



**BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURAL 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**

**Fresno, California, November 16, 2015**

**Testimony of Dennis Schad**

**(Second statement)**

**(Rebuttal)**

**In Support of Proposal 1 of California Dairies, Inc.,  
Dairy Farmers of America, Inc., and Land O'Lakes, Inc.**

**Proposal to Establish a Federal Milk Marketing Order for the  
State of California**

**Cooperatives' Exhibit 12**

## Cooperatives' Rebuttal Testimony

### **I. Pooling Milk in FMMO 1**

The Dairy Institute entered Exhibit 23 into the record on September 28, 2015 (NT, pg. 1051), an FMMO 1 document, "Non-Pool Handler Listing August 2015." The witness, representing Proposal 1, was questioned about the products manufactured in various plants listed on the report. The witness was asked, "And being a non-pool plant means that they're not subject to minimum price regulations in the Federal order, correct." The witness answered affirmatively.

The question implies that dairy plants and handlers are routinely de-pooling milk of dairy farmers associated with FMMO 1. As an active participant in the marketing of milk in the FMMO 1 marketing area, I can note that actually very little milk is de-pooled in the marketing area of the Northeast FMMO. That Order contains a provision, Dairy Farmers for Other Markets (§1001.12 (b) (5) and (6)), which excludes the milk from the pool of a dairy farmer that has been de-pooled. This onerous provision assures that virtually all milk associated with the Order remains pooled at all times, even when there is a negative PPD. Milk delivered to the plants listed on Exhibit 23 is routinely pooled on FMMO 1.

### **II. Pay Prices and Class III Price in Federal Orders**

Dairy Institute Exhibit 102 purports to demonstrate that dairy farmers in Texas, New Mexico and Michigan have been and are currently being paid below the Class III price. As evidence, the witness subtracted from the state's All Milk price the sum of the state's Class III price at test (witness used FMMO monthly tests when state specific milk tests were unavailable) plus the month's FMMO Producer Price Differential (PPD), adjusted for the state's location differential. Putting aside our reservations as to whether a state's All Milk price less that state's

Class III at its component test (or FMMO as a proxy for the state's component test) plus the FMMO PPD, adjusted for the state's location, is a proper measure by which to conclude that dairy farmers in that state are paid less than the Class III price, the proponents of Proposal 1 offer **Exhibit 12.A. Difference Between All Milk Price and The Class III (test) plus Adjusted PPD 2009-2015**. Using the same measure as the Dairy Institute's, six states: Wisconsin, New York, Pennsylvania, Iowa, South Dakota and Minnesota, representing 51 percent of the nation's cheese production, have in every month during the last five and a half years paid dairy farmers in excess of the Class III price. These pay price levels are further confirmed by **Exhibit 12.B. The Market Administrator's Bulletin for FMMO 1 for June 2013**. On pages 2 and 3, the Market Administrator disaggregated the Order's Mailbox Prices for the first quarter of 2013, parsing out the effects of transportation, producer PPD payment and producer premiums on the reported Mailbox price. Table 3 of Exhibit 12.B shows that the average premium paid to dairy farmers in the Northeast, including Pennsylvania and New York, during the period was \$1.06 above Federal Order minimums.

### **III. Sales Below Federal Order Minimum Prices in FMMO Markets**

Multiple Dairy Institute witnesses have asserted that producer milk that has satisfied its class obligation to the FMMO pool, nevertheless is routinely offered to manufacturing plants at below Class prices. DIC witnesses assert that this 'cheap milk' would unfairly compete with California cheese plants under Proposal 1. Land O'Lakes is a major marketer of milk in FMMOs 1, 30 and 32. I have asked the Cooperative's accounting department to aggregate the volumes of milk in our two marketing areas that were sold at "distressed" or under-class prices during 2014. That year was particularly stressful with increasing milk production in the Cooperative's milk sheds and falling commodity prices. Minnesota and Wisconsin, states that dominate LOL's

Midwest supply, increased production by 4.3 percent and in LOL's major milk shed in the Northeast, Pennsylvania, milk production grew by 2 percent. From a high of \$2.35 in September, the NDPSR cheese price fell to \$1.74, while the NDPSR non-fat powder price decreased by \$0.83 (40 Percent) from its high in March to its lowest price in December. Last year's market environment could hardly be characterized as a "sellers' market."

As noted, the LOL accounting department reported to me volumes of milk sold at under-class prices during 2014. In the Northeast 0.68 percent of milk marketed (not including deliveries to LOL plants) was sold at under-class or distressed prices, while 1.07 percent of LOL's Midwestern marketed milk was sold at under-class prices. The weighted average of these below class sales for the two LOL regions is 0.9 percent. If we used Hilmar's weighted average below class price of distressed milk sales of \$2.24 (Exhibit 98, pg. 5), the value is about \$0.02 per cwt across the Cooperative's third party milk sales.

Elvin Hollon's testimony later in this Hearing will present DFA's nationwide experience which confirms the limited impact of below class sales in Federal order markets.

Dr. Schiek testified to the existence <sup>of the</sup> lack of "willing capacity" during the periods in 2007 and 2015 when milk was exported from California at considerable loss to handlers. His testimony was confirmed by the Leprino witness. He implied, had the State regulations allowed, cheese plants would have taken volumes above their supplier contracted volumes, thereby mitigating the out-of-market costs incurred by handlers. The proponents of Proposal 2 assert that the inclusive pooling provisions of Proposal 1 would again leave its members without a "market clearing" pricing alternative for incremental volumes.

The provisions of §1051.73 "Payments to Producers and to Cooperative Associations" require that minimum Class prices are paid. The accounting for the enforcement of this

provision is made at month's end and all payments made by the pool plant are summed against the volumes and components of milk received at the plant. All handlers have testified that premiums above minimum prices are being paid in the California market. Hypothetically, if a plant is paying an average premium above minimums of \$0.25 per cwt and the price of incremental market clearing milk is \$2.50 under Class (Hilmar testified that its weighted average cost was \$2.24 plus transportation - Exhibit 98, pg. 5), the buyer and seller could agree to deliver a volume equal to 10 percent of the monthly sales volume as additional milk to the plant at the incremental "market clearing" price. If a plant bought 5 million pounds of milk per day, the hypothetical example would allow the plant to buy 500 thousand pounds of milk (10 truckloads) per day at the "market clearing price." Under Proposal 1 the FMMO audit would reveal that the aggregate monthly sale was at or above minimum class prices.

#### **IV. The Limited Financial Effect of De-Pooling in Federal Orders**

The Hilmar witness, representing the Dairy Institute of California, offered Exhibit 100 to show that there is massive de-pooling of Class III milk in the Federal orders. As evidence, the witness provided a copy of Table 5 from the Pacific Northwest (FMMO 124) annual report showing large decreases in producer receipts allocated to Class III. I suspect the witness is correct in assuming that the decreases in Class III receipts in February, April, October and November were due to handlers, pooled on that Order, choosing not to report the milk of dairy farmers delivered to Class III plants during the month. There are two things to note: first by de-pooling the handler is avoiding a payment into the pool of moneys from the Class III price. In effect, the handler is avoiding the sharing of a portion of the Class III price to the pool. If the sale is a third party cooperative sale to a cheese manufacturer, when the milk is pooled, the cooperative must pay the difference between the sale price received from the cheese



manufacturer and the Uniform Price into the pool. The second point is that Order 124 contains among the most liberal re-pooling provisions of any order. Therefore, de-pooling of Class III milk on FMMO 124 would be expected to be the most extensive in the Federal order system and reflect the most impacts upon the competitive value of Class III milk. The DIC witnesses provided no study of these financial impacts of de-pooling.

In order to measure the financial significance of de-pooling in the Federal orders, I estimated those impacts in the next four Cooperative's Exhibits. For the calendar year 2014, **Exh. 12.C. Value of De-Pooling FMMO 124 – 2014** estimates the volumes of Class III milk de-pooled by handlers in FMMO 124 and quantifies the financial effect of de-pooling across the milk used to produce cheese in Order 124. In Exhibit 12.C the volume of the months in which the PPD was positive was summed and divided by the days in those months to estimate the base daily average of Class III receipts on the Order. In months where the PPD was negative, the order's actual Class III volume was subtracted from the order's daily average multiplied times the days of the month, estimating the volume of milk de-pooled during the month. At the bottom of the table, the month's de-pooled volume was multiplied times the month's FMMO negative PPD. Those values were summed and divided by "the milk used to produce cheese" which was the sum of annual reported Class III plus the estimated de-pooled volumes. The estimated effect on the total volume of milk used to produce cheese in Order 124 <sup>in 2014</sup> was \$0.237/cwt. The next three exhibits use the same method. **Exh. 12.D. Value of De-Pooling FMMO 30 – 2014** shows an effect of \$0.015 in Order 30. **Exh. 12.E. Value of De-Pooling FMMO 32 – 2014** demonstrates an effect of ~~\$0.045~~ <sup>\$0.055</sup>/cwt in Order 32, and in **Exh. 12.F. Value of De-Pooling FMMO 33 – 2014**, the effect in Order 33 is \$0.040/cwt. The weighted average impact of de-pooling of these large cheese-producing Federal orders was \$0.042/cwt. <sup>(orders 124, 30, 32, 33)</sup>

## V. Problems Using California Cheddar Cheese as Proxy for All California Cheese

At least two witnesses, representing the Dairy Institute, have asserted that California is a cheese exporting state. The witness, representing Hilmar, stated that “California produces roughly twice as much cheese as it consumes based on a 2014 population value of 38.8 million, ERS estimates of cheese consumption per capita (34.2 lbs. per year 2014) and NASS California cheese production.” (Exhibit 98, pg. 24) However, the same ERS source also reported the annual per capita consumption of cheddar cheese was 9.68 lbs. Using the same arithmetic as DIC, the estimate of California cheddar cheese consumption is 375,584,000 pounds per year. The same NASS Dairy Product Annual Products Report (pg. 32) noted that California cheddar cheese production in 2014 was 375,839,000<sup>pounds</sup>. Including the statement that the State’s largest cheddar cheese producer exported “nearly 10% of its cheese” (Exhibit 98, pg. 26), one could conclude that California was actually cheddar cheese deficit in 2014.

The proponents of Proposal 2 would have the Department believe that the manufacture of all cheeses in the state incur extraordinary manufacturing and transportation costs. If half of the State’s total cheese is exported beyond state lines, then half is remaining within the State accruing the home field advantage of less expensive sales and transportation logistics. No evidence was provided regarding the manufacturing or transportation costs nor the yields of the varieties of cheese, other than cheddar, yet we have had days of testimony regarding the inadequacy of the FMMO Other Solids formula to value the whey component of cheese making.

## VI. Make Allowances

DIC asserts that the make allowances for butterfat, non-fat milk solids and cheese/protein in the product formulas for a California Federal Order should be lifted directly from the 2014 CDFR Survey of Manufacturing Costs, plus a .15 cent allowance for marketing expense.

However, my prior testimony quoted CDFA representatives, testifying at the 2000 USDA Hearing, expressing another view of price setting at CDFA. They stated that make allowances in the CDFA product formulas took account of other factors not included in the Manufacturing Cost Surveys and that the price setting formulas are an expression of policy. (Exhibit 70, page 34) Dr. Schiek, during cross examination of his testimony contained in Exhibit 122, confirmed that characterization of CDFA price setting. Not having a CDFA other solids/whey make allowance, DIC cobbles a proxy whey make allowance by subtracting the FMMO non-fat dry milk allowance from the FMMO whey make allowance (\$.1991 - \$.1678) to approximate the difference in the cost of drying whey and drying non-fat dry milk. DIC then adds this difference to the 2014 CDFA Manufacturing Weighted Average Cost Survey for non-fat dry milk (\$.1997), plus a marketing cost of .15 cents to approximate a cost to dry whey.

As noted in my prior testimony, CDFA manufacturing costs are included in all FMMO make allowances (**Exhibit 12.G. Table 1. 2008 AMS Impact Analysis of Tentative Partial Final Decision**), except for the cost of drying whey. As California finds it inappropriate for a CSO order to adopt make allowances directly from the CDFA Manufacturing Survey, so should the California Federal FMMO.

CDFA notes that there are four plants that manufacture cheddar cheese in the form that can be priced by NDPSR. Since 2011, the disparity in size between the four plants precluded CDFA's announcement of the average selling price or the volume sold. The current 2014 Survey notes that <sup>two of</sup> the four cheddar cheese plants surveyed produce 40 pound blocks, 500 pound barrels and 640 pound blocks, yet the DIC proposal would set cheese prices based only on 40 pound blocks. Due to the few cheddar cheese plants in the Survey, CDFA has been unable to report ranges of costs among the plants, as CDFA does in the butter and nonfat dry milk plants. In



effect, DIC is proposing that USDA set prices for milk<sup>used</sup> to produce cheese based on the weighted average manufacturing costs of four plants that are dominated by one very large cheese plant.

DIC further proposes that USDA recognize “spatial value” of butter, powder and cheese by subtracting a western value adjuster (FOB adjuster) from the NDPSR monthly announced price. The DIC witness explained that the fixed adjuster for each commodity is based on the average of the 5-year historic difference between the price determined by CDFA audits for the commodity and the NDPSR prices. There is an immediate problem in this process. CDFA has not announced a cheese price since at least 2011. To bypass the lack of CDFA reported California specific cheese prices since 2011, DIC cobbled together a complex process to approximate an FOB adjuster for cheese based on two time series.

While there are no published CDFA data to verify it, DIC’s premise is that cheddar cheese prices are lower in California than in other areas of the country, notably the Midwest. However, recent prices from the Dairy Market News(DMN) indicate that the California price is actually higher than the Midwest price for wholesale 40 pound blocks of cheddar cheese delivered in less than carload lots. **Table 12.H. Average Wholesale Delivered Price of 40 pound Blocks of Cheddar Cheese in LTL Lots** shows the prices reported in DMN for the above commodity for Wisconsin, the West Coast<sup>and</sup> ~~and the Northeast~~. DMN reports that for the 18 month period between January 2014 and June 2015 the West Coast price averaged 2.17 cents above the Wisconsin price. In the absence any other published sales reports of cheddar cheese, the DMN reports of regional cheese prices must take precedence.

DIC introduced an alternative proposal to price Other Solids. Noting that only 13 of California’s 57 cheese plants also process whey, DIC called for a new process of valuing Other Solids. Dr. Schiek testified, “The milk price should reflect what the cheesemaker can earn by

selling his wet separated whey f.o.b. his cheese plant.” (Exhibit 122 pg. 14.) Proposal 2 describes a pricing formula based on the value of WPC 34, less the cost of drying WPC, less the cost of cooling and delivering liquid whey to a whey drying facility. DIC estimated that the total cost of these operations was 31.1 cents.

While there may be an acceptable yield component to the DIC Alternative Proposal, there presently is no transparent and verifiable price series for WPC 34. Likewise there were no cost studies by third parties to verify the cost of drying WPC 34, and the DIC Proposal make allowance assumes that all whey is cooled and transported to a whey aggregator.

In essence, the DIC Alternative is a solution in search of a problem. Dr. Schiek utilized Exhibit 96 to illustrate the number of cheese plants with whey processing facilities, however he failed to note the volume of monthly milk pounds that are processed at plants with whey drying facilities. Assuming that all plants in Groups 5 through 8 are of equal size, then one could argue that 86 percent of the Class 4b milk was processed at dairy plants that had whey drying capabilities. Further, the Cooperatives’ Exempt Plant proposal could exempt as many as 25 of the 57 cheese plants from minimum class pricing.

## **VII. Dairy Price Hedging in California**

Dairy farmers: Jared Fernandes, Dino Giacomazzi and James Netto testified that the California pricing system increased the uncertainty of hedging their milk price and inhibited their use of commonly used forward milk pricing tools. Mr. Fernandes stated, “The difference between the two price series is almost always negative, with the Class 4b price less than the Class III. More importantly for hedging and risk management purposes, the basis is *highly volatile and unpredictable* (author’s emphasis) month to month.” (Exhibit 22). In response to the dairymen’s testimony, the witness representing Hilmar stated, “Proponents of Proposal 1 have

suggested risk management for California producers is ineffective because of the difference between the California 4b price and the FMMO Class III.” (Exhibit 98, pg. 12) The witness then provided statistical evidence that “. . . California is neither the best nor the worst.” (Ibid.) The witness purports to show with Figure 5 in Exhibit 99 that California is the 4<sup>th</sup> best in the group of ten states, comparing the differences between the states’ NASS All Milk Price and the Class III price. The chart’s footnote explains that for each year the maximum spread among the states’ All Milk and the Class III was added to the minimum for that year. Those values for the five and a half years were averaged. Figure 5’s footnote also explains that the calculation used the absolute value of difference, such that a negative number was treated the same as a positive number.

Figure 5 of Exhibit 99 shows that California scores 4<sup>th</sup> best and Pennsylvania last in this measure. **Exh. 12.I. Difference Between CA All Milk and Class III Prices 2010-2015** (Exhibit 103) graphs each of the data points used for Figure 5’s conclusion and shows that in 33 months of the 66 months surveyed by the Dairy Institute witness, the difference between the California All Milk Price and the Class III price was negative. **Exh. 12.J. Difference Between PA All Milk and Class III Prices 2010-2015** (Exhibit 104) charts the data points for the “worst” state, Pennsylvania. In all months the difference between the Pennsylvania All Milk price and the Class III were positive.

While a Pennsylvania dairy farmer has a great level of certainty that his farm price will always be above the Class III price, the California dairyman knows that it is as likely as it is not that his farm price will be above or below the Class III price. Smoothing out the positive and negative differences with the use of absolute numbers does nothing to reduce the risk that an actual California dairyman experiences with the California pricing system. Dairy farmers with

actual experience have testified that they have used standard risk management tools and have reported that the California prices cannot be successfully hedged.

Figure 6 of Exhibit 99 is calculated in the same manner comparing the states' Mailbox Price and the Class III price. **Exh.12. K. Difference Between CA Mailbox and Class III Prices 2010-2015** and **Exh. 12.L. Difference Between PA Mailbox and Class III Prices 2010-2015** are the graphs for these variables and reveal similar results as Exhibits 103 and 104.

**VIII. Cooperative Response to Dairy Institute Proposal Concerning Increased Shrinkage Allowance in 7(b) Plants**

Dairy Institute provided four witnesses, Messrs. Herbein, Zolin, Meek and Suever to testify in support of proposed changes to §1051.43 to accommodate purported excessive shrinkage in §1051.7 (b) plants. Mr. Herbein provided a study of dairy plants represented as federally pooled Section 7 (b) plants and plants pooled on the California state order. The witnesses testified that the 19 plants manufactured Extended Shelf Life (ESL) or aseptic milk products. Mr. Herbein's cross section study, "Shrinkage Ultra Pasteurized and Aseptically Processed Milk at 7(b) Distributing Plants," (Exhibit 84) included at least 6 plants: Saputo (Frederick); Friendship; Murray; Newington; White Bear Lake and Frazier that are not pooled distributing plants and therefore not subject to the shrinkage provisions of Section §1000. 43.

Dairy Institute witnesses also cited Table 18 of Exhibit 9, Total 7(a) and 7(b) Plants with Excess Shrinkage, All Orders – January 2009 – June 2015. While Dairy Institute witnesses insisted during the hearing that California data was needed for a California decision, no California plants were included in the USDA study.

ESL products are value added products and should not be granted excessive shrinkage consideration under the California order.



## **IX. Similarities between California and Carolina Promulgations**

In observing the 30-some days of this Hearing, I am struck with the similarities between this promulgation hearing and the Carolina promulgation decision (55 Fed. Reg. June 22, 1990 pg. 25,601) in 1990. Like the proponents of Proposal 1, the dairy farmers in Carolina testified that the Carolina order <sup>should</sup> adopt the national manufacturing price levels for Class II and III, at that time the Basic Formula Price (BFP.) While describing the determination of the monthly BFP in detail (Ibid, at pg. 25,641-3), the Secretary took official notice of Class II Final Decisions (1982 and 1989) to determine the new Order's Class II price (Ibid. pg. 25,641). The Secretary also relied on previous Federal order decisions to determine Classification of Milk, based on its use (Ibid. at pg. 25,634). As noted in my previous testimony, the Secretary rejected a proposal that would continue the Carolinas' state order pricing of butterfat that conflicted with the butterfat pricing in adjacent Federal orders, citing previous FMMO decisions (Ibid. at pg. 25,643). The importance of aligning the Class I differentials in the Carolina order and existing orders was also noted (Ibid. at pg. 25,639-40). The Carolina order also provided for an other-than uniform producer payment system through the approval of base-excess payment in the new order (Ibid. at 25,643).

The Carolina Promulgation decision also addressed an issue that is, in my opinion, very germane to this proceeding. A handler, Coburg Dairy, proposed a modification to the provisions to the Carolina order that charged a handler the difference between the Class III and Class I price for a non-fluid milk product reconstituted into a fluid milk product. The witness observed that it would be likely that any reconstitution that would occur ~~in~~ at the time of the 1989 Hearing would be the result of a reverse osmosis manufacturing process. The witness stated that such

concentrated milk product would be priced as Class II in most Federal orders, causing a pricing conflict.

The Secretary ruled:

The reconstitution charge adopted in the Carolina order is the same as the one applicable in most other Federal orders. Thus, if the reconstitution charge were modified in the Carolina order, there would not be uniformity of classification of the reconstituted milk product with the other Federal orders. It is concluded, therefore, that a reconstitution charge at the difference between Class III and the Class I price shall apply until such time that this issue can be reviewed on a national basis. (Ibid. 25, 637)

Some of the issues raised by the proponents of Proposal 2 including: the appropriateness of combining both block and barrel cheese prices in the ~~DPRSR~~<sup>NDPSR</sup> survey; regional pricing of commodities included in the ~~DPRSR~~<sup>NDPSR</sup>; and the appropriateness of combining manufacturing costs of plants both within and beyond California's borders to determine product formula make allowances - have been addressed in previous Federal order hearings, which is not to say the Secretary could not notice those issues at a future hearing. Others, such as increased shrinkage allowance in §10\_\_ . 7(b) plants and a review of whey pricing have not been addressed in a national hearing. It should be noted that the Carolina order was not suspended until a national hearing could be held to resolve the issue of price conflict, nor should a California order be so delayed.