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BEFORE THE UNITED STATES DEPARTMENT

OF AGRICULTURE

AGRICULTURE MARKETING SERVICE

In the Matter of Milk in California
Notice of Hearing on a Proposal to
Establish a Federal Milk Marketing
Order

7 CFR Part 1051
Docket No.: AO-15-0071
AMS-DA-14-0095

LEPRINO FOODS COMPANY'S REPLY BRIEF IN REGARDS TO PROPOSALS FOR A FEDERAL MILK MARKETING ORDER FOR CALIFORNIA.

This reply brief is submitted on behalf of Leprino Foods Company ("Leprino"), which operates three cheese manufacturing facilities within the marketing area under consideration for Federal Milk Marketing Order regulation through this rulemaking. Leprino was an active participant throughout the hearing held September 22 - November 18, 2015 in Clovis, California and previously submitted a post-hearing brief.

We have reviewed the reply briefs submitted by Dairy Institute of California, of which we are a member, and Hilmar Cheese Company and concur with and endorse those reply briefs. Additionally, we offer the following observations regarding the briefs submitted by the Cooperative proponents of Proposal 1 and Select Milk Producers.

<u>Cooperative Proponents of Proposal 1 Brief</u>

The Cooperatives' brief largely relies upon broad characterizations that lack substance.

Class III / IV

The Secretary's statement from Federal Order Reform, quoted by the Cooperatives on page 72 of their brief, is correct that:

> *"The most important criterion is sound economics--the ability of the BFP to reflect the supply and demand for raw milk. Currently, the BFP is intended to represent the interaction of supply and demand for manufacturing milk and thereby, the supply and demand for fluid milk at a minimum level. A replacement that fits this traditional role suggests that the supply and demand for manufacturing milk should be reflected in the new price.*
>
> *Sound economics also implies that minimum prices for milk used in manufactured products will be market-clearing."*[1]

However, the Cooperatives' proposal is inconsistent with this, arguing for a Class III and IV price that is based upon a national average prices for commodities that exceeds the location value of the milk being priced. In doing so, the price would neither reflect the supply and demand for raw milk in California nor be market clearing.

The Cooperatives erroneously point to the application of the current Class III and IV price formulas to western Federal Milk Marketing Orders as evidence that the price levels are reasonable for manufacturers of Class III and IV products under proposal 1. In doing so, they ignore that, in contrast with proposal 1, no Order to which they point requires that minimum regulated milk prices be paid by manufacturers. Manufacturers in all other Federal Orders can decide whether to participate in the Order at all. Additionally, manufacturers have the option to depool and the hearing record includes evidence of significant periods of depooling by cheesemakers in the region.

[1] Milk in New England and Other Marketing Areas, supra, 63 Fed. Reg. at 4877.

In arguing that Class III can be reasonably paid by manufacturers in the west, the Cooperatives continue to rely heavily upon the testimony of their expert witness, Paul Christ. The brief states that:

> *"Mr. Christ, a witness whose breadth of experience in the dairy industry and FMMO system was unequaled by any other witness in the hearing, carefully evaluated this contention and identified seven factors which lead him to conclude: "It is not likely that the proposed prices for manufacturing milk in California will be too high." (Christ Tr. Vol. XII, p. 2470 (Oct. 7, 2015); Exh. 58, p. 12.)."*[2]

While Mr. Christ's career is one to be respected, the knowledge upon which he draws his conclusions that western cheesemakers outside California pay Class III prices is not consistent with that standard. His lack of current knowledge was revealed under cross-examination at the hearing.

> *"Q. I would like to turn specifically to the cheese production and your understanding of the cheese production in the states in the West, and particularly those states that you believe are heavily influenced by Class III pricing, and for which the Class III pricing would be binding on the major cheese makers. Would you agree, I believe you have already testified to this effect, that cooperatives are not bound by the minimum pricing provisions of Federal Orders?*
> *A. No, they can -- they can choose to to pay their producers directly through pay price or indirectly through earnings.*
> *Q. Okay. Thank you. So let's start with the Pacific Northwest. Are you aware of major commodity cheese production in the Pacific Northwest that is not done by, not produced by Cooperatives?*
> *A. I'm not familiar with the market structure in the Pacific Northwest, so I don't know whether to answer yes or no.*
> *Q. Arizona, same question.*
> *A. The question is whether it is operated by Cooperatives?*
> *Q. Correct. The cheese production in Arizona, cooperative versus proprietary.*
> *A. Okay. I do not know who produces cheese in Arizona."*[3]

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[2] Cooperative Brief, page 82.
[3] TR Vol XII, pages 2573 – 2574.

Mr. Christ's assertion that cheesemakers in western Federal Orders pay the Class III value is compromised by his lack of knowledge about cheese producers in the region, their ownership structure, and their payment of minimum prices.

The Cooperative brief mischaracterizes the Dairy Institute of California proposal regarding the underlying price series to be used in the calculation of the Class III and IV prices formulas.

> *"The DIC is not satisfied with average product prices to which California contributes approximately 33-40% of total transactions. DIC wants only California prices."*[4]

However, the record is clear that the Dairy Institute proposal utilizes commodity prices from the western states to establish the Class III and IV prices.

The cooperative brief relies upon analysis by Dr. Lon Hatamiya to conclude that there is no higher cost of doing business in California than in other parts of the country.5 Our experience and record evidence shows otherwise. But even if it did not, the adoption of a regulated price formula that incorporates ten-year-old manufacturing costs to allow for the cost of converting milk into finished product is not justified by the cooperative testimony, brief, or by sound policy.

The Cooperative brief erroneously estimates the volume of whey processed in California by incorrectly interpreting the characterization of plants, such as Saputo's plants, that condense whey for shipment to a different facility for further processing. The brief states that:

> *"One of the major cheese producers in the state, Saputo, consolidated all its whey processing at one location, although it has four plants which process milk into cheese. (Dryer Tr. Vol. XXII, pp. 4301-03 (Oct. 23, 2015).) The three Saputo plants whose whey processing has been consolidated to one plant will show up as non-processing plants in Exhibit 96. Those Saputo non-whey processing plants are of substantial size, according to*

[4] Cooperative Brief, page 92.
[5] Cooperative Brief, page 85

Saputo's witness, who would not reveal volumes but said at any plant "you need to be able to process quite a bit of milk." (Id. at 4251.) If one assumes that the non-whey-processing Saputo plants are the nonwhey processing plants in Groups 8 and 9 of Exhibit 96, 94.7% of the cheese producing capacity in California processes its whey. When LOL and DFA plant volumes are added, as well as Gallo's purchased volume, well in excess of 95% of whey in California is processed."[6]

However, examination of Footnote 3 of Exhibit 96 shows that plants that concentrate whey prior to shipment for further processing, are included amongst those characterized in the table as having whey processing capacity.

"Plants that manufactured at least one of the following whey products during the first three months of 2015: Dry Whey (Animal/Human), WPC 25%-90% (Animal/Human). Whey Protein Isolate, Deproteinized Whey. Delactose Permeate Whey, and Concentrated Whey (Animal/Human).[7]

Therefore, the Saputo plants are already characterized in the exhibit as having whey processing capacity. Further, the product set included in the characterization of plants with whey processing on Exhibit 96 includes products that capture only a portion of the whey and products that command a discounted value, such as animal feed. The characterization of a plant as having whey processing capacity does not equate to a plant having the ability to capture the full value of whey assumed in the Class III formula proposed by proponents of proposal 1.

<u>Quota</u>

The Cooperatives' expert witness, Dr. Lon Hatamiya, and brief ignores that the distribution of pool revenue under the quota system is a zero sum game. Pooled producers will receive the same aggregate revenue from the pool regardless of whether quota exists in its current form, is modified, or is discontinued. Although the quota pool distribution to individual producers may be impacted by the outcome of this rulemaking with some producers receiving more or less

[6] Cooperative Brief, pages 80 – 81.
[7] Hearing Exhibit 96.

than they receive under the current quota configuration, the total value distributed to producers from the pool remains the same regardless of quota treatment.

Select Milk Producers Brief:

The hearing record does not support the Select Milk Producers brief inference that Marquez Brothers International is more profitable after building their whey protein plant and the logical extension that they can afford valuation of whey consistent with the Class III formula. The brief specifically states that:

> *"perhaps the most telling evidence on the matter of whey processing costs comes from the testimony of DIC member, Marquez Brothers International. In that testimony, the witness patently acknowledged that his plant was profitable even before installing its whey manufacturing capacity. Maldonado, Tr. Vol. XXIII at 4665. It can be inferred that the profitability of the plant only improved after its whey plant operations began. It is also important to note that this plant was constructed in 2004 -- a time when the California 4b price and the FMMO Class III price were in closer alignment."*[8]

The referenced testimony is:

> *"Q. Mr. Beshore asked you some questions about how you handled your whey before 2004.*
>
> *A. That's correct.*
>
> *Q. Let me ask, I don't think he asked this specifically. Before you built that whey facility, was your cheese operation profitable?*
>
> *A. Yes, it was profitable. Yes. It depended on the milk prices and some years are bad, some years are good."*[9]

The inference of increased profitability subsequent to Marquez Brothers' building of the whey

[8] Select Milk Producers Brief, page 10.
[9] TR Vol XXIII, page 4665.

plant does not recognize several key facts reflected within the hearing record. Specifically:

1. The inference in the Select brief relies upon an assumption that Marquez Brothers was profitable while paying for a whey value in the Class 4b price even though they did not have a whey operation prior to 2004. However, the "baseline" period used to establish the historic profitability (pre-2004) was a period during which, for the most part, the California 4b formula did not incorporate whey valuation (beyond whey cream) in the formula. A whey factor was first introduced in the Class 4b formula in April 2003. Given the weak whey market prices at the time of the whey factor adoption, the factor contributed a negative 2.14 cents per hundredweight to the Class 4b milk formula on average in 2003.
2. The inference does not recognize the increased costs incurred, due to the operational and capital costs of processing the whey and the increased California Class 4b milk cost related to the incorporation of a whey factor, subsequent to the commissioning of Marquez Brothers' whey protein operation.
3. The inference does not recognize that Marquez Brothers, similar to most plants of its size or smaller, does not have the capability to achieve the full value of whey assumed in the Class III price formula.

   "To capture the maximum value of the whey stream, it is important to have the ability to take it all the way to a dry state. Unfortunately, the installation of whey evaporators and dryers is an extremely capital intensive operation and subject to large economies of scale. Small and medium size cheese companies like MBI, don't dry permeate/lactose fraction and don't have the ability to fund a 35 million permeate drying facility, so will be unable to capture revenues to keep up with the rising milk cost."[10]
4. The inference in the Select Milk Producers brief directly contradicts the Marquez Brothers direct testimony.

   "Despite our 25 multi-million dollar investment to alleviate the environmental

[10] TR Vol XXIII, page 4627.

problems associated with whey, we have not seen a return on that investment. Our total loss incurred from August 2005 to August 2007, mainly due to the whey component, is approximately $7 million. To date, we have not yet recovered from these losses and we are years away from ROI."[11]

Conclusion

The proponents of proposal 1 have provided no evidence, during the hearing or in brief, that the proposed Class III and IV formulas are relevant to the proposed marketing area in time or space. The make allowance factors are outdated and the commodity price references relate to a weighted average geography that carries a locating value in excess of that achievable in the west. For these reasons, if the Secretary proposes an Order under this rulemaking procedure, the Class III and IV formulas put forth by the Dairy Institute of California should be adopted.

[11] TR Vol XXIII, page 4631.