

BEFORE THE UNITED STATES DEPARTMENT OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

In the Matter of Milk in California;	7 CFR Part 1051
Notice of Hearing on a Proposal to	Docket No.: AO-15-0071;
Establish a Federal Milk Marketing Order	AMS-DA-14-0095

Clovis, California, September 22, 2015

Testimony of Greg Dryer

This testimony is submitted on behalf of Saputo Cheese USA Inc., a U.S. Division of Saputo Inc., a publicly traded, international, dairy, and grocery products manufacturer and marketer. Saputo produces, markets, and distributes a wide array of dairy products, including cheese, fluid milk, extended shelf-life milk and cream products, cultured products and dairy ingredients. Saputo is one of the top ten dairy processors in the world, the largest cheese manufacturer and the leading fluid milk and cream processor in Canada, the third largest dairy processor in Argentina and the fourth largest in Australia. In the US, Saputo ranks among the top three cheese producers and is one of the largest producers of extended shelf-life and cultured dairy products. Saputo operates 55 plants worldwide employing 12,060 people and selling products in more than 40 countries. In the U.S., Saputo has 24 plants in 11 states employing more than 5,000 people. Seven of those plants and approximately 1,500 of those people reside here in California.

I am Greg Dryer, Senior Vice President of Industry and Government Relations for Saputo Cheese USA Inc. I have been directly employed in the U.S. dairy industry for more than 35 years in a variety of roles. I currently represent the company on the Board of Directors of a number of U.S. Trade Associations and in matters such as the one under consideration here. My prior background was as a CPA in the field of Public Accounting.

Saputo's position for this hearing is that promulgation of a Federal Order for California is not warranted. In the event that the Secretary decides otherwise, we oppose all proposals other than the proposal submitted by the Dairy Institute of California.

ORDERLY MARKETING OF MILK IN CALIFORNIA

The question for USDA to ponder in the decision to promulgate a new Federal Order for the state of California is whether this petition seeks to resolve a condition of disorderly marketing or is simply an attempt at achieving government mandated price enhancement.

In the past five years, there have been seven CDFA hearings involving Class 4b milk. The Secretary denied seven additional petitions for hearings during that time. In 2012, dairy producers ^{unsuccessfully} sued the CDFA for refusing to bring California's Class 4b price into closer alignment with the USDA Class III price.

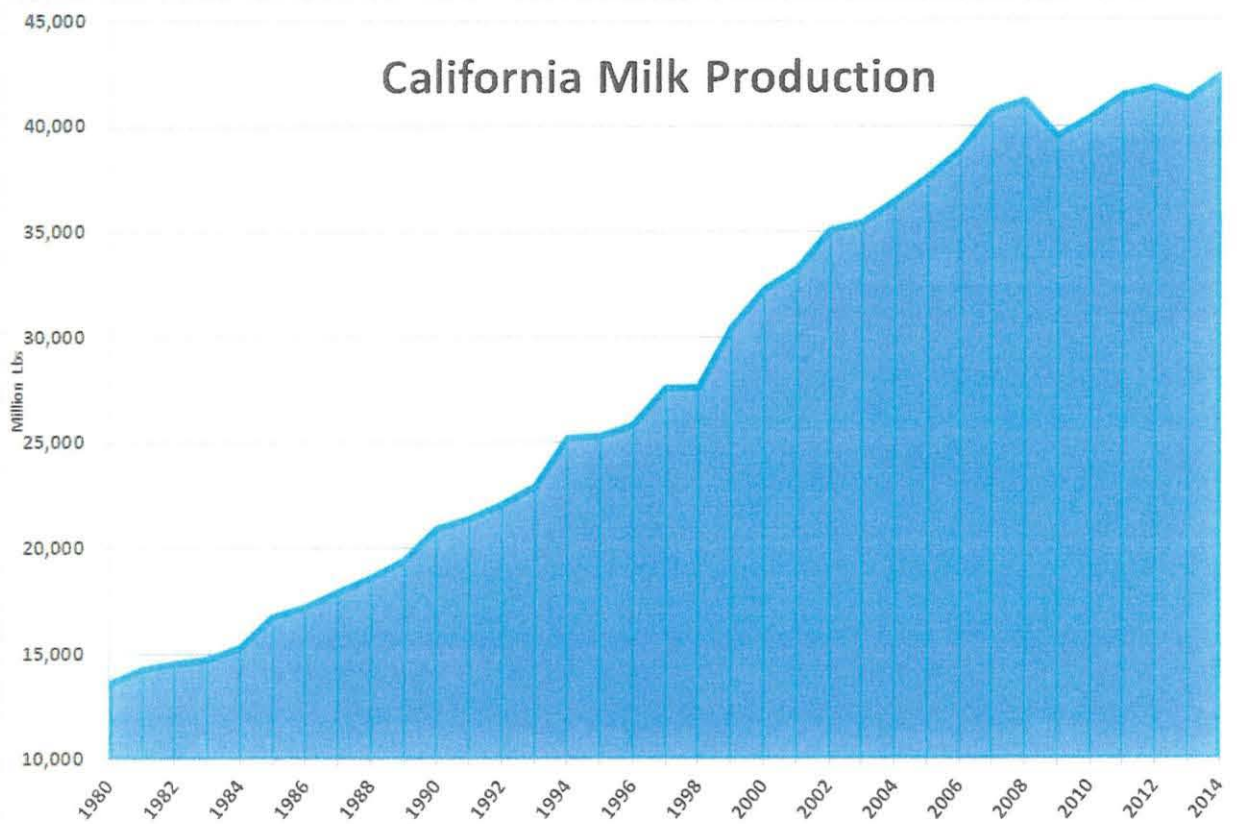
Regarding orderly marketing, one could argue that the state system in California in many respects facilitates orderly marketing as well or better than does the Federal Order system.

- The number of California public hearings held to address stakeholders' concerns mentioned in the previous paragraph supports that hypothesis.
- CDFA is obligated to announce a decision within 52 days following the close of a hearing.
- CURRENT commercial end-product prices reported from the 26th of the prior month through the 25th of the current month serve as the basis for California milk prices. Producers and processors receive market signals in real time.
- The Class 4b price formula has changed seven times in the past five years.
- CDFA conducts annual manufacturing cost studies and publishes the results. Those studies can provide the basis for hearing requests to update make allowances in milk prices formulas.

USDA continues to use an "other solids" factor based on the dry whey price that has periodically created enormous problems for cheese makers around the country. To elucidate that point, attached are comments that were filed by the Wisconsin Cheesemakers Association April 13, 2015 on the 610 Review of Federal Milk Marketing Orders Docket ID: AMS-DA-09-0065.

To quote from that document: “The California Department of Food and Agriculture faced a similar problem when they moved to a cheese milk pricing formula that valued whey solids in a similar fashion to FMMO Class III Other Solids. The state returned to a lower whey valuation for their Class 4b formula when it became apparent that their formula overvalued milk relative to its true worth for the vast majority of California cheese processors that do not manufacture dry whey.” “The true, basic commodity that should be reflected in the Class III milk price formula is separated, wet whey. Dried whey is a value-added product produced by a small number of plants in the U.S. Separated wet whey is generally purchased on a contract basis using a price that is a fraction of the price of whey protein concentrate containing 34 percent protein (WPC 34).”

There are many similarities and differences between the two systems but perhaps the most striking is the fact that in California, selling market milk within the state at below the minimum regulated price is illegal. In the Federal Order regions, that is not the case. Plants may de-pool or purchase surplus milk from farmer cooperatives at below class prices. The significance of that distinction cannot be overstated. When such a firm price floor exists, establishing minimum prices above market clearing levels results in chaos. Imagine what might have happened if mandatory pooling had existed across the country this past spring when surplus milk grossly exceeded demand in several regions. From 1980 through last year, milk production has more than tripled in the state of California. California producers are among the most prolific and proficient in the world. It is important to recognize that the enormous increase in production was not demand driven.

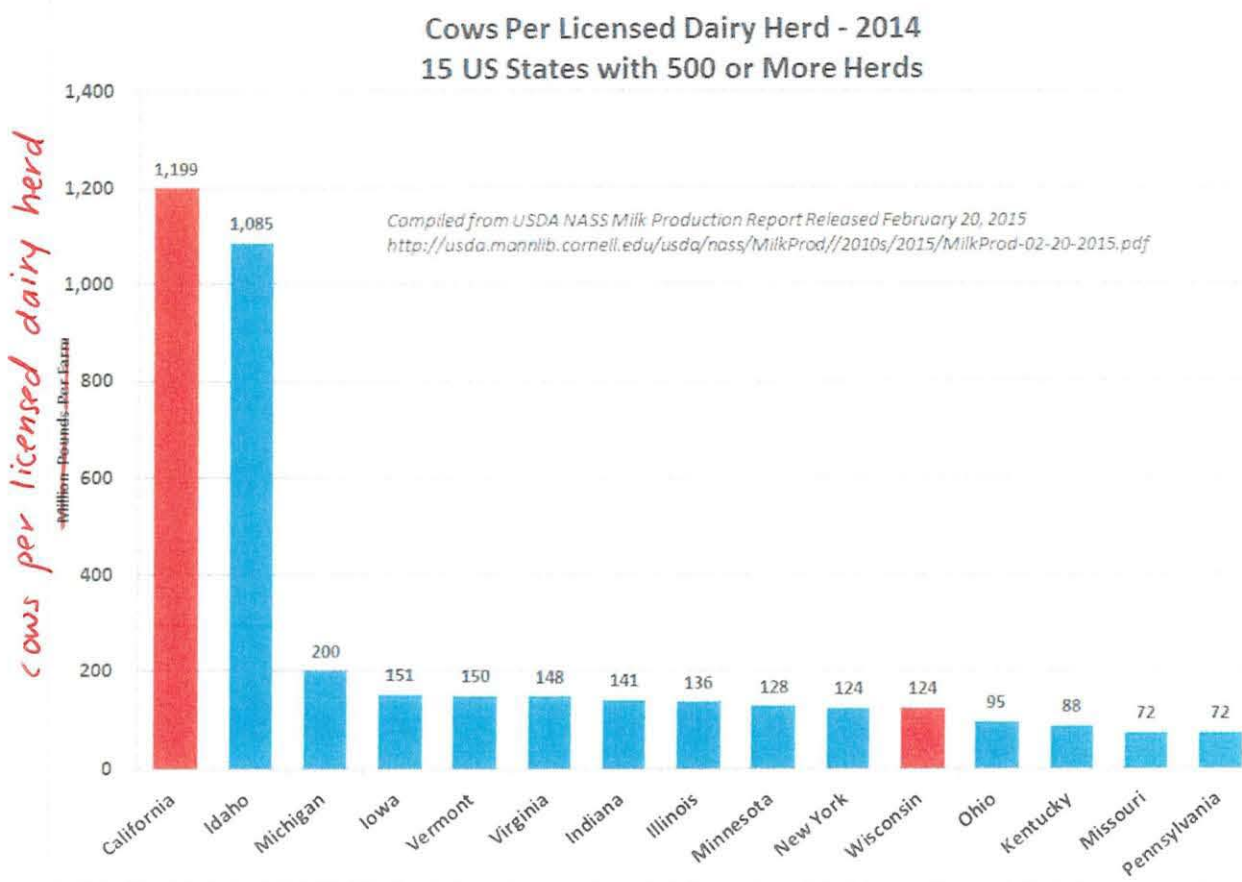


Attached are Milk Producers Council newsletter excerpts from November 7th and 14th 2008 by Sybrand Vander Dussen who was President of MPC at that time. Quoting from it: “The dairy industry in California continues in its addiction of over-production of milk. Dairy producers seem to have only one clear focus, produce more milk. As costs go up, as milk prices decline, we produce more milk. As coops battle to place milk and milk products, we produce more milk.” “But the reality is, dairymen produce in an unrestrained fashion with no consideration of demand, leaving the industry in a perpetual state of overproduction which causes a myriad of problems, all of which should be unnecessary.” “Our coops cannot demand higher prices from Buyers, simply because they must get rid of more milk than the market wants.” “The overarching theme here is that overproduction is the single culprit keeping us from operating an orderly, intelligent industry.”

State minimum prices are exactly that, minimums. Nothing in policy or law keeps coops from setting a higher price. Only the neutering effect of overproduction. “ “We don’t need Sacramento. We don’t need minimum prices. We don’t need the support price program.”

Producers, through their cooperatives, found the need to build capacity to accommodate the volume of milk that vastly exceeded local demand. The orientation was toward butter/powder plants but there were cheese plants constructed as well. Most of those cooperative cheese plants have since failed. The cheese plants closed or sold out because they were unable to provide adequate returns to their members to justify their continued existence given California’s economic conditions and milk price system.

The fact that California has predominantly enjoyed a milk surplus has led to orderly marketing but with less competition for milk and lower than comparable prices than those in the Federal Orders. Class 1 needs are easily satiated as are the needs of most other buyers. Difficulty only seems to arise when supply exceeds local demand at the regulated price. In that case, sellers must ship milk discounted below the regulated price out of state and often at great distances to competitors of California processors. Providing those competitors with a significant cost advantage.



cows per licensed dairy herd

It is important to understand why the California surplus exists. In 2014, only fifteen states were home to five hundred or more dairy farms. Of those states, only two averaged more than two hundred cows per herd. Idaho averaged roughly 1,100 per herd and California 1,200. According to USDA, scale has an enormous impact on the cost of milk production. In a report titled "Profits, Costs, and the Changing Structure of Dairy Farming" published in September 2007 by USDA ERS, the cost of production from herds of 1,000 or more cows was estimated to be \$7.23 per hundredweight lower than herds of 100 to 199 cows based on 2005 data.

Dairy costs of production, by herd size, 2005

	Enterprise size (number of milk cows)					
	<50	50-99	100-199	200-499	500-999	>999
Mean herd size	35	69	133	295	666	2083
Output per cow (lbs)	15,055	17,149	18,228	19,487	20,719	20,195
	<i>Dollars per hundredweight</i>					
Total operating costs	12.30	12.94	11.51	11.31	11.07	9.74
Purchased feed	3.60	3.75	4.12	5.00	5.64	5.99
Homegrown feed	5.02	5.07	4.06	3.01	2.58	1.47
Grazed feed	0.41	0.15	0.11	0.10	0.02	0.01
Allocated overhead	17.79	12.56	9.31	6.61	5.00	3.85
Hired labor	0.50	0.80	1.34	1.84	1.80	1.61
Unpaid labor	10.60	6.10	3.13	1.34	0.54	0.17
Capital recovery	5.26	4.56	3.89	2.55	2.03	1.66
Total costs	30.09	25.50	20.82	17.92	16.07	13.59
Gross value of prod.	17.87	17.56	17.20	17.25	16.56	16.54
Net returns	-12.22	-7.94	-3.62	-0.67	0.49	2.95

Source: ERS estimates, at www.ers.usda.gov/data/arms/CostOverview.htm

Herd size refers to all dairy cows on an enterprise, including dry cows but excluding calves, heifers, and bulls. Gross value of production for the dairy enterprise includes milk, cull cattle sales, and other revenue generated by the dairy enterprise. Net returns are the difference between gross value of production and total costs. Organic operations are excluded.

To quote directly from that report, “*Smaller farms tend to get higher prices for their milk than larger farms. But cost differences tend to overwhelm this advantage: larger farms, especially those with more than 1,000 cows, are realizing economic profits while most smaller farms are realizing negative net returns. In turn, differences in returns are driving investment decisions that are shifting production to larger farms.*”

The average herd size for all U.S. states excluding California in 2014 was 171 cows. Quoting from a December 1, 2014 article on the USDA ERS website by James MacDonald and Doris Newton entitled “Milk Production Continues Shifting to Large-Scale Farms,” “*The shift to larger dairy farms is driven largely by the economics of dairy farming.*

Average costs of production, per hundredweight of milk produced, are lower in larger herds, and the differences are substantial. These costs include the estimated costs of the farm family's labor as well as capital costs, in addition to the cash expenses that are included under operating costs." Further, "While some small farms earn profits and some large farms incur losses, financial performance is linked to herd size. Most of the largest dairy farms generate gross returns that exceed full costs, while most small and mid-size dairy farms do not earn enough to cover full costs. Full costs include annualized costs of capital as well as the cost of unpaid family labor (measured as what they could earn off the farm), in addition to cash operating expenses. The cost differences reflect differences in input use; on average, larger farms use less labor, capital, and feed per hundredweight of milk produced. These financial returns provide an impetus for structural change."

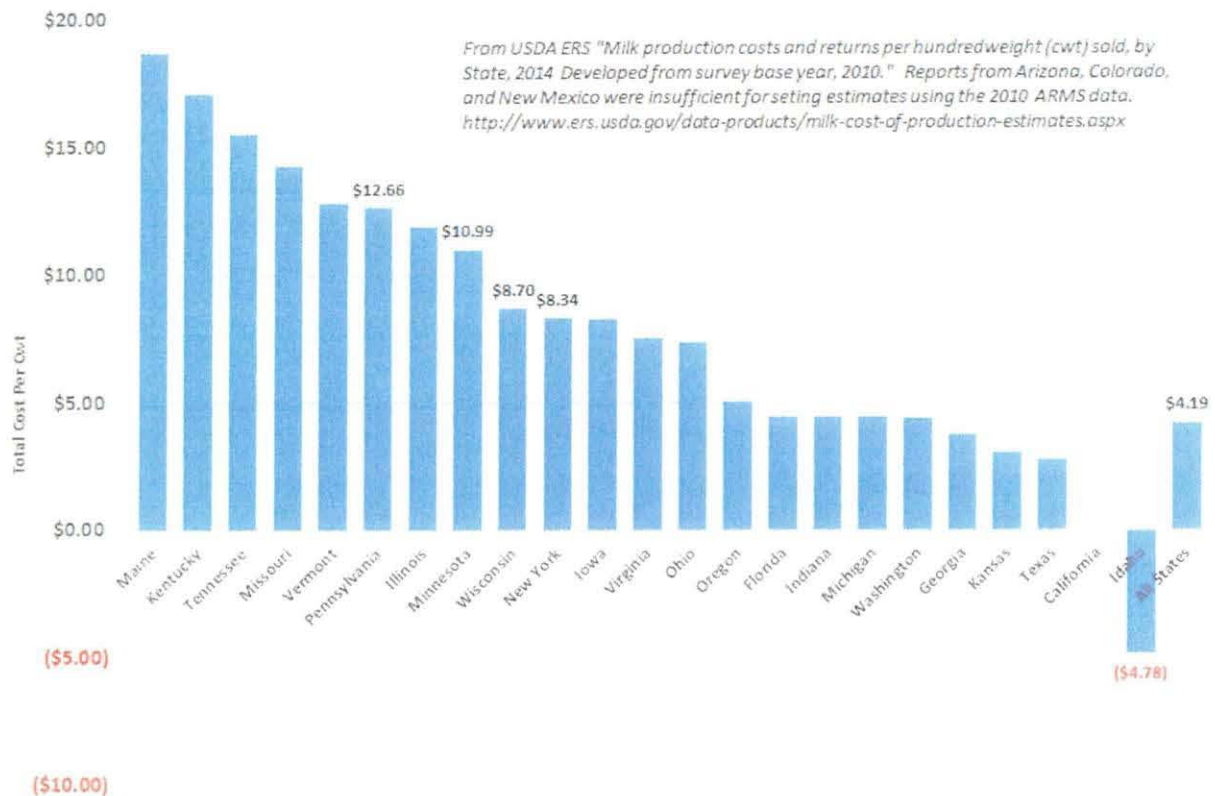
USDA ERS continues to report milk cost of production by state and by size of operation based on Agricultural Resource Management Survey (ARMS) data from milk producers conducted every five years. Years between surveys are adjusted using indexes that reflect differences between the period and the baseline. To the best of my knowledge, these are the ONLY reports that compare U.S. farms of all sizes by state or region.

From 2010 through 2014, California ranked second lowest in cost among the 23 reported states. California's average cost over those five years was below the following states:

Wisconsin	by \$ 8.70 per hundredweight
New York	by \$ 8.34 per hundredweight
Pennsylvania	by \$12.66 per hundredweight
Minnesota	by \$10.99 per hundredweight

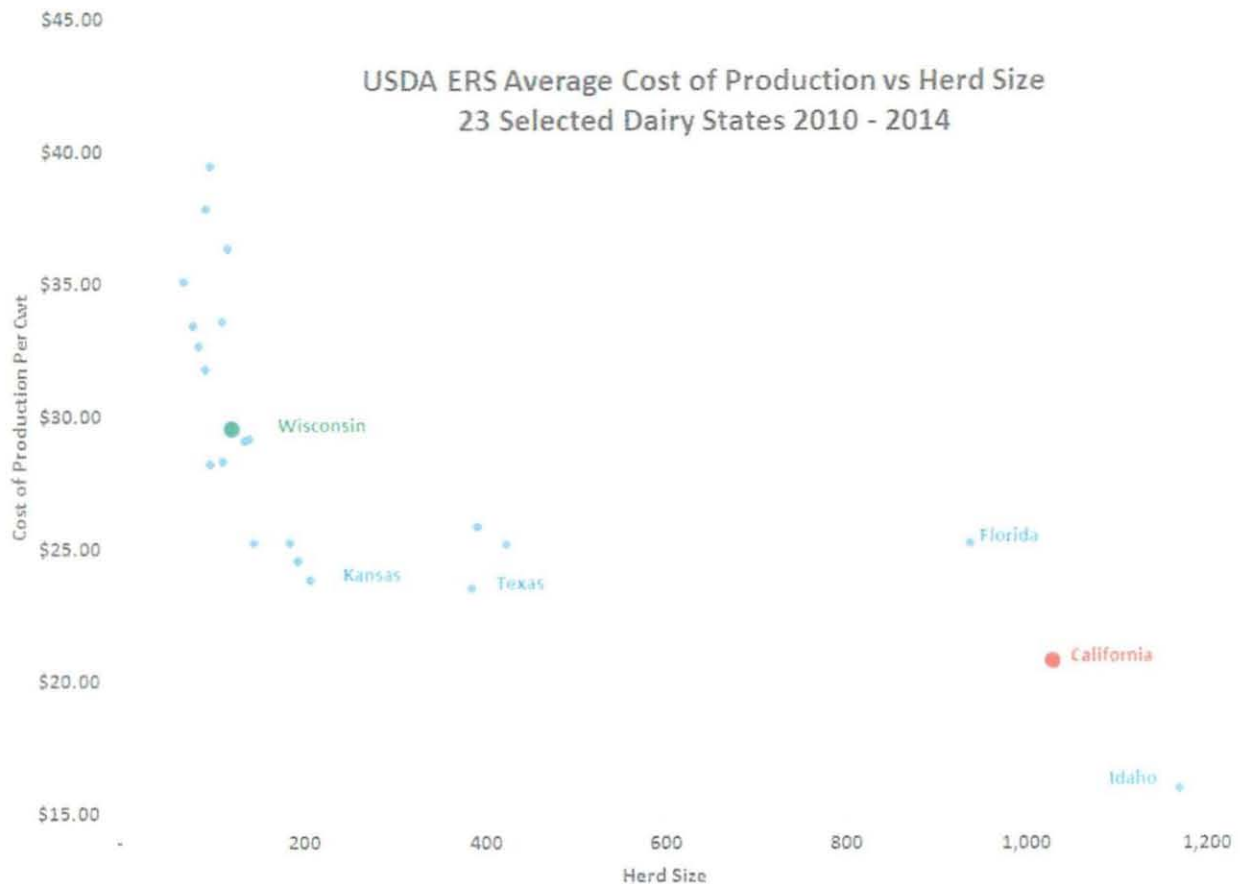
Idaho, which is home to many former California producers, was the only state with a cost that was below that of California and that was by \$4.78 per hundredweight.

Average 2010 - 2014 Milk Cost By State above California



The 2014 USDA "Milk cost of production by size of operation" report pegged the cost advantage of a 1,000 or more cow farm over a farm with 100 to 199 cows, at \$11.54 per hundredweight. Given the magnitude of this cost advantage, it is not difficult to understand the propensity of those large producers to grow.

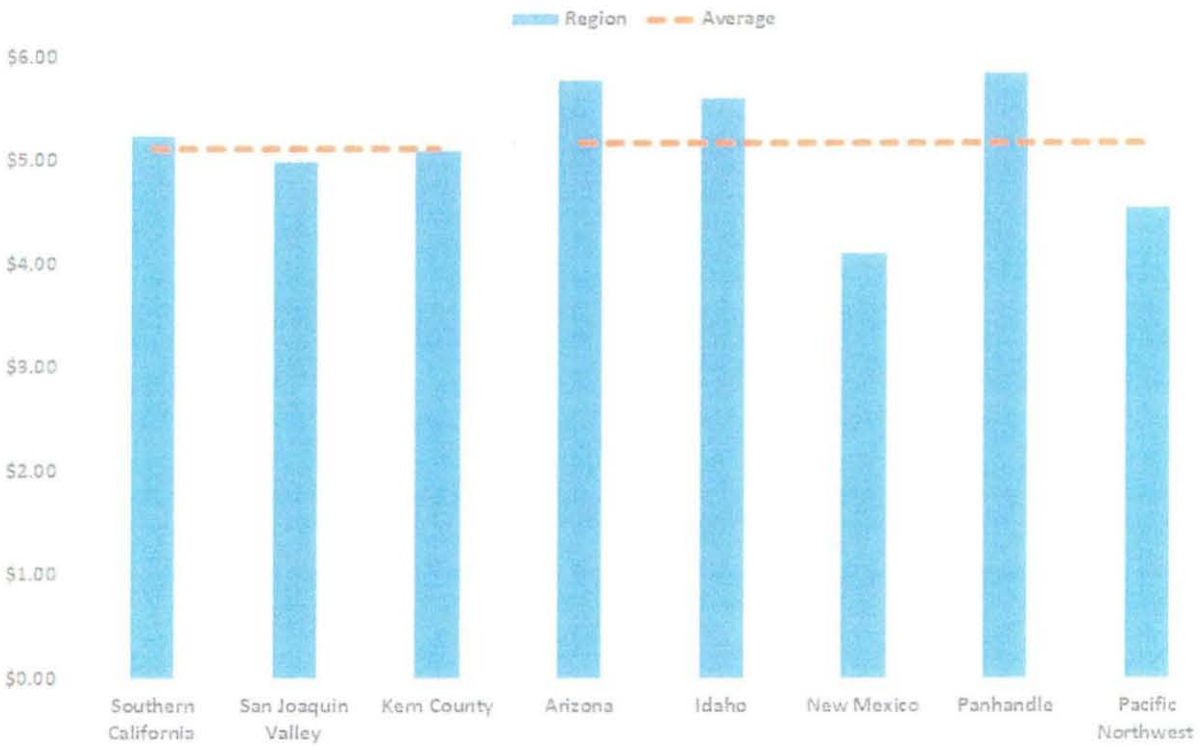
CDFA has been responsible and mindful that a regulated minimum price that is high enough to inhibit demand or encourage more supply might tip the delicate balance in California and lead to disorderly marketing.



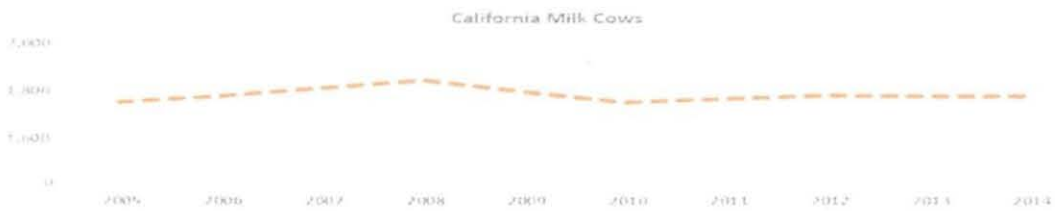
There are other cost studies published but they typically compare farms of similar sizes. Genske, Mulder & Co. LLC for example, has most recently reported 2013 Dairy Income and Expense data in Hoard's Dairyman. It compared farms ranging from about 1,800 to 3,000 cows in size on average. The regions compared were Arizona, California, Colorado, Idaho, New Mexico, Texas, Washington, Upper Plains states, and Lower Plains states. Of the nine regions compared in the 2013 report, California had the lowest total expenses per hundredweight of milk produced and the second highest net income per hundredweight. This is within the context of the existing California milk pricing system.

Another report available in the public domain is Frazer, LLP's "Dairy Farm Operating Trends". The report compiles data from dairy operations in Southern California, the San Joaquin Valley, Kern County, Arizona, Idaho, New Mexico, Texas Panhandle, and the Pacific Northwest, which consists of Washington and Oregon operating collectively. The report includes a comparison of the results in those regions listed both on a "per hundredweight of milk" basis and on a "per head" basis. To quote from the report, "*Our publication continues to be recognized as the top industry source for relevant dairy statistics. This report is provided to and widely utilized by dairy farmers, lending institutions, universities, colleges and other agribusiness industries.*" In reviewing the reports for the five years ending 2014, Kern County California had the highest net income among all regions in 2010 and 2011. Idaho had the highest net income in 2012 and 2013 and the Panhandle of Texas had the highest net income in 2014. For 2014, the average net income for the three California regions was \$5.10 per hundredweight. The income for the five regions in the report outside of California averaged \$5.16 per hundredweight. Based on the Frazer and Genske studies, it is reasonable to conclude that California producers are competitive with other regions in the Western United States despite operating within the pricing confines of the California milk marketing order.

Extracted from Frazer, LLP
 Dairy Farms Operating Trends - December 31, 2014
 Net Income Per Cwt - 2014

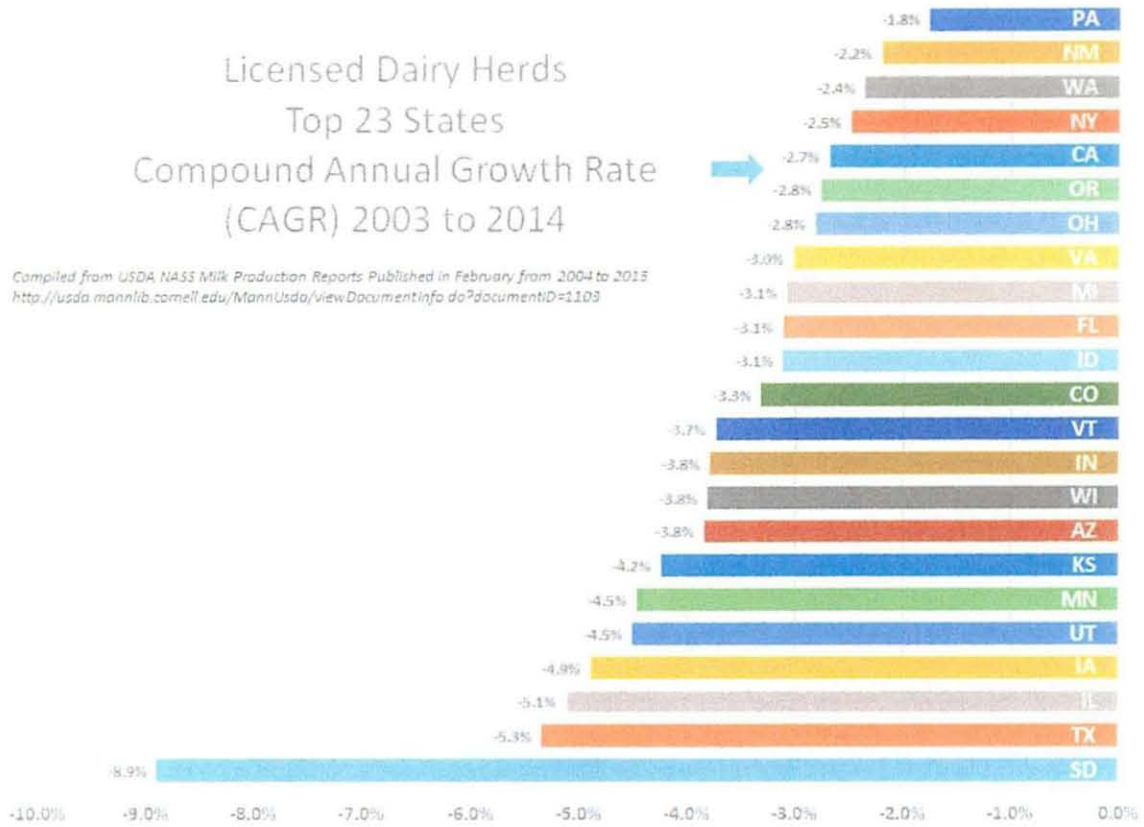


California did experience a reduction in average licensed dairy herds in 2014 according to the USDA Milk Production Report dated February 20, 2015 comparing 2014 with 2013. The percentage reduction in California herds however, ranked 34th among the 50 states and among the 15 states with 500 or more herds, only three lost a lower percentage of their herds than did California. One of those was Pennsylvania, the only state to report an increase in herd numbers. The suggestion that conditions are worse in California than Other states is simply not supported by the facts.

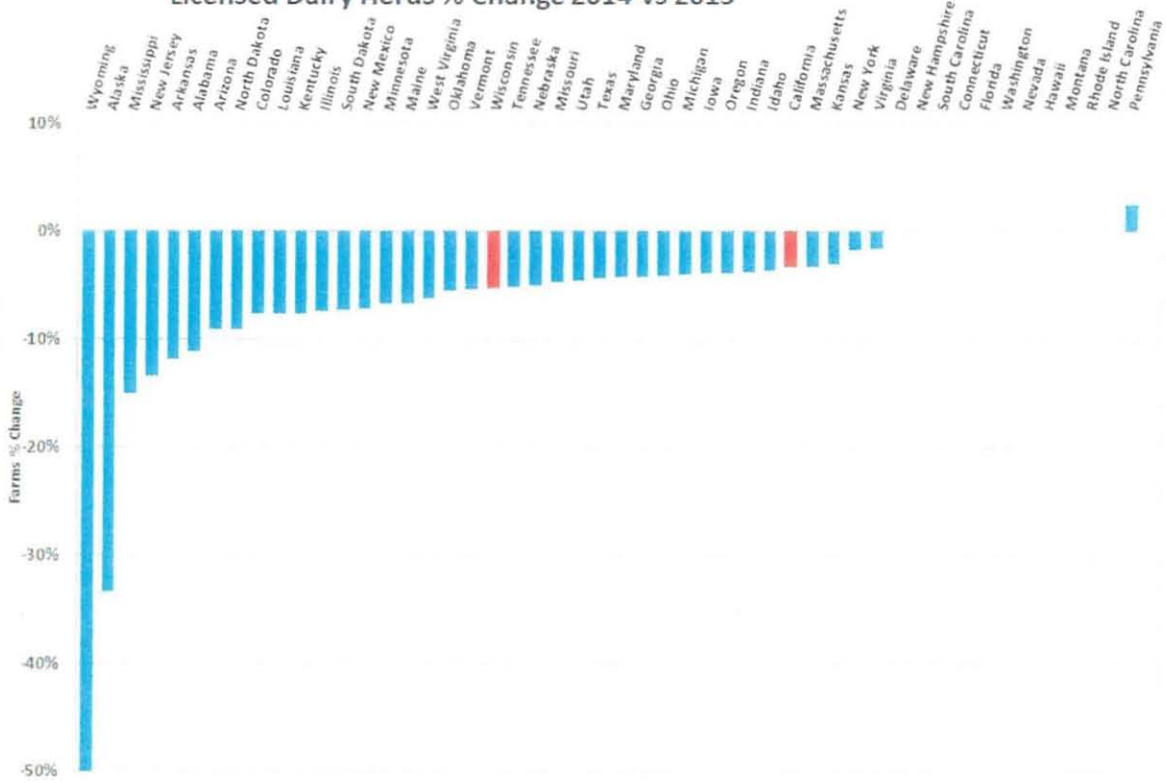


Licensed Dairy Herds Top 23 States Compound Annual Growth Rate (CAGR) 2003 to 2014

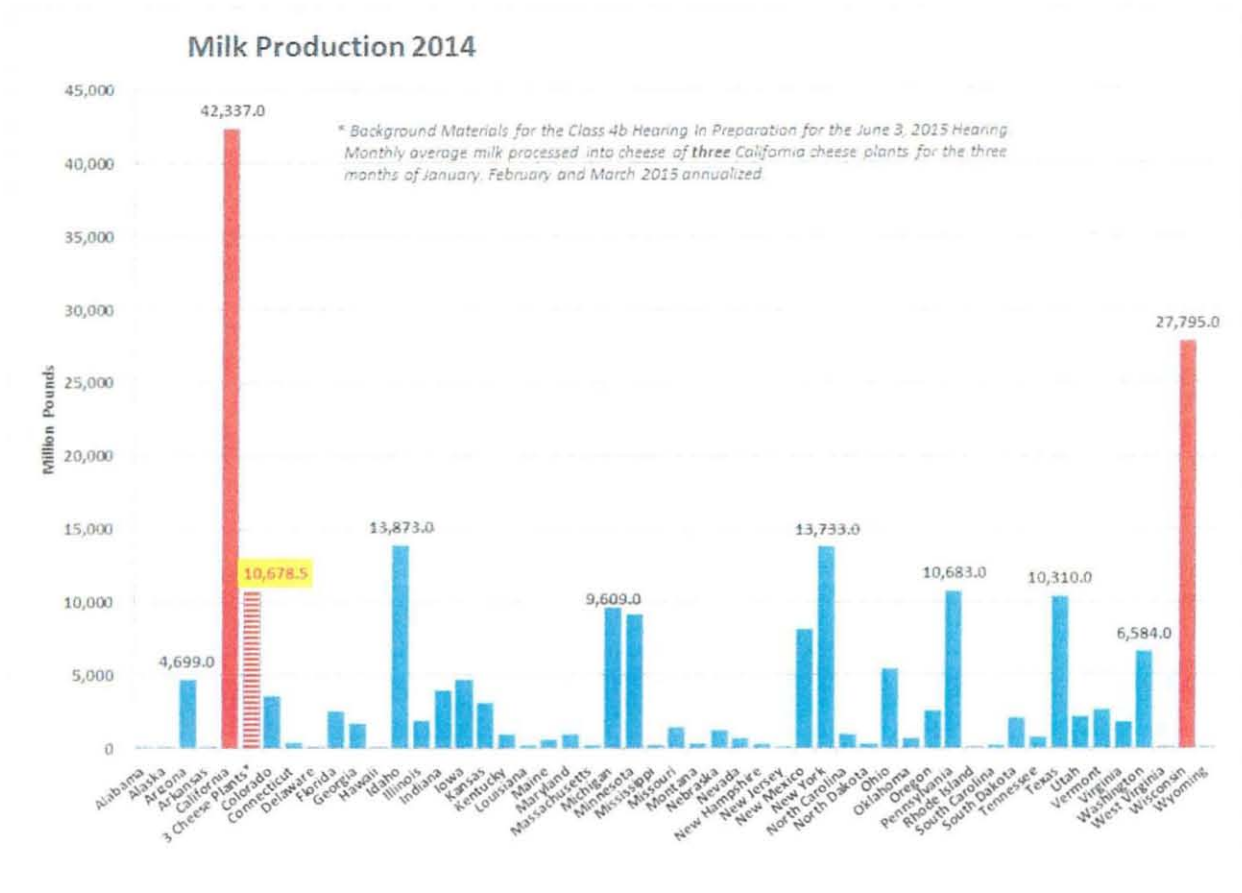
Compiled from USDA NASS Milk Production Reports Published in February from 2004 to 2015
<http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1103>



Licensed Dairy Herds % Change 2014 vs 2013



The rapid growth in California's milk supply has led to the construction of very large plants producing bulk commodity products capable of accommodating the ever-increasing milk flow.



Bulk products command lower margins than those of the smaller specialty plants that operate in other key cheese producing areas such as WI, MN, NY, PA, and VT. In other areas of the West, where larger plants are more common, the industry is either completely unregulated such as Idaho or most of the manufacturing is dominated by cooperatives, which have pooling and pricing flexibility to adjust to changing market conditions. According to background materials provided by CDFA for the hearing held on June 3, 2015, from January through March 2015, 57 cheese plants processed 45% of California's milk.

Just three of those cheese plants processed more than 56% of that Class 4b milk which means they processed in excess of 25% of the state's entire milk supply. On an annualized basis, those three plants process more milk than is produced in 45 of the 50 United States based on 2014 production numbers. More than the states of Texas, Michigan, Minnesota or New Mexico. More than Washington and Oregon combined.

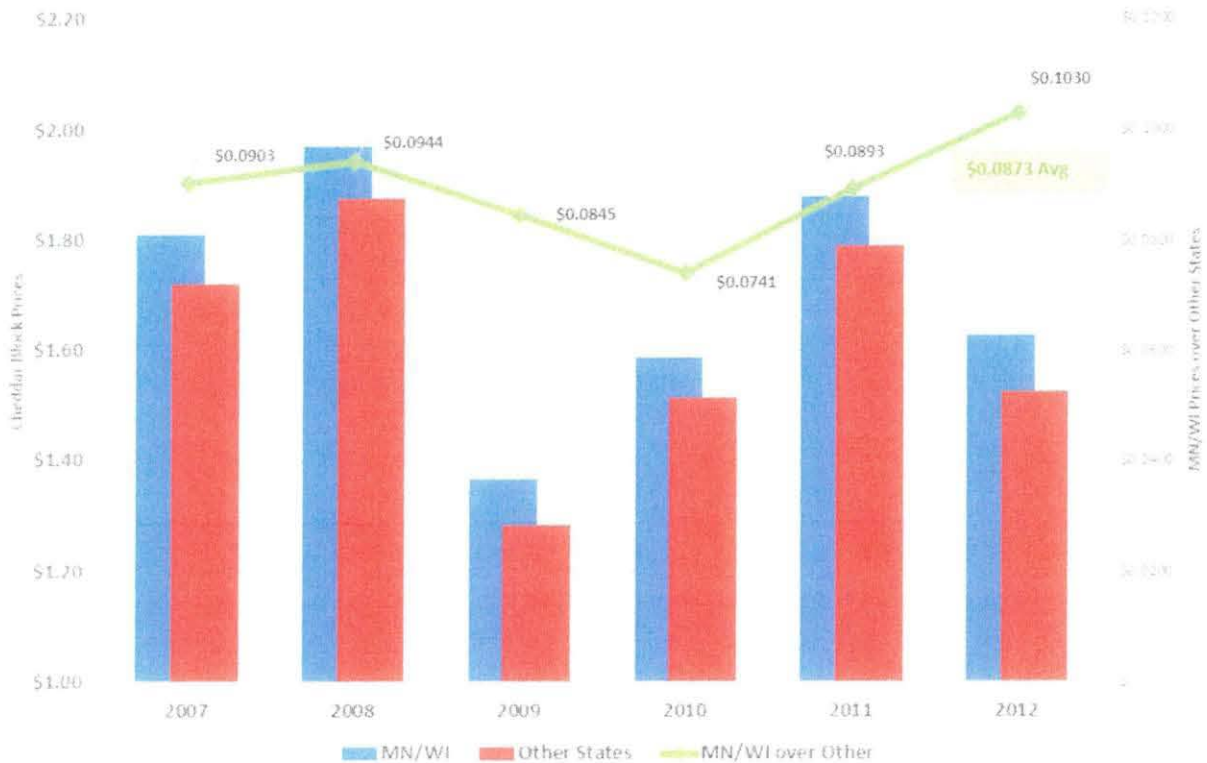
The Preliminary Regulatory Impact Analysis in Table B11 showing Class Price at Test changes under the Cooperative Proposal reveals an average annual price increase on Class III milk in California of \$1.84 per hundredweight. Applying that increase to the annualized production of the aforementioned three cheese plants would increase their combined cost of milk by \$196.5 million per year. It is unrealistic to believe an increase of such magnitude could be absorbed without threatening their viability. If you assume cheese is typically worth \$1.60 to \$1.70 per pound, and ten pounds of milk is required to make one pound of cheese, then a \$1.84 increase in the cost of milk represents \$0.184 per pound of cheese or more than 10% of the cheese's gross value. That cost increase is so large, it would likely place California cheese plants, especially high volume, low margin plants, in a difficult position to justify their continued operation. Since Class 4b accounts for almost half of the milk in the state, disorderly marketing conditions would inevitably ensue.

Cooperative organizations control the vast majority of milk in the state. They have more than enough bargaining power to negotiate prices with their customers that are reflective of the market conditions that exist in California.

ARGUMENTS IN CONSIDERATION OF A FEDERAL ORDER

- The argument disorderly marketing exists in California is false.
- The argument that California is losing dairy farms at a faster rate than the rest of the country is false.
- The argument that California milk production is declining because cows are leaving the state is false. (The 2015 decline is due almost entirely to lower production per cow.)
- The argument that producers in other parts of the country have caught up to California's production proficiency is false. (It may be true in isolated cases, but not in general.)
- The argument that California producers have not been listened to is false. (There have been seven hearings in five years and the Secretary established the Dairy Future Task Force to address their concerns.)
- The argument that de-pooling does not benefit FMMO milk buyers is false. Mr. Wegner of Land O' Lakes confirmed that in previous CDFA hearing testimony.
- The argument that California cheese plants can afford to pay the same price as those in the Midwest is false, given the cost of doing business in California including transportation of product to the population centers in the East. It costs about twelve cents per pound to ship cheese from California to the Midwest and about sixteen cents to the East Coast. For the five last years that USDA NASS surveyed and reported Dairy Product Prices, Minnesota and Wisconsin cheddar block prices averaged about nine cents higher than those of the "Other States". See following chart.

USDA NASS Survey Annual Average
Cheddar Block Prices
(Stopped Reporting After March 2012)



- The inference that California producers under the California system make less net income than their Western counterparts is false.
- The idea that mega cheese plants consuming oceans of milk can compete on milk price with specialty plants buying small volumes of milk is false.
- The argument that the Federal whey factor more appropriately values whey than California's whey factor is highly debatable.
- The notion that California's milk production will decline to the point it cannot supply the fluid market is false. (Just three cheese plants in California process almost double the amount of milk needed to supply the declining Class 1 market.)

per hundredweight

•The argument that raising the 4b milk price by one or two dollars will discourage dairy farms from converting to almonds, which according to testimony, return the equivalent of \$40 per hundredweight, is false.

To establish a Federal Order, especially one that specifies unprecedented mandatory pooling, would put proprietary plants in an untenable position, rendering them unable to compete effectively with cooperatives who have pooling and pricing flexibility under the Orders. California's dairy industry needs both processors and producers, cooperatives and proprietaries. If USDA decides to recommend a Federal Order, Saputo supports only the proposal submitted by the Dairy Institute of California, which provides for voluntary pooling, and milk prices based on Western product prices among many other provisions.