, California. We produce and market various varieties of Hispanic cheeses and other dairy products under our Don Francisco brand and produce some private label and conventional cheese. Rizo Lopez Foods was founded in 1990 by me and my brother Edwin in Riverbank, California. The strong acceptance of our products in the marketplace over time required us to move from our original plant/facility in Riverbank to a 130,000 square feet new facility in Modesto in 2012. This new investment not only included the land and empty building but also much new equipment. We employ approximately 220 people in the plant with more to be hired as we grow in the new plant. We sell most of our products through a network of wholesalers who supply some of the finest supermarkets from California to Florida. While sales growth has been moderate each year, our profit or loss is primarily dictated by the cost of milk, as milk is approximately 60 percent of our total product cost.

We strongly oppose the Producer Proposal because of the financial harm to our company. The milk price increase could result in $224,000 to $320,000 per month in additional cost to our company. You can see it on Attachment A. This annualizes out to a range of between $2.6 to $3.8 million in additional cost which would reduce our profit from current levels by 50 to 70 percent. See Attachment B.

Our facility is sized and designed to increase not only current and new products but also efficiency over time. The investment of the new facility and new equipment increased our capital needs greatly over the last two years. If the Producer Proposal cost increases take effect, we will not have the profits necessary to fund both current and future capital investments. Projects on our list include equipment that expands our capacity, improves whey processing and reduces our need for City water that has cost us over $2.5 million. These projects would have to be "put on hold" since we would not want to increase our debt load during a time of shrinking profits. We do recover some of our whey bit it amounts to only approximately one percent of our total revenue.

Due to the significant amount of the increase requested in the Producer Proposal, the number of competitors in the market, and price resistance from customers, the Company would suffer by having to absorb the full impact of the cost increases initially and prices increase could only be implemented gradually. With the price increase, we would expect demand to be reduced, causing a further erosion in our profitability. We expect our production hours then would need to be reduced from a five day work week to a three to four day work week. This would equate to a loss of wages in our community of approximately $215,000 per month in our employees' community.

In summary, we are opposed to the producer proposal because our cost of milk would result to our customers and eventually the consumer ranging from approximately $.07 to $.11 per pound, see Attachment C, in order for us to recoup our milk costs. And all of this could not be passed on immediately and only incrementally over time in our highly competitive national Hispanic market where sales are made or lost over probably $.0025 per pound of cheese. We also will not be able to invest in the capital expenditures listed above because we could not borrow the money needed and put additional financial pressures on the Company. Again, we oppose the producer proposal as written. We would support the Dairy Institute proposal but we prefer the status quo. This concludes my testimony.

Thank you, Mr. Hearing Officer, and we appreciate the opportunity to testify before this panel. And we request to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Any questions from the panel?

MR. SHIPPELHOUTE: Looking at your Attachment C. It appears that you are indicating what the price increase for your cost would be -- the price increase needed to recover any milk price increase at various costs per hundredweight; would that be --

MR. RIZO: Yes.

MR. SHIPPELHOUTE: What kind of yield factor? What products are you using when you developed this table?

MR. RIZO: We are mostly Hispanic cheeses. Our basic products are Hispanic cheeses, queso fresco, cotija, panela and Oaxaca.

MR. SHIPPELHOUTE: So your yield factor is obviously significantly different than a cheddar cheese.

MR. RIZO: Yes, sir. But our market is completely different than the cheddar cheese, too.

MR. SHIPPELHOUTE: Sure. Is your marketplace pretty saturated?

MR. RIZO: Yes it is.

MR. SHIPPELHOUTE: It's pretty competitive with other --

MR. RIZO: Yes it is. So we have to go out and compete in Florida and the East Coast, which is becoming increasingly difficult.

MR. SHIPPELHOUTE: That's all I have.

MR. EASTMAN: Go ahead, John.

MR. LEE: How much of your overall sales is out-of-state sales?

MR. RIZO: About 25 percent.

MR. LEE: Thank you.

MR. EASTMAN: So what do you do with your whey stream that comes off of your cheesemaking process?

MR. RIZO: We process some of it. We do it at 24 percent.

MR. EASTMAN: So you concentrate it?

MR. RIZO: Yes, we concentrate it to 24 percent and then we sell it to another company that further processes it.

MR. EASTMAN: Okay. What is the pricing based off of your whey stream, how is that negotiated? Is it based off of the WPC market or dry whey or some other price series?

MR. RIZO: It's based on the Western Dry Whey at this moment.

MR. EASTMAN: Okay.

MR. SHIPPELHOUTE: Another question I have. On page 1 of your testimony you indicate that milk is approximately 60 percent of your total product cost.

MR. RIZO: Yes.

MR. SHIPPELHOUTE: I've heard other folks' testimony of 90, 95 percent. So I'm assuming your product is much more labor intensive?

MR. RIZO: Yes.

MR. SHIPPELHOUTE: So your labor costs are significantly higher than the other folks who may have testified earlier today?

MR. RIZO: Yes. Queso fresco, for example, takes a lot of labor to do.

HEARING OFFICER SUTHER: Thank you for your testimony.

MR. RIZO: Thank you.

HEARING OFFICER SUTHER: Mr. Kasbergen.

Mr. Kasbergen, would you please state your full name, spell your last name and state your affiliation for the record, please.

MR. KASBERGEN: Cornell Kasbergen, K-A-S-B-E-R-G-E-N. I own and operate a dairy farm in partnership with our son and daughter-in-law in Tulare, California.

Whereupon,

CORNELL KASBERGEN

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any written testimony that you would like to enter into the record?

MR. KASBERGEN: No, sir.

HEARING OFFICER SUTHER: Thank you. You may proceed.

MR. KASBERGEN: Just a few comments and notes, no really prepared comments.

I think if you look at the California dairy industry through the '90s and the 2000s we were the envy of the world. We were the innovators. People came from around the world to see our industry. And there was a shift in the mid-2000s.

And just to back up, I also own and operate a dairy farm in Wisconsin in partnership with my brother.

I think in the mid-2000s there was a shift when we weren't getting the full value of the whey. And I think it's evidenced by some production numbers that from 2008 through 2014 California's milk production only grew 2.5 percent. If you take the previous twenty-some years we probably averaged 3 to 4 percent. So over that six year time period a .43 percent growth rate is pretty flat. Uncharacteristic of this industry. So what happened?

If I compare my milk prices in California to Wisconsin, which I provided testimony in May 2012, consistently a $2 to $3 difference. More money in Wisconsin versus California. We are really, really good at what we do but we cannot overcome a $2 to $3 a hundredweight difference. To even maintain our milk production during this time period is phenomenal. I think it's a testament to the type of people, business people we are. Phenomenal. No one would -- I mean, I'm constantly amazed that we have even done this. But I think what has happened in the last five months is a fundamental shift.

We are on -- we have peaked. I would content going forward we are going to lose 2 to 5 percent for the foreseeable future, year over year. The only thing that is going to slow it down would be to give us the money that everyone else in the rest of the world pays. A Class III or a 4b whey factor that comes close to the federal order. Now this whey factor doesn't get close to the Class III price, it's still $.40 short. Probably a historical number that was referenced earlier today.

We hear a lot about depooling. Hilmar said they bought 1,000 loads for underclass. Just did some quick calculations. A thousand loads at the Texas plant; .15 percent of the milk production. Insignificant. The depooling in the federal order only allows a handler to depool. If we had a similar law -- if our system was similar there would be only one plant that could depool its milk. The co-ops handle the rest of the milk that goes to these plants. So all the cheese plants that say, well, they don't pay -- they are not required to pay the minimums.

Reading Tom Wegner's testimony from I think it was the May 2012 hearing as well, his statement said that all plants regardless pay the Class III price. The handler doesn't have to pool the milk. So when Land O'Lakes sells milk to a Class III plant in the federal order only Land O'Lakes can depool that milk, not the plant. The plant still is required to pay the Class III. The same thing would have happened here in California with similar rules.

But the misconception is that those plants don't pay the minimum. In all the years, in the 17 years that we have had our dairy in Wisconsin we have never been paid less than Class III. We have been paid more than Class III. So when the Dairy Institute and other cheese plants say they don't have to pay the minimum, they're right. They pay more than the minimum. It's a fact. If you pay less than Class III in Wisconsin or anywhere in the Midwest you wouldn't have any milk. Very simple.

This fundamental shift, we're losing -- we're losing dairies, we're losing cattle, we're losing ground that we can buy feed on. We're farming less. We ourselves this year for the first time planted 120 acres of almonds.

You know, our future. I love what I do, I think we are very good at it, but as Frank Mendonsa said, we're tired. I mean, it's evidenced today by probably about a handful, maybe 10 producers out of the 1,500 show up today. The strong message to you and the Secretary, lost faith. We put a lot of effort going towards the federal order because we have lost faith in you to be the referee, because you haven't been fair and equitable, as evidenced by what's going on with milk production.

Cattle are leaving the state. When dispersals happen, 60 to 70 percent of the cattle are leaving. A 5,000 cow dairy in Bakersfield, a grinder dairy that was probably 10 years old, state of the art, 1,500 acres, gone; more coming.

I, like my good friend Xavier Avila, hope this is the last hearing that we have. I'm optimistic that we are going to have a federal order that will fix what you have the power to do and have had. But for whatever reason you have decided to put this industry on the edge and you have pushed it over the edge. And it's sad because we've got dairy producers that are the best in the world at what they do but we cannot overcome, you know, the $1.80 a hundredweight or $2 a hundredweight that we're getting short on the 4b price.

I would hope you would find it in your wisdom to -- you have the power to correct it. You have the power to at least hold this production where we're at. Because if you don't and we've got the 2 to 3 percent, we're going to lose production. And what we have done, one thing I did fail to mention. Over that 2008 to '14 time period where we only grew 2.5; Wisconsin grew 13.5. The United States grew 8.4. We have given up market share. You know, we went from 11 percent market share to 22 because we were close on pricing.

But when you discount pricing. And we have held our own for awhile but you can see the writing is on the wall. I think the producers in Wisconsin are probably happy because they've taken advantage of this just like we have. I have a neighbor, a neighbor here in California milking 4,000 cows, just pulled a 5,000 cow permit 30 miles from our dairy in Wisconsin. The cows are going to Wisconsin, they're going to go back home. I hope they don't have too, it's too damn cold over there. The weather is a lot nicer here.

I just hope you find it -- you have the power to save this industry from a lot of pain. Because we are going to go through a lot of pain again. I almost feel like it's '09 all over again. And we experienced a hell of a lot of pain in '09 and I don't -- it's not necessary, we don't have to go through it. Why should we bear the brunt of pricing of this pricing system where we don't have a fair shake.

It's like giving somebody a 50 yard head lead in a 100 yard dash. We're good but we're not that good.

I was sitting here listening to the plants and the processors and thinking, we must have the most efficient dairymen in the world and we've got to have the most inefficient clients because they can't make it like the rest of the world. Thank you.

HEARING OFFICER SUTHER: Are there any questions from the panel?

Thank you for your testimony.

Mr. Rutherford.

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

MR. RUTHERFORD: John Rutherford, R-U-T-H-E-R-F-O-R-D. I am Dairy Procurement Director with Alouette Cheese. Whereupon,

JOHN RUTHERFORD

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other materials other than the one you have presented?

MR. RUTHERFORD: I do not.

HEARING OFFICER SUTHER: It will be Exhibit number 60.

(Exhibit 60 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. RUTHERFORD: I am John Rutherford, Dairy Procurement Director for Alouette Cheese USA. I handle the purchasing of the milk, cream, nonfat dry milk and other dairy ingredients that are supplied to our three facilities as well as the dairy economics and policy issues that impact Alouette.

Alouette Cheese USA, or AC-USA, owns three manufacturing facilities which are located in New Holland, Pennsylvania, Lena, Illinois and City of Industry, California. We employ about 250 people over these locations, producing gourmet cheese spreads, soft-ripened cheeses, goat cheese and cream cheese. Our plant in City of Industry is known as Fleur de Lait-West, or FDLW, and produces nothing but cream cheese.

AC-USA sells into all major marketing streams, including wholesalers, grocery and club stores, food service and industrial customers. The production from FDLW is primarily bulk packaged for industrial and food service customers in the Western half of the U.S. We also support a growing export business from this location.

I am concerned with the effects that the proposals before CDFA today would create for Fleur de Lait-West. The whey not captured in our cheese is actually of negative value to us, so the prospect of being forced to pay more is not appealing.

Whey not included or captured in our cheesemaking is lost. It is separated from the curd, collected and hauled away at our expense. A minority of it, approximately one load per week, is hauled away at no charge to a company that has a use for it in their process. However, the remainder is hauled away. WE pay for 100 percent of this cost and there is no payment back to us for the contents.

It is important to note that not all whey is created equal. The whey from cream cheese production has a lower pH, which creates issues for further processing. Unfortunately, Low Acid Whey, or LAW, cannot just be commingled with whey from other plants. It cannot even be diluted into a larger volume of "regular" whey for further processing. When it is processed, it must be with other low acid whey. I have read. because it has actually been an internal project for me, that there are markets and uses where dried low acid whey is preferred, but to date this market has not been interested in Alouette as proved by zero calls from anyone looking to add our low acid whey to theirs. We are not large enough to make it economically feasible to invest in the equipment to do this ourselves.

We are not the market leader in the cream cheese market segment in terms of volume produced and sold. As such, we are more of a price taker. We are not able to set the market price, instead it is set for us by the market. We must produce and distribute our product within this boundary already set by the market while leaving enough margin available to provide a return for this activity.

When the price of one of our ingredients is raised without any improvement in its performance, there can only be a negative impact on our margin. This reduces the return on the investment in the plant. A reduced return means less is available for ownership, less retained earnings available for future investment and less payback for future activity of the plant.

Reduced payback, leading to cuts in investment in the plant undermines the long-term competitiveness of the plant. Our best option would be to review and possibly reformulate our recipe and hence a change in our final product. If we were talking about a new recipe to allow a more efficient cost or develop a valued attribute, there would be a future benefit. But when it is only to dampen or avoid the negative effect of a price change it is not a given that this would reflect well in our future sales volume. Most likely a reformulation would be away from raw milk, towards some other dairy ingredient.

In summary, the effects to FDLW of increasing the cost of whey are all negative. We would have an increase in the cost of milk for our product that does not offer any recoverable benefit. Thus, our margin will be reduced as will be the long term viability of our plant, at least as a facility located in California. We can attempt to change our recipe but at best this would only reduce some of the price effect and could change some characteristics of our product.

For the reasons above I urge Secretary Ross not to implement either proposal. Both proposals are the equivalent to a tax on our facility for manufacturing with California produced milk. Although at least in theory a tax means money is collected to fund some greater good. In this case, Alouette receives no benefit, only the cost. Alouette Cheese is looking for opportunities to drive costs out of our production, not add them.

If we had to choose between the two proposals, our choice is clearly to the Dairy Institute proposal. The Dairy Institute proposal is certainly more reasonable than the CDC/MPC/WUD proposal in that it represents a cost I might be able to pass off if there was someone willing to purchase our whey for further processing. The CDC/MPC/WUD proposal seems to expect that any plant, no matter its size or products, will be able to produce and market the whey that it otherwise pays to dispose.

Thank you, Secretary Ross and members of the hearing panel, for the opportunity to present my testimony today.

HEARING OFFICER SUTHER: Any questions from the panel?

MR. LEE: Yes. I'd like some clarification from you regarding your plants in Pennsylvania and Illinois. Are they similar plants to the one in Industry?

MR. RUTHERFORD: The plant in New Holland, Pennsylvania, yes, that is where we do our gourmet spreads as well. That's the other facility where we primarily make cream cheese. Lena, Illinois is the soft-ripened and actually where we make the goat cheese too.

MR. LEE: Do those plants also have the same issue with whey, disposal of whey?

MR. RUTHERFORD: Yes.

MR. LEE: Do you handle it similar to how it is handled at the California plant?

MR. RUTHERFORD: For the plant in New Holland, yes. We pay to have it hauled away and it goes to a slight different -- it actually goes into a methane digester in New Holland. In Illinois, part of our whey was able to be captured and delivered to a plant that was doing some further processing with it until anytime here we are about to have the plug pulled on that. I got a call last week. Well, we were able to sell it. Now they are saying that due to the decreased whey market the best they can offer us is to haul it away, which is still better than paying to have it hauled away. That would be the whey from our soft-ripened cheese so it's slightly different anyway..

MR. LEE: To the best of your knowledge, when you procure milk in those locations, the out-of-state locations, do you normally pay the federal Class III price or is it a lower price or a higher price?

MR. RUTHERFORD: Generally we pay the Class III price. Our average cost of milk would be a little lower than that in Illinois where some of the year -- because in the springtime we have instituted a project where we can -- during spring flush it is quite common to be able to buy milk at underclass. So depending on how the discounts are running we will make some extra cheese then. I am not able to do that in New Holland.

MR. LEE: Thank you.

HEARING OFFICER SUTHER: Any further questions?

Thank you for your testimony.

Mr. Doornenbal.

Mr. Doornenbal, would you please state your full name, spell your last name and state your affiliation for the record, please.

MR. DOORNENBAL: My name is Rien Doornenbal, the last name is spelled D-O-O-R-N-E-N-B-A-L. I'm a dairyman from Escalon.

Whereupon,

RIEN DOORNENBAL

Was duly sworn.

HEARING OFFICER SUTHER: Would you like these documents entered into the record?

MR. DOORNENBAL: I would.

HEARING OFFICER SUTHER: They will be Exhibit number 61.

MR. DOORNENBAL: Thank you.

(Exhibit 61 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. DOORNENBAL: So I am here today to support the proposal made by Western United Dairymen, Milk Producers Council and CDC to change the whey value calculation as it relates to the 4b price.

I would like to make a couple of comments on some of the testimony that I heard today. First of all, Dr. Erba talked about the Department's concerns. My words would be, the Department's preoccupation to balance the state's milk supply through the pricing system. Dr. Erba made a comment that I have often thought myself and believe strongly myself that it is not the Department's job to control the supply of the milk, that is the job of the co-ops and of the processors. And they can easily do that and have done that through the base systems and through contracts.

Another person that testified that I would like to comment on is Tom Barcellos, one of my fellow dairymen. I am here mostly to talk to you about what's happening in my area of the state. It's quite a ways from Tom, where Tom lives. But what is happening in my area of the state is exactly the same thing that's happening in his area in that there are a lot of us dairymen that are waiting to see what is the outcome of this hearing. We're waiting to see what will be the outcome of the proposed federal milk marketing order. We are not going to continue to produce milk at the prices that we are receiving relative to the prices that other dairymen receive in the rest of the United States.

Frank Mendonsa testified that the mindset of the producer community has changed since 2009. And I am here to tell you that I couldn't agree with him more. I was at a wedding recently and talked to a rather prominent dairymen from a very prominent dairy family and he said, we're done expanding the dairy business in California. We'll keep milking cows but we are not interested in expanding our dairy business. We are going to be working more on permanent crops, we are going to be working on farming other crops. One of the crops that he is really interested in is farming tomatoes. And this was a large dairyman.

The smaller dairymen are also struggling with the same issue, what are we going to do? They know that they cannot, that it is not worth it to be in business in California and receive a price that is continually lower than the surrounding states.

I believe at one time we could produce milk here in California for less than other states. I think that when I really think about the reason -- and I have to go back because although I wasn't in business yet when milk pooling started in California I was old enough to be aware of that event. And I actually went in business with my dad, my father, in 1975 so I have seen this business, this dairy business in California grow by leaps and bounds.

And I never dreamt that in my end game -- I'm 64. I think that in my career I'm probably in my end game. I never dreamt that I would see what looks like to me the death of the dairy industry in California. Another thing you realize when you're 64 is that life can throw you some strange curve balls once in a while, you just have to learn to live with it.

I believe that one of the reasons that the dairy industry could produce milk for less than the rest of the country at one time really didn't have anything to do with cheaper costs of goods. I think what it had to do with, we were on the cutting edge here in California as far as learning how to manage and operate large herds. That was our, that was our advantage. And as Cornell stated, the dairy industry in California at one time was the envy of the rest of the country. So the rest of the country came here and they learned; they learned how to dairy the way that we were dairying.

And the only difference today if you look at the facilities of an efficient dairy - as efficient as you can be in California - and an efficient dairy in Wisconsin, and Cornell has both; the only difference is they put an end -- they cap the ends of their free stall barns and they have side curtains so they can control the winter. For the rest, the milking parlors are the same, the inside of the free stalls are the same, the rations are very similar. So we are not more efficient anymore than the rest of the country. We just can't take a lower price for our milk that perhaps at one time we could because we made it up with efficiency. It's not that we have gotten less efficient it's that the rest of the country -- And I was in Europe a couple of years ago and they are also -- they have also become very efficient as far as how they produce milk.

Most of my -- most of my fellow dairymen in the Escalon area are diversifying into permanent crops. Now this is not because, necessarily because permanent crops are so lucrative. This is because they are just sick and tired of the dairy business. And they are hoping, they are hoping that things might just change. But they are also realistic enough to know that things won't necessarily change.

Now I have given as my exhibit, the top picture, if you would look at it. That was a dairy I was -- I took a picture of that dairy yesterday. And what you see there, you see corn growing; in the background you see a free stall barn.

Now if you please would, please take a look at the second picture. That is the exact same dairy. That is the exact same free stall barn except it's taken from the opposite side of the dairy. And I would ask anyone of you from the panel to volunteer, what do you see growing on that side of the dairy?

MR. SHIPPELHOUTE: Depending on which one, number two, one of them is almonds and one is walnuts.

MR. DOORNENBAL: The third one is walnuts, let's not talk about that quite yet.

Also if you notice on the top of that free stall barn you'll notice that the roof is deteriorating. What you see there, and I have known this dairyman all my life, I haven't talk ed to him in a couple of years, but the picture tells me the story. The picture tells me a lack of commitment to the dairy industry. And I know this guy, he is a true-blue dairymen, he loves his cows. You know what, he doesn't love them enough to go broke. He's looking. He's looking for another avenue so he can make a living.

The third picture is a picture that I took on my own dairy. You see walnuts growing there. And behind the walnuts you see a silage pile and behind the silage pile you see a hay barn, okay.

I was at this exact same spot a couple of years ago and I testified that I had changed the name of our business from Doornenbal Dairy to Doornenbal Ranches because we were diversifying. We have diversified into growing for our cows. We are also diversifying into permanent crops. It was kind of humorous to me because later I heard feedback from one of my fellow dairymen who sees some of you or sees those of you on the panel more often than I do and he said, you know, that Doornenbal guy, that ranches guy, you know, he's a really smart guy, he's diversifying. When I heard that I was just, I was floored because you didn't get my point. I wasn't diversifying just to be diversifying, I was trying to figure out how I was going to make a living because it didn't look like the dairy business was going to do it.

And I'm like Cornell and I'm not ashamed to say it. I'm good at what I do and we have a good crew of people that make our dairy good at what they do. But we can't do it for less money than what the rest of the country gets.

We have four children. Two of our sons decided to go in the dairy business. And I said, you know what, you go work for somebody else. And if you still behave yourself, you can prove what you can do, I'll see if I can help you get started on your own. They came back to me, they said, Dad, we want to start somewhere else. Okay, where are we going to go? You know what they said? Individually, anywhere but California. Okay, anywhere but California. And that was before we had some of these milk price debacles. That started out with the regulations. So the oldest one started in another state in 2008 and later on his brother followed him to another dairy out of state.

And we hear -- I've heard a lot of talk today about that a lot of dairymen -- what the dairymen get paid in other states is not the Class III price and what the processors pay is not the Class III price because of all the depooling that goes on. Well I'm here to tell you, and I swore to tell the truth, that we have never -- my sons have never, as long as they have been in business out of this state - one of them started in 2008, the other one in 2012 - have never received less for their milk, and it goes into cheese, than the Class III price. Not one month; not once. So I don't know what's going on, all these stories, but that's what I know.

I think one of the most disheartening things to me about being in the dairy business in California is dealing with this department. Might I read to you the California

Food and Ag Code Section 62062? You know what I'm going to be reading to you. It says: "The method for 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 here I have in front of me the Hearing Panel Report and it's based on the public hearing held here on May 31 and June 1 of 2012. So we addressed this issue of having a minimum price for manufactured products that had a reasonable and sound economic relationship to the surrounding states was addressed here.

An analysis of the correlation between Class 4b and Class III - which would be Federal Order Class III - prices shows that the current Class 4b price is highly positively correlated and moves closely with the current Class III price. A positive correlation implies that as one price moves up or down the other price moves in the same direction.

Now here is the part that makes -- a couple of the producers talked about trust. This is why we don't trust you. Although the spread between the two prices has grown in recent years the correlation has remained relatively consistent, indicating that the two prices continue to maintain a reasonable and sound economic relationship.

I am going to respectfully tell you as

representatives of Karen Ross that that explanation that even though Class 4b and III, even though that spread has increased, the fact that that spread is becoming more and more constant with each other or it doesn't vary as much as what it used to, that that's what it means to maintain a reasonable and sound economic relationship? I am going to tell you respectfully, and I'd like you to pass this on to the Secretary, that is an insult to the dairymen's intelligence.

Cornell says we have lost faith. We have. We have lost faith with this department; we have lost faith. This is the second time that I have testified to this issue. I am not a person who wants to grovel. I am not going to get on my hands and knees and I am not going to beg. This is my second time here; this is the last time that I am going to be asking you to do something about the 4b price. Because I don't have time to fool around with you guys because there are other things to do. There are other places to invest the money, there are opportunities. So the decision of what happens to the California dairy industry right now, you have a huge responsibility.

(Applause.)

HEARING OFFICER SUTHER: Thank you for your testimony. We will now take a real quick five minute break and they we will be back with Rob Vandenheuvel.

(Off the record at 5:48 p.m.)

(On the record at 5:56 p.m.)

HEARING OFFICER SUTHER: We are now back on the record. It is 5:56.

Mr. Vandenheuvel, could you please state your full name, spell your last name and state your affiliation for the record, please.

MR. VANDENHEUVEL: Yes. The name is Rob Vandenheuvel, V-A-N-D-E-N-H-E-U-V-E-L; I am the General Manager of Milk Producers Council.

Whereupon,

ROB VANDENHEUVEL

Was duly sworn.

HEARING OFFICER SUTHER: Do you have any other statements, written statements, other than the one you've presented you'd like entered as an exhibit?

MR. VANDENHEUVEL: No.

HEARING OFFICER SUTHER: It will be Exhibit number 62.

(Exhibit 62 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. VANDENHEUVEL: Thank you. Hearing Officer and Members of the Panel, my name is Rob Vandenheuvel and I am the General Manager of Milk Producers Council, a nonprofit trade association representing California dairy farmers.

I am going to skip a little bit through my written testimony, a lot of these items have been covered, one of the perks of being later in the day.

Our dairy families appreciate the Secretary calling this hearing on her authority under the Food and Ag Code. We believe the testimony we are about to give, as well as that of the other producer groups, individual producers and cooperatives, will provide ample evidence that a significant upward adjustment to the Class 4b monthly milk price calculation is warranted.

Before going into the details of the producer-sponsored proposal, the hearing notice published by CDFA asked that we provide "the economic conditions that would support adjustments to the current Class 4b pricing formula."

The most logical place to start is an analysis of CDFA's own published Cost of Production compared to the average prices paid throughout the state. In fact, as referenced in the CDFA's notice, the Code specifically directs the Secretary to consider the "reasonableness and soundness" of California's milk prices - the combined income from all classes - in relation to the cost of producing milk and incorporating a cost of management and a reasonable return on necessary investment.

You can see the table below there. Those are figures from the cost of production unit. Both the Cost of Production noted there per hundredweight And the Milk Price Received, which is a calculation using the Income Over Feed Cost to add back the feed cost. That's the mailbox milk price that applied to those dairies that were surveyed. You can see that over the course of 2008 to 2014 there were some highs and there were some lows, with an average of $.77 per hundredweight lost each and every year for that seven year period.

The next table applies these figures to a sample dairy with 1,000 milk cows, producing an average of 70 pounds of milk per cow per day. While a summary of the annual data appears here, a monthly breakdown is attached to the testimony. You can see there taking that $1.87 loss in 2008, a $5.05 loss in 2009. Move over to the next category, a 1,000 cow dairy would be affected in those two years by a $481,000 loss and a $1.28 million loss. So you take that all the way through the seven year period. And a dairyman that theoretically started in 2001 milking 1,000 cows at 70 pounds of milk per cow per day over that seven day period, if they started January 1 of '08, they could be expected to be $1.37 million in the hole today, given the cost and price data in CDFA's own Cost of Production Unit.

That next table there is a linear graph showing that. And you can see while 2014 was a strong year for milk prices, in the context of the past several years we are still an industry very much trying to recover.

CDFA's Cost of Production Unit has not yet published the first quarter of 2015, it's expected to be published later this month. However, we do know, as has been noted several times today, that the prices paid to dairy farmers since the fourth quarter of 2014 has dropped significantly.

Some might point to the general U.S. dairy market trends as a source of the volatility. While there is certainly a cyclical nature at play generally in the U.S. dairy industry, California dairy families have been realizing lower milk prices than our out-of-state colleagues. CDFA maintains data on the mailbox milk prices in California, compared to other select regions of the country. On the next page you can see a printout of the most recent, the 2015 mailbox data. I did include an attachment to this testimony showing the past several years. I included 2015, however, in this narrative because this is a hearing about current costs and the current challenges.

As demonstrated by this information, the current state of the industry isn't simply a story of a national trend downward, but rather a significant disadvantage to our out-of-state competition. When competing with dairy industries in other states, whether that be for animals or feed, our California producers are at a significantly weaker relative position than our competition. In addition to price alone, another indicator of this is the comparison of California's production growth compared to other states.

And you can see I have presented there data on production in California versus the United States. Cornell Kasbergen a few minutes ago gave very similar data so I won't go into that but that's over the last seven years, the total cumulative growth for California versus the U.S. And it is also worth noting that the number in the U.S. includes California. California brings that average down but we are a major contributor to that number. So the 80 percent of the milk produced outside of California would have an even larger growth than that.

The next page, page 4 there, shows the more recent data, January, February, March and April. Showing the Year-Over-Year declines in California versus the Year-Over-Year gains in the U.S. And again the U.S. numbers do include California so it would be even more pronounced if you took California out of that U.S. calculation.

Need for a Significant Adjustment to Class 4b.

Today's hearing is correctly focused on the one area of the California pricing system that warrants immediate and significant adjustment by CDFA. The current Class 4b formula generated a monthly minimum price for approximately 45 percent of the pooled milk sold in California. Those sales to California manufacturers of cheese and whey products clearly represent a significant portion of the income or the overall revenue of the California dairy families.

Section 62062 has been frequently referenced by producers in discussions about the 4b price. I am not going to read it again but it deals with a reasonable and sound economic relationship.

In evaluating this requirement of the Code, the first issue is to identify an appropriate benchmark for the national value. The reasonable relationship is to a national value so what is an appropriate national value? In the case of cheese and whey products -- milk sold to manufacturers of cheese and whey products, producers have long argued that the Federal Order system provides an appropriate benchmark. There are two primary justifications for that argument: 1, the federal order monthly minimum price serves a similar function to the California monthly minimum prices; and 2, a significant volume of milk produced and sold outside of California falls within the federal order jurisdiction.

First, the function. While federal orders are not identical to the state order here in California, they do publish monthly minimum prices for milk sold to manufacturers of cheese and whey products, the Federal Order Class III price. This minimum price applies to milk that is regulated under the various pools operated by the ten federal orders around the country.

Second, the volume. According to USDA, the total U.S. milk production in 2014 was 206 billion pounds. About 42.3 billion pounds was produced in California, leaving a net of 163.7 billion pounds of milk produced outside of California. USDA, and I included this document as an attachment to the testimony, reported that 129.4 billion pounds of milk were received last year by handlers regulated under the ten federal orders. That means approximately 79 percent of the milk produced outside of California is sold to handlers regulated under the federal order system. All ten federal orders use the same formula in calculating a Class III hundredweight price.

With the recognition that the federal price is, in fact, an appropriate benchmark on which to measure our 4b against, the next step is determining what a "reasonable and sound economic relationship" is. MPC would submit the following considerations in substantiating the lack of a "reasonable and sound economic relationship" when comparing the 4b price to the Federal Order Class III.

First bullet: From 2000 to 2009 the California 4b price averaged $.41 per hundredweight below the Federal

Order Class III price. From 2010 to present that gap has widened to $1.82 per hundredweight. We would ask how these two starkly different scenarios can both be considered a "reasonable and sound economic relationship"?

Second bullet: From 2000 to present, the other main manufacturing class of milk, Class 4a, averaged $.30 per hundredweight below the Federal Order Class IV. With the exception of '07, when a gap of $.96 per hundredweight occurred due to some extraordinary circumstances, there hasn't been a year when the average Class 4a price was more than $.44 per hundredweight below the Federal Order Class IV price. From 2010 to present, the gap has been $.24 per hundredweight. We would ask again how a $.24 per hundredweight gap can be a 'reasonable and sound economic relationship" for Class 4a manufacturers, who by the way most of which are dairy-owned plants currently, while during the same period maintaining a $1.82 per hundredweight gap for Class 4b manufacturers.

Prior hearing panel reports on this issue have included commentary about the various pooling rules in California compared to the Federal Order system as the main justification for the large gap in Class 4b versus Federal Order Class III. However, those same pooling differences existed in 2000 to 2009 when the relationship between those prices was much closer. Further, those same pooling differences existed for California's Class 4a milk, which has maintained a much closer relationship.

The bottom line is that MPC and the California dairy families we represent believe there is no justification for the significant gap we've seen between California's Class 4b price and the Federal Order Class III price. That is why MPC and our fellow producer organizations and cooperatives have strongly supported the Secretary's decision to focus solely on the Class 4b formula in considering price adjustments in this hearing.

The Producer Proposal.

Given all the discussion above, MPC would certainly have liked to present a permanent proposal that resulted in a Class 4b price equal to the monthly Federal Order Class III price. However, given the specific limitations included in the hearing notice that all proposals be temporary in nature and only the whey-related calculations may be adjusted in the hearing, we testify today in full support of the joint proposal submitted by California Dairy Campaign, Western United Dairymen and ourselves. Testimony has already been provided earlier today by Annie AcMoody of Western United Dairymen, delving into the details of the unified producer proposal. Therefore, I would simply echo Ms. AcMoody's comments with regard to those details.

As to the impacts the proposal would have on California's prices, I would refer to the summary document. It's got a long title but it's the document that was put out as a background packet by CDFA staff prior to this hearing. The analysis shows that under the producer proposal, average Class 4b prices over the past five years would have been $1.46 higher. Over that same time period the average Class 4b price at $16.36 a hundredweight average for that period, was $1.84 below the actual average Federal Order Class III price, which was $18.20 during that time period. Taking all this information into account we can see that had the producer proposal been in place the past five years the average 4b price would have still, despite all the testimony we've heard earlier today about the huge increase, it still would have been $.38 a hundredweight below the Federal Order Class III price. A much smaller margin, which is why we support this proposal, but a continued discount. The CDFA data is consistent with our own internal analysis, which showed that addressing only the whey-related portions of the formula would continue to result in a discounted 4b price, relative to the Federal Order Class III, albeit at a much smaller discount than we currently see.

In addition to the impact directly on the 4b price, CDFA's analysis shows that the impact the proposal would have had on the Overbase prices: an average increase of $.67 per hundredweight higher for the period of 2010 to 2014. Now there is no way t get that money back that we've lost, the time has past, but it is an interesting analysis showing the $.67 that the proposal would have provided in that five year period versus the $.77 gap between the cost of production and the milk price received during that time period. it would have gone a long way in closing that gap and putting our producers on much more sound footing financially.

On a more current basis, using May 2015 market data, we see that the *Dairy Market News* price for Western dry whey was $.4325 per pound. The current 4b price generated a $14.63 per hundredweight price, while the producer proposal - if in place - would have generated a price of $15.56, a $.93 per hundredweight improvement. That would still represent a discount to the May 2015 Federal Order Class III price which was announced today ta $16.19, but would provide the immediate adjustment to current pricing levels that MPC and our fellow producer groups and cooperatives would hope the Secretary would support.

The Dairy Institute Proposal

In addition to the unified producer proposal, MPC has had an opportunity to review and analyze the proposal submitted by the Dairy Institute on behalf of the dairy manufacturers they represent. We believe this proposal falls significantly short of what producers believe is appropriate for this hearing, both in its proposed changes and in the length it suggests.

First, the proposed changes. The Dairy Institute proposal aims to utilize the market value for Whey Protein Concentrate 34 percent in calculating the Class 4b price. However, in the context of this hearing, with only two weeks since we first saw the proposal, we really have no ability to thoroughly analyze the impact this change would have compared to the historical use of a dry whey price series. The data we currently lack for dry whey, such as manufacturing costs or prices received by plants, would equally apply to WPC34. While the background packet distributed by CDFA staff prior to this hearing did include some volumes of WPC produced, it was for all products of 25 to 89.9 percent protein composition.

The cover letter submitted by Dairy Institute with their proposal stated that there are California plants selling liquid whey that is more closely tied to movements in the price of WPC34, but we don't have any real data to verify or analyze that. Further, that alone is not an adequate rationale for fundamentally changing the price discovery mechanism in the Class 4b price. I would note that according to CDFA's *Dairy Information Bulletin*, cheddar cheese made up only 15 percent of all cheese manufactured in

2014, and that included all types of packaging, from the 40 pound blocks to be sold at bulk prices to individually packaged finished products sold at higher prices per pound. Mozzarella actually made up nearly 59 percent of all cheese manufactured in California last year. So under the Dairy Institute's logic is it still appropriate to use 40 pound blocks of cheddar cheese as the input to the Class 4b formula when a majority of the actual cheese being produced is Mozzarella, a higher value product with significantly more moisture, resulting in much higher yields of cheese per 100 pounds of milk. That's obviously outside the scope of this hearing, but it's a question worth asking in the context of the Dairy Institute's supporting document for their proposal.

It is also worth noting that a change from dry whey to WPC34 for a temporary period could create additional instability in the relationship between our 4b prices and the Federal Order Class III as the Federal Order system continues to utilize dry whey in their formula.

Second, the length of the proposed changes. The notice of the hearing allows for proposals with effective periods up to 24 months in length. While the joint proposal lays out a 24 month effective period, the DIC proposal limits it to only six months. MPC believes that a six month period is far too short and would encourage the Secretary to implement the decision for the maximum 24 month period allowed under the rules of the hearing. It's worth pointing out that the Department has the authority to call a hearing at any time under its own motion, just as was done today, if the Secretary believes adjustments to the State's pricing mechanisms are needed. So by definition, every decision is temporary and can be changed at some point in the future In that light, MPC does not believe it is good policy to predetermine such a brief effective period for this hearing decision.

Conclusion

The financial challenges facing California's dairy families are well-documented and back up by CDFA's own data. In the State Marketing Order that was set up to "enable the dairy industry, with the aid of the state, to ... bring about and maintain a reasonable amount of stability and prosperity in the production of market milk" that's an excerpt from Section 61805(d), there is ample evidence that a significant upward pricing adjustment is justified. Secretary Ross wisely identified the Class 4b price as the appropriate portion of our pricing structure to implement such an adjustment, and we encourage both the Secretary and the Hearing Panel to strongly consider the joint producer proposal as the temporary adjustment implemented for the next 24 months.

I had a couple of additional notes that were not in the written testimony. There was quite a bit of talk today about sales below class that occur. There have been recent reports about sales below class in areas of the country where surplus milk exists right now. It is worth noting, I don't think I heard anyone mention this. When those sales occur it is the producers, either individually or through their cooperatives, alone that bear the cost of that. Exclusively. The processors enter into contracts, they get all the milk that they have purchased under those contracts. If there is surplus milk that doesn't have another home and they have the ability to take it, they get a benefit from that. But it does not cost them anything to be moving milk around like that, that is borne by the producers. We do it in California today. We haven't had surplus milk in a while but when we do it has to be hauled to a calf ranch, sold at discounts, hauled out state to find a home, at the exclusive cost of the producers.

So there was a lot of concern by processors about this. And while we certainly appreciate their concern, it is really our decision as producers as to what we do with our milk. And that's why the co-ops have set up base programs to implement because they want to avoid that because that comes at a cost. But to use that as a justification to discount all of our milk sold at the 4b price is disingenuous because that is not a processor issue, that is a producer issue.

There was a lot of talk about California and our state, the costs of regulatory costs borne by small manufacturers, or all manufacturers for that matter. Dairies face those same additional costs here in California, our cost of production studies show it, and yet we are the lowest milk price in the country. Or among the lowest. The lowest most months. We cannot afford to be the low-cost milk. For the same reasons that the plants talk about today they can't afford to pay more, we can't afford to may more for our feed but we do because that's the way it works. The farmer has got to make money, the dairyman has got to make money too.

And then -- 22 seconds. I've got to really be selective here.

(Laughter.)

I think that's -- I'm going to wrap it up. I've got a lot more I could go into. I really appreciate the opportunity to testify today. I'm happy to answer any questions and request the opportunity to submit a post-hearing brief. Right at 20 minutes.

HEARING OFFICER SUTHER: Your request to a post-hearing brief is granted and now we'll take questions from the panel.

MR. SHIPPELHOUTE: A quick question. On page 3 of your testimony you have the table showing the prices paid. These are kind of repetitive to what some folks have said earlier but they indicate which states you think are most closely representative of the market conditions or class usage in California?

MR. VANDENHEUVEL: Well, I would answer it a couple of ways. One is that it is very rare, regardless of marketing conditions or the blend of milk that we produce. When you explain to non-dairy folks the milk pricing structure, which is an exercise in futility, I wouldn't recommend it to anybody, but I have tried because people have asked. They are shocked when they find out there's something in California that is cheaper or lower cost than in the rest of the country. Everything seems to be more expensive here, which we certainly see on the cost side, but yet we maintain a milk price at the farm level that is lower than everybody else.

Looking at this list. There are obviously some areas, you know, in terms of the types of products that are made. Certainly, the Midwest makes a lot of manufactured products and not as much Class I, we do as well. Of course they have geographic differences, I understand that. But they're talking about -- here you see Wisconsin, $3.08 per hundredweight, $2.92, it's not a little bit above. There's a geographic differences but $3 a hundredweight is a significant upward adjustment.

The talk of New Mexico earlier. I don't believe that we are an appropriate comparison to New Mexico. We sit in a population center of 35 million people with access and ports to the west of us. New Mexico, I've got family out there, I've gone out there. If you drive out there there's not 35 million people that live out there in terms of consumers. They don't have access to ports. It is not a fair comparison to California. They have transportation issues that erode a lot of the monies that they are generating in terms of milk sales that eat into that mailbox milk price.

You know, there are some other areas. The Pacific Northwest has a lot of butter-powder manufacturing that would be comparable to us, not a perfect comparison, they have slightly higher Class I. And Arizona was not included in the mailbox milk price analysis. They obviously have butter-powder manufacturing as well. The figures I've seen, not in this mailbox milk price analysis but that their milk prices are higher than California's.

MR. SHIPPELHOUTE: No other questions.

HEARING OFFICER SUTHER: Thank you for your testimony.

Mr. Rumiano.

Mr. Rumiano, could you please state your full name, spell your last name and state your affiliation for the record, please.

MR. RUMIANO: John Rumiano, R-U-M-I-A-N-O, and I am co-owner of Rumiano Cheese Company.

Whereupon,

JOHN RUMIANO

Was duly sworn.

HEARING OFFICER SUTHER: The document you've provided, is that the only exhibit you would like to provide at this time?

MR. RUMIANO: Yes.

HEARING OFFICER SUTHER: It will be Exhibit number 63.

(Exhibit 63 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MR. RUMIANO: Thank you for having me, first of all.

My name is John Rumiano and I am co-owner of Rumiano Cheese Company. In 1919, my grandfather and his brothers purchased a small dairy in Willows, California, and began making cheese in 1921. By the min-1930s they had become California's largest cheese manufacturer with eight cheese factories. Over the years they sold all but two factories and in 1980 my brother and I purchased the company from the family. The company consisted of a manufacturing plant in Crescent City, California, and a packaging and distribution plant in Willows. Both plants are still in operation. And I'd like to add to that that they're still 1920 and 1930 buildings so we haven't had a lot of capital to build and increase our capacity at our plants either as a manufacturer. We are now a fourth generation family business and we currently employ approximately 160 people.

Over the past 35 years we have paid millions of dollars to dispose of our whey, so a few years ago we installed a whey processing plant. Although it started out profitable we are now losing money on conventional whey. Fortunately, we are producing some organic whey product that keeps us afloat, but those organic markets are expected to weaken as well.

Our crescent City factory is currently running at capacity, producing approximately 12 million pounds of 40 pound blocks of commodity and specialty cheese annually. Our Willows facility handles the packaging and distribution of the cheese. We have struggled to make a profit in our manufacturing facility for the last 35 years, but we have persevered by co-manufacturing specialty cheese and by buying and selling cheese from other manufacturers.

We began buying nd selling a full like of food service cheese items to help supplement the manufacturing side of our business. I guess that's kind of like putting in trees. "Outside cheese" as we call it, is commodity-type cheese that we purchase from outside sources. Our current outside cheese purchases account for 75 percent of our total cheese sales and our manufacturing accounts for the other 25 percent. Varieties such as Cream Cheese, American, Muenster, Parmesan, Blue Cheese, Swiss and many other varieties are no longer made in California in any significant volume so we bring them in from out-of-state. I wonder why that is that nobody wants to make cheese here? The milk price is so low. There is some kind of a disconnect somewhere. That's a side note. We currently purchase the majority of this product, this 75 percent, from out-of-state.

If the price of California's commodity cheese increases as little as $.025 per pound, we would be forced to purchase more cheese from out-of-state which in turn would lessen the demand for millions of pounds of California cheese. We can buy Northwest cheddar cheese for $.025 a pound more than California commodity cheddar cheese right now. And this out-of-state cheese that I'm talking about, which we do buy for particular reasons, the shape of the block, aging, flavor profiles and other things and diversity as well. We buy a lot of cheddar from in-state, but out-of-state is $.025 a pound less to buy than California. So there's a disconnect somewhere. I don't know why that is but we -- I could show you that if you need proof later; $.025 a pound. And we buy millions of pounds of cheese from Utah, Wisconsin, Illinois, and they are very, very competitive on their cheese prices. We can't make it here at that price so we buy it out-of-state, so there's a disconnect somewhere, I don't know what it is.

An unfair increase in the milk price could put our cheese manufacturing facility in jeopardy due to the extreme competitiveness of the cheese market. California is already a difficult state to do business in and we really don't need any more financial burdens.

California dairy farmers are very hard-working people who have some difficult times, but adding an unfair burden to the processors is not a viable option to help improve milk prices.

Another side note. If the cheese market goes to $1.20 for the next five years, it doesn't matter how much more we pay the dairymen because they couldn't sustain it. But the world markets are driving this price down in the cheese market and the dairy markets. I think that's probably the biggest culprit why they can't make money, because there's over-production, in my opinion, almost all the time in this country. And the co-ops have always contributed to that because they don't need to make money on their cheese, only on the milk. At least in the last few decades. The perception of an individual like myself is they just pump out the milk. We could never compete with the co-ops because they just sell it almost at cost to move milk anyway. That's one of the reasons for over-production, in our opinion.

Anyway, thank you for your time. Rumiano Cheese supports the proposal set forth by the Dairy Institute.

HEARING OFFICER SUTHER: Any questions from the panel?

MR. EASTMAN: I do have a couple of questions. With the cheese that you are making in California, what do you do with your whey stream?

MR. RUMIANO: We put it in a WPC80 plant three years ago and we were doing pretty good on it; but according to recent numbers we are not in the black, at least right now. I'm on the sales side, my brother couldn't make it, so I got the information from him, but that's what I understand right now. We're doing good on the organic side because a percentage we went organic a few years ago on like a third of our production, but the conventional apparently right now not so much.

MR. EASTMAN: Is that based, do you think, simply the price of WPC80 decreasing?

MR. RUMIANO: You know, I'm probably not the one to ask that. But one other thing too is our cost of production is high for our cheese and for our whey because we only make 12 million pounds a year, you know, so our overhead eats up a lot of our efficiencies.

MR. EASTMAN: Would you be willing to request a post-hearing brief and submit sort of a -- maybe ask your --

MR. RUMIANO: Yes.

MR. EASTMAN: -- brother who is not here?

MR. RUMIANO: Yes. My brother may be able to put something together. You would like to know?

MR. EASTMAN: Kind of what's happened, what's changed with regards to the profitability on the WPC80?

MR. RUMIANO: Okay. Well the market, I know that went down. All powder markets tanked.

MR. EASTMAN: If you think that just simply is a question that the price has dropped then that's understandable but if you want to just confirm that.

MR. RUMIANO: Okay.

HEARING OFFICER SUTHER: Any other questions?

So I guess you are asking to being able to file a post-hearing brief?

MR. RUMIANO: Yes I am, thank you.

HEARING OFFICER SUTHER: That will be granted, thanks.

MR. RUMIANO: Okay.

HEARING OFFICER SUTHER: Thank you for your testimony.

Ms. Taylor.

Ms. Taylor, would you please state your full name, spell your last name and state your affiliation for the record, please.

MS. TAYLOR: Sure. I'm Sue Taylor, T-A-Y-L-O-R, with Leprino Foods.

Whereupon,

SUE TAYLOR

Was duly sworn.

HEARING OFFICER SUTHER: The written documents that you provided, would you like those entered into the record?

MS. TAYLOR: Yes, please.

HEARING OFFICER SUTHER: Any other documents?

MS. TAYLOR: No.

HEARING OFFICER SUTHER: That will be Exhibit number 64.

(Exhibit 64 was entered into the record.)

HEARING OFFICER SUTHER: You may proceed.

MS. TAYLOR: Thank you. I am Sue Taylor, Vice President of Dairy Policy and Procurement for Leprino Foods Company.

I am testifying today in support of the Dairy

Institute of California's proposal for whey valuation in the Class 4b formula.

I am also testifying today in opposition to the Class 4b formula whey valuation proposed by Western United Dairymen, California Dairy campaign and Milk Producers Council.

Regulated Milk Price Policy

Regulated minimum milk prices must be set at levels that contribute to orderly marketing of milk. This necessitates that the regulated minimum milk prices for manufacture of hard manufactured products be set at levels that clear the market. To do so, the minimum regulated price of milk in California must be set at a level that does not exceed returns achievable under good management practices by the regulated California manufacturers.

Whey Valuation Remains Challenging

The valuation of whey in a regulated milk price context remains challenging due to the lack of ready market value of dilute whey as it comes off the vats and the scale-related barrier created by the high capital cost of whey processing capacity. The preponderance of testimony at this and prior hearings indicates that whey processing is a highly capital intensive operation that is not economically viable on a small scale basis and, therefore, cannot be considered a product that can be universally produced by entities subject to the price regulation. This necessitates that the valuation of whey in a milk price formula be approached with extreme caution.

The explicit inclusion of a whey factor became an increasing challenge for those without whey processing capacity as whey prices strengthened a few years later. With whey driving up regulated minimum by over $3 per hundredweight at times in 2007, plants without processing capacity struggled and some were shuttered. In Federal Order areas, some plants that are located in dense cheese production regions were able to recoup some value by the sale of whey to consolidators as prices increased. But, as John Umhoefer of Wisconsin Cheesemakers Association noted in multiple editorials at that time as well as in recent months, the whey factor was even problematic for those cheese makers selling to consolidators in Wisconsin. The whey factor was also problematic for manufacturers of whey proteins because sweet whey values in the milk price formulas outstripped returns for protein. It was not uncommon in that time frame for cheese makers unable to recover the whey value assumed in the Class III milk formula to negotiate with their suppliers for relief from the full Class price.

But in California manufacturers do not have the choice of whether to elect out of the minimum price regulations if they are purchasing Grade A milk and the viability of several cheese plants was threatened during the high whey price periods of 2006 and 2007. The financial stress was reflected in some plant closures, three plants being placed on the ineligible list for the Producer Security Trust Fund, and the sale of a proprietary cheese company. Additionally, Land O'Lakes was very public about the financial difficulties at their mozzarella plant in Tulare and subsequently sold that plant. Dairy Farmers of America were similarly quite clear that their Corona cheddar cheese and whey plant had been a financial drain. Their August 8, 2007 press release announcing the reduction in throughput at the end of that month and planned closure January 1st indicated that "Market conditions and operating results have hindered success at our Corona plant and in our American Cheese Division. We constantly look for ways to end losses and stimulate profitability." That press release is attached as Attachment B.

It was clear that CDFA had overvalued milk to cheesemakers before the December 2007 formula change due to the crisis amongst cheesemakers just noted, in combination with the stimulation of increased milk production that led to disorderly marketing conditions, including milk being sold out-of-state, to calf ranches and being disposed of in manure lagoons.

The direct pass-through of the full whey value in the Class 4b formula was replaced by the $.25 per hundredweight fixed factor in December 2007 under the leadership of CDFA Undersecretary George Gomes. Although that fixed factor was modified in more recent hearings to a sliding scale, the Department's recognition under Undersecretary Gomes and, more recently, under Secretary Ross that many cheesemakers do not have the ability to capture full sweet whey value even under best management practices was and remains sound policy.

The Department's exhibit released on May 28th for this hearing reflects the continued complexity of the whey issue across the cheese manufacturing sector. Forty-four of the 57 cheese plants in the state do not process whey. Assuming that the plants in each size category are of the average size shown in the exhibit, there is no whey recovery - not even concentrated liquid whey value - on 224 million pounds, 14.2 percent, of Class 4b milk used monthly to produce cheese. Comparing the Department's data with comparable data that the Department released for the May 31, 2012 hearing shows that two of the plants that previously did not have whey processing now do. Using the same methodology to estimate the average monthly 4b milk volume represented by plants with no whey recovery value yields an estimate of 291 million pounds, or 18.8 percent of Class 4b milk at the time. See Attachment A. Although the volume at risk due to no whey value recovery has been reduced from 18.8 percent of Class 4b milk to 14.4 percent, that volume still represented 6.4 percent of all California market milk during those months. Without the capacity from those plants, significantly greater disorderly marketing would have been created. Given the supply/demand balance that existed at the time, more milk would have needed to clear out of state, likely at a severe discount.

Dairy Institute's Proposal Values Whey Most Appropriately

The Dairy Institute proposal to value the whey portion of the Class 4b milk formula relative to its liquid whey value replaces the existing sweet whey factor with a more relevant factor for today's marketplace. It reflects recent advances that have facilitated investment in concentration capacity by some cheesemakers that did not previously have it and increases the Class 4b price consistent with those advances.

The WPC34 price index is the most common reference used for the sale of liquid concentrated why by cheese plants that do not have the scale to make full whey processing economically feasible. As many witnesses testified at this hearing, the prices received for that liquid whey are discounted to reflect that liquid concentrated whey requires additional processing with highly specialized and capital intensive equipment in order to produce a full value product. The Dairy Institute proposal reflects a survey of cheese plants and was corroborated by industry consultants working with many of the cheesemakers with insufficient capacity to have economically viable whey processing operations producing dry products.

The Dairy Institute proposal appropriately caps the whey contribution in the Class 4b formula at 41.25, in recognition that 14.4 percent of Class 4b milk that is not even recovering the liquid whey value and the viability of some of those plants will likely be threatened by the increased cost burden related to a product that they cannot, even under best management practices, extract a value from.

<u>Western United Proposal was Proven Untenable in its Less Onerous Version</u>

The Producer Coalition proposal is premised upon a desire to bring the valuation of whey in the Class 4b formula in the California milk pricing system into closer alignment with the valuation of whey in the Federal Order system. In doing so, significant differences in how the prices apply within the two regulated systems are rationalized away. Specifically, manufacturers in California must pay the minimum regulated price for all Grade A milk processed, whereas manufacturers outside of

California can choose whether to participate in minimum milk price regulations. The only entities upon which the minimum regulated milk price is fully binding in the Federal Order are bottlers. Manufacturers of all other dairy products make an economic decision regarding participation. Even if they opt to buy milk pooled under the Federal Order system, they can purchase milk at below regulated minimums.

The Western United proposal attributes more value to whey than the Class 4b formula did before December 2007, when overvaluation led to the financial difficulties and closure of cheese plants, and all the other effects I have already discussed. In fact, the proposal even values whey at a level as much as $.12 per hundredweight higher than is valued in the Federal Orders, a regulatory structure for which participation is voluntary for cheesemakers. Even with the safety valve that is provided through the voluntary application of the Federal Orders to cheesemakers, the level established in the Federal Order Class III formula is problematic. The fact that the Federal Order overvalues achievable returns by many cheesemakers is evidenced by recent industry discussions and is reflected in the recent editorials by John Umhoefer and Mike McCully. Those are all attached to my testimony.

It is not difficult to anticipate the damage that would be done if the Western United, et al., proposal is adopted. The proposal once again sets up the scenario of signals to producers to increase milk production while signaling to cheesemakers to reduce manufacturing capacity. Based upon history, that signal will be once again manifested in increased bankruptcies, plant closures and a shift in manufacturing volumes from California to other states by multistate operators. The proposal would set up a scenario in which even those of us with the scale and capability to economically process whey would be better off shifting production. In addition to our cheese making assets, we have invested hundreds of millions of dollars in capital to produce specialized whey products in our California plants and continue to need to reinvest in order to maintain markets in a highly dynamic marketplace. Adoption of the proposal would, over the long term, result in a loss of reinvestment in California facilities and their eventual obsolescence and closure.

<u>The Current Class 4b Formula Overvalues Cheese</u>

I am going to condense that because Hilmar also talked about the fact that the current make allowance isn't reflected with the current costs. I am going to condense that and say, if you look both the f.o.b. factors as they most recently published, which are still out of date because of the proprietary data issue, and the cost data that was issued by the Department, the 4b formula overvalues the cheese part of the milk by $.32 a hundredweight.

The Value of Milk for Cheese Making is Not the Same in California as it is in Wisconsin

The equity argument made by some producers arguing that the minimum regulated price in California needs to be at the same level as set in the Federal Order is based upon false premises. It both ignores the differences in the way that the two regulated systems work, prices in California being binding and those in the Federal Orders being discretionary for manufacturers purchasing Grade A milk, and ignores the location value of milk. Although California manufacturers and producers can circumvent the pricing requirements by mutually agreeing to convert to Grade B status, that is not a practical alternative in the commercial markets that most cheese makers sell into and is certainly not an option for Leprino.

The difference in the location value of milk is driven by the need to move dairy products from the largely surplus Western region of the country to the deficit population centers in the East. The cost of trucking cheese from our California plants to the Midwest where many of our customers who produce frozen foods or shredded and package cheese for retail distribution around the country are located is in excess of $.10 per pound and the cost of trucking to the Northeast is in excess of $.15 per pound.

In order to compete for those customers our pricing needs to be competitive with the alternative supply sources in others of the country, most importantly in the Midwest. USDA's price surveys have historically reflected that the price surface for commodity cheddar and butter is essentially West Coast pricing plus transportation, a corroboration of this theory.

Let me go on to talk a little bit about our own costs also corroborating, you know, some of the data. And most importantly at the end of that next paragraph, reference that the make allowances in the Federal Order system were set based on a hearing in 2006 and 2007 for which the data that was considered was from 2005 and 2006. And it would not be sound policy for California to set pricing relative to a system that has decade-old cost data.

I do not question the conclusions drawn by the Western United witness in today's hearing that farm level premiums in Wisconsin exist. however, the analysis used to substantiate that conclusion is flawed and overestimates the farm level premiums. In this paragraph I will be making some adjustments in the post-hearing brief. I point out that the all-milk price is at full test, whereas I believe that the witness was referencing the Class III at standard. In a subsequent conversation, private conversation with that witness I found out that she had made adjustments in the fat level but had not made adjustments in other components. So the argument in that paragraph still stands but it's probably overstated so I will be reviewing that as part of the post-hearing brief.

Other Producer Arguments

The argument made by proponents of the Western United proposal that the current Class 4b price makes it difficult to hedge farm level milk price risk based upon the Class III futures contract may be true but ignores that other futures contracts are available that are very effective in hedging California price risk.

Need to Rethink Regulated Pricing Structure

Leprino appreciates the efforts of Secretary Ross to stimulate a dialog about revisions in the regulated milk pricing system that are needed in order for all sectors of the California dairy industry to thrive and leverage growing global opportunities.

There are lots of reasons to be excited about the global opportunities and I would say that over the last several years the periods where dairymen thrived in terms of high-profitability years, including 2014, were largely driven by export surges. I think the industry universally looks at the global marketplace as being the source of growing future demand and also economic value. There are lots of California processors who have invested heavily in that. Leprino opened a business hub in Singapore in 2011 specifically to support our exports from the U.S., most of those coming out of California.

We need to make sure that we continue to have that discussion and migrate to an effective policy that allows the dairy industry to leverage those opportunities. And by "dairy industry" I mean across the producer and processor sector, because ultimately those higher demand points drive higher overall prices in California and the rest of the country that translate into higher milk prices.

Conclusion

The policy challenges associated with incorporating an explicit whey factor tied directly to market movements in a minimum regulated milk price that obligates businesses that may not have a viable mechanism through which to recover the whey value are no less today than in 2007. The Department must be careful not to recreate the financially tenuous environment that existed in 2007 and jeopardized both cheese processors and the outlet they provide for California-produced milk.

The Dairy Institute of California proposal does the best job of balancing producer interest and market realities. The Department should accept Dairy Institute's proposal and reject the Western United, et al,, proposal and the entire industry should dedicate its energy and efforts toward longer term policy reforms that will benefit all sectors, including producers.

Thank you for your time and consideration. I respectfully request permission to file a post-hearing brief.

HEARING OFFICER SUTHER: Your request to file a post-hearing brief is granted.

Questions from the panel?

MR. LEE: On page 6 of your testimony about a quarter of the way from the top where it states: "Although California manufacturers and producers can circumvent the pricing requirement by mutually agreeing to convert to Grade B status, that is not a practical alternative in the commercial markets that most cheese makers sell into and is certainly not an option for Leprino." Are you referring to the ability for pooled plants to go Grade B or non-pool?

MS. TAYLOR: I'm not going to try to interpret the technical requirements within the state but the broad ability to be able to get outside of the pricing regulation. If you're Grade B, buying Grade B milk and you're a Grade B dairyman, is what I"m referring to. And on the product side, particularly on the whey product side, our customers all require Grade A. Much of that whey goes into Grade A products themselves, some by a standard requirement and the other quality Grade A rules. It's required. And also for many of the international sales that's an expectation.

MR. LEE: Thank you.

MR. EASTMAN: I have a question. So with regards to your -- in terms of support for the Dairy Institute's alternative proposal. Would you suggest that that's your first sort of desired outcome? There's been other processors that have stated that they would suggest or recommend no change; but if change had to be made then the Dairy Institute alternative proposal is the best choice for that. Where do you lie there with your support? What do you argue for?

MS. TAYLOR: Leprino's perspective on it -- first of all I will say that the Dairy Institute proposal will not increase our costs because we are currently paying a whey premium, so the negative impact of the proposal is our producers will no longer be getting that for themselves, it will be divvied out through the pooling process. We can be indifferent from that perspective, it is not going to impact our cost at that level.

Now, the Western United proposal would have very significant impacts on our costs and be very detrimental to us as well as other folks in the cheese industry.

MR. EASTMAN: The other question I had was, obviously still there are certain cheese processors that do nothing with their whey so they get no value. So do you really think that whether -- if the Secretary were to choose, that there is some level of increases that are warranted? In your mind, for cheese processors that do nothing with their whey, does it really matter if that increase is based on WPC34, dry whey or frankly anything?

MS. TAYLOR: For those recovering nothing it is just an absolute question of price level. The reason why I think that the Dairy Institute proposal focused on WPC34 makes more sense is because there is some variability as to the pricing mechanisms for liquid whey in the state. But my understanding is that the majority of it is priced relative to WPC34 so it at least conforms the returns for those folks who are in a liquid whey market to what's available in the marketplace.

MR. EASTMAN: Okay. And then those that just simply dispose of it with no revenue period. Would you think that there's --

MS. TAYLOR: Very different.

MR. EASTMAN: -- for them --

MS. TAYLOR: It's just --

MR. EASTMAN: It's just a cost to them.

MS. TAYLOR: And they're the folks who I don't have specific insights into their financials. There are lots of them that have testified today. I am highly sensitive to jeopardizing their businesses as well. But they are the ones that it's just the absolute price level that is going to hit them.

MR. EASTMAN: Thank you. That's all I had.

HEARING OFFICER SUTHER: Thank you for your testimony.

I would like to remind everybody your post-hearing briefs will be due by 4:00 p.m. on Monday, June 8th.

If there is no one else left to testify this hearing is now closed at 6:50 p.m. on June 3rd and we are now off the record.

(Thereupon, the public hearing adjourned at 6:51 p.m.)

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CERTIFICATE OF REPORTER

I, RAMONA COTA, a Certified Electronic Reporter and Transcriber, 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, or in any way interested in the outcome of said matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 12th day of June, 2015.

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RAMONA COTA, CERT**478