



**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**

Clovis, California, September 22, 2015

**Testimony of Elvin Hollon
(First statement)**

**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 1

I am Elvin Hollon. I am employed by Dairy Farmers of America, Inc. as the Director of Fluid Marketing and Economic Analysis. My office is located at 10220 Ambassador Drive, Kansas City, Missouri, 64153. I am testifying today in support of Proposal 1, the proponents of which are: California Dairies, Inc., Dairy Farmers of America, Inc., and Land O'Lakes, Inc.

All of the proponents are member-owned, dairy farmer cooperatives. Dairy Farmers of America (DFA), my employer, is a member-owned Capper-Volstead cooperative with approximately 14,000 members with 9,000 dairy farms in 48 states, including California. The three proponent cooperatives' farmer members together represent over 75% of the milk produced in California.

I. Why a California Order?

A California Federal Milk Marketing Order (FMMO) is necessary in order to recognize for California dairy producers the full nationally defined value from all uses of milk produced and marketed in the state, as well as to achieve common regulatory minimum prices to all processors in the country. The FMMO proposed by the cooperatives would not only promote and enhance orderly marketing conditions, but would also address long standing conditions of disorderly marketing. In order to achieve this result, a California FMMO must be fully integrated into the FMMO system. A stand-alone California State Order (CSO) no longer achieves these results operating as a separate pricing entity.

The FMMO Reform process established a national uniformity of manufacturing milk values and broad regional marketing order marketwide pools. The California state system, however, has not adapted, leading to market conditions that have become increasingly difficult for California dairy farmers and the operation of the cooperatives they have built. The failure of California regulations to establish minimum prices to California producers which reflect national

values for classified milk uses has cost California dairy farmers more than \$1.5 billion dollars since 2010, according to published industry estimates. The Cooperatives' dairy farmer members have carefully studied the operations and impacts of an FMMO and have concluded that a California FMMO is imperative in order for them to have the opportunity to achieve returns that are in parity with those of other dairy farm enterprises in the country.

FMMOs are crafted singly and individually to address marketing conditions present in the areas they govern. The Secretary is both authorized and required to recognize unique and individual conditions that also have explicit relationships with other marketing orders to form a coordinated national system. In order to craft the proper provisions for a California FMMO, the Secretary must understand the unique conditions of the California marketing area as well as the integrated relationships firmly established by existing Order provisions between the California dairy industry and the remainder of the FMMO system, and strike the proper balance between the prevailing interests of the entire system and the interests and conditions present in the California market.

We will demonstrate that California producer milk returns are well below those of similarly situated FMMO producers throughout the country and that minimum regulatory prices to processors are not in accordance with the FMMO national pricing grid which is derived from common uniform pricing provisions applicable to all FMMO processors, and based on a series of market driven prices that represent national values.

Finally, we will show that based on the unique marketing situation in the California market, our proposed pooling provisions must be incorporated in the California FMMO pooling standards so that the FMMO will function as intended.

II. The California Dairy Marketplace

The state of California is the largest milk producing state in the U.S. with more than 20% of national production. According to United States Department of Agriculture (USDA) statistics, California is the country's leading dairy state. In 24 categories where a pound, a gallon, a cow, a farm or a plant can be counted, California is the top ranking state in thirteen categories, number two in six categories, number three in two categories, number four in one category, and number seven in one category and number eight in one category. These statistics were published in the National Agricultural Statistics Service publications Milk Production (February 2015), Dairy Products Annual (April 2015) and Production, Disposition and Income (April 2015).

California is first (category / percent of U.S. total where applicable) in total state milk production (21%), number of milk cows (19%), production of Italian cheese (32%), mozzarella cheese (37%), Hispanic cheeses (52%), condensed skim milk (unsweetened) (37%), nonfat dry milk-- human grade (41%), butter (33%), dry buttermilk (47%), ice cream (17%), ice cream mix(17%), sherbet mix (10%) and the total value of milk production at \$9.346 billion (19%) for 2014.

The California dairy industry is ranked second in the production of all types of cheese (21%); American style cheeses (14%), other than American style cheeses (21%), sour cream (14%), lowfat ice cream (6%), and lowfat ice cream mix production (6%). The industry ranks third for production of creamed cottage cheese (9%) and the number of dairy plants (9%). The industry ranks fourth in cheddar cheese production (12%) and seventh in the number of dairy farms (3%) eighth in milk per cow.

If California's milk producers adopt an FMMO, it would be the largest order pool with a monthly average volume of slightly below 3.4 billion pounds, eclipsing Order 30's average 2014

monthly pool volume of 2.7 billion pounds. In terms of Class I volume it would be the third largest of the Orders behind Order 1 (approximately 760 million pounds in 2014) and Order 33 (approximately 520 million pounds in 2014) with an estimated monthly volume averaging 438 million pounds.

In spite of its significance nationally, California has been the most important region in the country which has not been part of the FMMO system. For many decades, the California Department of Food and Agriculture (CDFA) has administered a state milk marketing order (CSO) and has reasonably balanced industry interests to the satisfaction of California's dairy farmers. In recent years, U.S. milk markets have become more regional and national in scope, and FMMO regulations have evolved with those developments. However, regulations in California have not responded to the shifts taking place in the national marketplace.

In 2014 Congress provided a necessary prerequisite for correcting this condition when it re-authorized the language in the 1996 Farm Bill allowing the USDA to promulgate a California FMMO while retaining the California state quota program. CDFA records indicate there are 2,233,428 pounds of solids not fat (SNF) quota issued (on a daily production basis). Recent CDFA published records indicate quota was traded for \$525 per pound of SNF per day yielding an aggregate market value of \$1.173 billion. That Congressional authorization makes clear that a California FMMO will have all the benefits and characteristics of the other ten FMMOs, while maintaining the unique California system of sharing milk sales revenues through the state quota program.

III. Price Alignment Issues: The California Dairy Marketplace and the United States: Producer Price Misalignment: Mailbox Price Comparison

One of the requirements the regulatory system is charged with is assuring a standard of uniformity and equity in both producer and handler prices. Data indicates that by having the

California dairy industry regulated outside the national FMMO pricing and marketing grid there is significant producer price misalignment with this standard. While many factors in the operation of a dairy farm are localized, several key factors are increasingly becoming regional, national and even international. We will have testimony from members who will discuss issues related to competition for feedstuffs, labor, dairy production items and capital. Our members in California find it increasingly difficult to bid for resources when faced with lower returns than their counterparts around the country and the world.

As a reliable and reasonable measure to demonstrate the price disparity for similarly situated producers, we reviewed a comparison of the Mailbox Milk Price (MMP) series published by AMS.¹ This price series has been available since at least 1998 and has been calculated on a consistent basis. As stated in the USDA / AMS publications, the price series is at-test, all revenues included and net of marketing expenses.

There are MMPs published for 20 different market regions. For comparison purposes we isolated the three states that comprise the majority of the Upper Midwest Order marketing area with high production of cheese, butter and nonfat dry milk and lower Class I utilization of milk. They are Wisconsin, Minnesota and Illinois. We note and agree with the assertion in the Dairy Institute proposal that there are many market similarities between these regions and the California market.

¹ Areas for which the MMP series is reported represent at least 75% of the milk marketed under Federal milk orders. The MMP reflects the net pay prices received by dairy farmers for milk. Prices reflect all payments received for milk sold and all costs associated with marketing the milk. Prices are weighted averages of the prices reported for all orders receiving milk from the reporting area and are reported at the average butterfat tests. Prices include, for the most part, the assessment under the Cooperatives Working Together (CWT) program. (Dairy Market News, USDA/AMS, August 21, 2015)

We also selected the Northwest States series composed of data from Oregon and Washington for comparison. These states comprise a significant portion of Federal Order 124, the Pacific Northwest Order. Like Order 30 and the California market, the Northwest States have significant manufactured dairy product output. The region shows high use in both Class III and Class IV products. Additionally, the Northwest States are similarly situated geographically as western states and face similar competitive situations in the marketing of manufactured dairy products to both eastern domestic markets and westward export markets.

The Upper Midwest and Pacific Northwest regions have many similar characteristics with the California dairy marketplace. However, a similar MMP is not one of the common characteristics describing these markets. We measured the period August 2012 to the most recent data available prior to July 2015. This period marks the most recent “non-temporary” upgrade of the “whey bracket pricing” used in the CDFA pricing formulas. (Additional details on the time periods for comparison will be presented in a following section of this statement.) Since the MMP is an at-test price, we adjusted the price for components in each region to the Federal Order standard for butterfat of 3.5%, for protein of 2.9915% and for other solids of 5.6935% in order to arrive at a standard price for comparison.

We used the monthly FMMO price per pound of each component in the calculation to compute a cents-per-hundredweight value. We used the Order 30 average producer milk component test for the Midwest Order states as Order 30 does not publish state level component tests. California does not publish a protein or other solids component values, so we used DFA producer component tests for the California averages under the assumption that since our producer volumes account for approximately 20% of the state’s milk supplies it would be generally representative of the state’s component test averages. For the Northwest states, we

used the Order 124 market tests. In each case the monthly test was compared to the standard test and the difference over or under the standard was subtracted or added to the mailbox price based on the difference.

For the recent period of August 2012 - May 2015 there are 34 monthly observations from the states listed. (See Table 1.A (4 pgs.) “Comparison of Mailbox Milk Prices Standardized for Butterfat, Protein, and Other Solids tests, California, and Selected Markets, August 2012 – to May 2015.”) For the 34 months and the four MMP regions for comparison -- 136 observations -- in no month did California have a higher or even close to equal MMP. The average difference over all observations was \$1.85 per hundredweight lower. The single largest difference was minus \$4.27 (Wisconsin 12/2012) and the narrowest was minus 43 cents (Northwest States 03/2015.) The California region averaged \$2.12 per hundredweight lower than the Wisconsin region for the 34 months; it was \$2.05 lower the Minnesota region; it was \$2.22 lower than the Illinois region; and it was \$1.01 lower than the Northwest region.

Using the MMP as a proxy for producer prices shows there are wide differences for farms in similarly situated regions of the U.S. Our proposal will correct the misalignment of producer prices.

IV. Overview/Comparison of CSO and FMMO Class Prices, Classification and Formulas

While both systems use classified prices, the class definitions are not identical, and, in some instances, are a cause of disorderly marketing. Generally Class I (Roman numeral in the FMMO system and Arabic numeral 1 in the CSO regulations) represents milk consumed in fluid form. Class II (Roman numeral in the FMMO system and Arabic numerals 2 and 3 in the CSO regulations) represents milk products such as cream-based items, ice cream and ice cream mixes, yogurt, dips, cultured products, cottage cheese and milk used to produce items such as

evaporated and condensed milks. The FMMO system includes all these products in a single class while the CSO system divides them into two classes – ice cream, ice cream mixes and frozen products are Class 3 products, and Class 2 contains yogurt, cottage cheese and other “intermediate” products, such as condensed and evaporated milks. Milk used to produce cheese and whey products is Class III (Roman numeral in the FMMO system and Arabic numeral-Roman letter 4b in the CSO regulations.) Lastly, Class IV (Roman numeral in the FMMO system and Arabic numeral-Roman letter 4a in the CSO regulations) represents milk used to produce butter and milk powders. Our proposal will use the existing FMMO classification system.

While both systems use end-product price formulas to determine class prices, the various underlying commodity price series, the effective dates for determining the prices used in the formulas, the yield constants, and the make allowances are not identical, and, in some instances, are a cause of disorderly marketing. The CSO system includes a factor in the Class 4a and Class 4b pricing formulas that adjusts the dairy product commodity price to reflect spatial pricing differences. The FMMO system does not make any such adjustment. All FMMO prices for Classes 2, 3 and 4 are uniform across the country. The fact that minimum base class prices and resulting dairy ingredients prices (for example, California Class 2 skim / fat prices versus FMMO skim / fat prices) use different underlying dairy product commodity prices and different periods to determine the base prices impacts milk marketing decisions, and, in some cases, causes disorderly marketing.

In the following sections of the testimony references will be made to class price averages for fixed periods. These dates which highlight the price differences were chosen purposefully. Prior to December 2007, the CSO regulations used an end-product price formula to assign a

value to whey in the Class 4b price formula similar to that used to establish class prices and similar in construct to those used in FMMOs. When this method was used, the spread between the CSO and FMMO prices was much narrower and more consistent. The CSO, however, discontinued the end-product pricing approach to valuing whey after November 2007.

Since 2007, the CSO has changed the whey component pricing factor contained within the Class 4b formula three different times. The first relationship established a fixed \$.25 cents per hundredweight contribution to the Class 4b milk price regardless of the reported market value for dry whey; this became effective December 2007. The second relationship, which was implemented in September 2011, established a bracket system or look-up table that changed the per hundredweight contribution to the Class 4b price at fixed rates depending on the reported market value for whey. The table included a floor of \$.25 per hundredweight and a ceiling of \$.65 per hundredweight. The last change (effective August 2012), retained the whey value contribution table but modified the interval range and increased the ceiling to \$.75 per hundredweight.

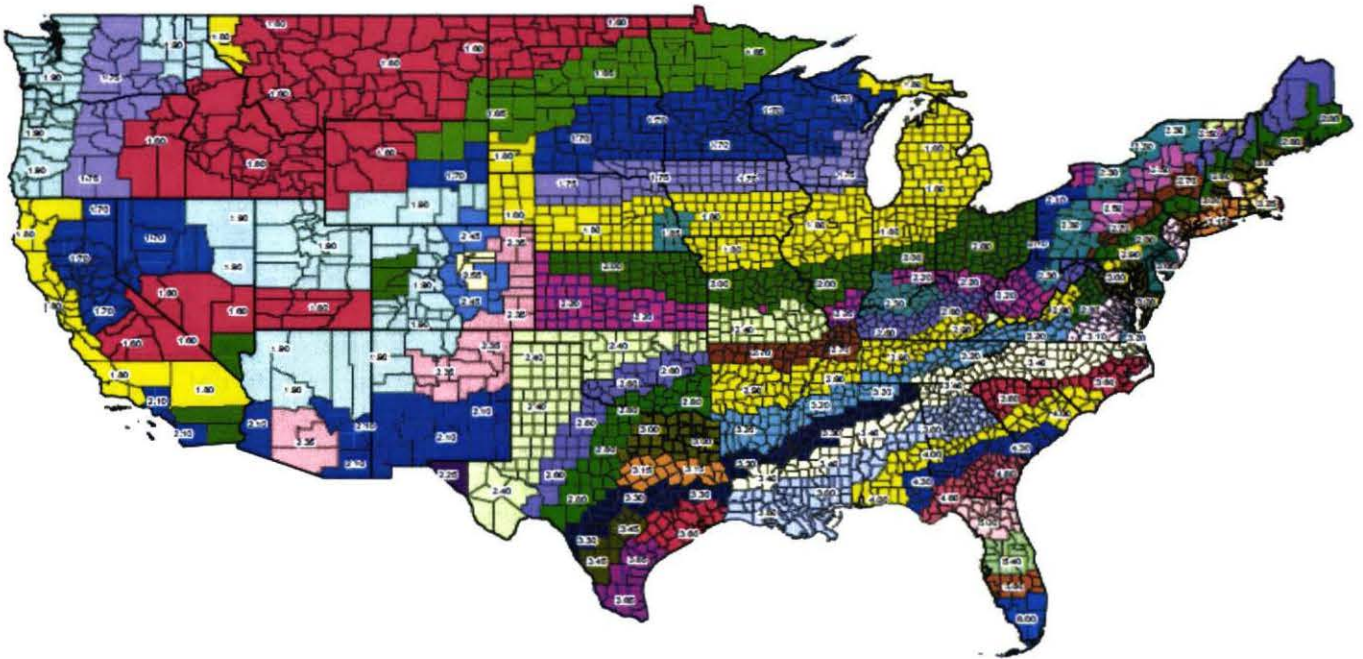
There has been another price formula change that became effective August 1, 2015. That change increased the CSO 4b price and increased producer mailbox prices. However, that change is temporary (expires July 31, 2016) and there will be little data to evaluate for this record because of the timing of the Hearing. As it is temporary and could only be extended through the result of another Hearing, its long term impact is both tenuous and not measurable.

A. Class I / Class 1 Price Misalignment for Similarly Situated Handlers

One of the tenets of FMMO marketing is common terms of trade that at the regulatory minimum price level are uniform and transparent. Observing the Class I price surface across the U.S. it is clear that there is a pattern for the Class I price surface and an orderly transition in the

price surface as it changes across the country. The graphic below, taken from the USDA / AMS web page depicts the Class I price surface. Clearly it has a differentiated regional basis and not a uniform national basis.

Federal Milk Marketing Order Class I Price Structure



Effective May 1, 2008

The principles for this price structure are outlined and described in the Reform Decision² as follows:

3. Class I Pricing Structure

This decision adopts a Class I pricing structure that provides incentives for greater structural efficiencies in the assembly and shipment of milk and dairy products. In conjunction with other reforms discussed in this decision, the adopted Class I

² “Reform Decision” refers to the “Final Decision” in the federal order reform process, issued April 2, 1999 and published at 64 Fed. Reg. 16026-16926 (1999).

price structure provides the necessary changes needed to improve milk pricing in the consolidated markets.

...

The adopted Class I pricing structure utilizes the USDSS model results adjusted for all known plant locations and establishes differential levels that will generate sufficient revenue **to assure an adequate supply of milk while maintaining equity among handlers in the minimum prices they pay for milk bought from dairy farmers.**

Background

Although not required by the 1996 Farm Bill, the legislation provided authorization for the Secretary to review the Class I price structure as part of the consolidation of the orders including the consideration of utilization rates and multiple basing points for developing a pricing system. **In any event, the consolidation of orders requires the review of the pricing system because historically, Class I pricing provisions, as well as other Federal order provisions, have been reviewed primarily on an individual market basis. The reform effort provides the opportunity to consider and establish a nationally coordinated Class I pricing surface that uses location adjustments to the differential levels to price milk for fluid use in every county in the United States.**

64 Fed. Reg. at 16108 (1999) (emphasis added)

...

Finally, **the adopted Class I pricing structure meets the requirements of the AMAA.** The broad tenet of the AMAA is to establish and maintain marketing stability and orderly marketing conditions for milk. The Federal milk order program will continue to achieve these goals primarily through classified pricing and marketwide pooling. As to pricing requirements, **the AMAA objective to stabilize the marketplace with minimum prices** and not set market prices is also achieved. **As a national Class I pricing structure, it specifically addresses, and adequately sets, appropriate Class I differential levels** that will result in milk prices that are high enough to generate sufficient revenue for producers so that an adequate supply of milk can be maintained while continuing to provide equity to handlers.

64 Fed. Reg. at 64118 (1999) (emphasis added)

The Reform Decision clearly intended to establish a uniform national price surface for Class I milk prices. As a part of that emphasis the Decision's price surface included provisions and prices for the California marketing area as proposed here. The California dairy industry had the option to be included in the Reformed Orders and provided input to the decision, but did not choose that option. Footnote 3 of the Legislative and Background Requirements of the Reform Decision notes:

The Omnibus Consolidated and Emergency Supplemental Appropriations Bill, passed in October 1998, extended the time frame for implementing Federal milk order reform amendments from April 4, 1999, to October 1, 1999. The extension specifies that the final decision, defined as the final rule for purposes of this legislation, will be issued between February 1 and April 4, 1999, with the new amendments becoming effective on October 1, 1999. The legislation also provides that California has from the date of issuance of the final decision until September 30, 1999, to become a separate Federal milk marketing order.

64 Fed. Reg. at 16027 (1999)

In addition to submitting comments and participating in industry and congressional proceedings, California dairy interests had approximately six months to review the provisions of the Reformed Orders and did not submit a petition for an Order at that time.

The CSO's separate Class I price surface compromises the uniformity of the national pricing grid and becomes a source of disorderly marketing. Table 1.B (5 pgs.) "Comparison of FMMO Class I Announced Prices in the Marketing Area and CSO Class 1 Prices, 2000 - July 2015" shows price comparisons between the national grid and the California CSO grid for in-state markets. Table 1.C (5 pgs.) "Comparison of CSO Minimum Class 1 Announced Prices in the Marketing Area with Surrounding Market FMMO Minimum Prices, January 2000 - July 2015" details price comparisons between key California markets and their natural competitor markets in the adjacent state as priced by the FMMO grid.

The national pricing grid establishes five differential zones in the proposed marketing area. (See Map 1.D “Federal Order Class I Differentials California Marketing Area.”) Those range from \$2.10 in the San Diego – Los Angeles area; \$2.00 in the Southeast corner of the state; \$1.80 from east and north of the \$2.10 / \$2.00 zones north up the Pacific coast, including the San Francisco and Bay areas, to Oregon; \$1.60 in the central part of the state with the largest production areas; and a \$1.70 zone north of the \$1.60 region bordering Nevada and Oregon, which includes the second largest production region in the state.

The CSO has two pricing regions. (See Map 1.E “California Department of Food and Agriculture Milk Marketing Areas.”) The Southern California marketing area generally encompasses the major population regions of Los Angeles and San Diego. The Northern California marketing area extends to the northern border of the state and includes the population centers of Sacramento and the San Francisco and Bay areas. Map 1.D also displays both pricing grids on a single map.

For the in-state comparisons we computed differences between the national FMMO grid and the CSO grid in each FMMO Order differential area. There are counties in each differential area that overlap the corresponding CSO Marketing Area. Table 1.B (5 pgs.) details the differences from 2000 to July 2015 with Table 1.B p.5 being a summary using the average comparisons for the periods noted previously. In the higher population zones the CSO Class I price is below the FMMO grid for all years / periods measured. Note that the periods shown for comparisons match the periods since 2000 where the CSO has made a change in the method for calculating the contribution of whey to minimum milk prices. For the most recent period of August 2012 – July 2015 the shortfall is 37 and 27 cents per hundredweight. In the lower priced zones there were some periods prior to September 2011 where the CSO Northern California zone

price was above the FMMO grid price but at small levels. And for the months since then the Northern California price has been below the FMMO grid each year by a low of 2 cents per hundredweight (\$1.60 zone) to 33 cents in the \$1.80 zone

Table 1.C makes similar Class I price comparisons with CSO prices and with out of state FMMO Class I price. The method used for comparison was to establish the FMMO grid difference by netting both Class I differentials and then comparing that value with the difference between the CSO price and the prevailing FMMO price. The locations chosen represent locations of processing plants and likely competitors.

The first comparison is between the minimum prices in the Phoenix, Arizona market with those of the Los Angeles / San Diego (LA/SD) market. The LA/SD market differential is \$2.10 per hundredweight and the Phoenix differential is \$2.35 so the FMMO grid spread difference is minus 25 cents. When comparing the annual CSO Southern California price with the announced FMMO price at Phoenix the difference averages minus 62 cents. The difference is negative for all the collective average time periods shown.

For the Las Vegas Nevada to LA/SD markets the FMMO grid difference is a plus 10 cents per hundredweight when the LA/SD differential of \$2.10 is compared to the Las Vegas differential of \$2.00. However comparing the Southern California announced price with the Las Vegas price results in a difference of minus 27 cents per hundredweight average for the August 2012 – July 2015 period. All period measures are negative.

For the Reno Nevada to Sacramento market comparison the FMMO grid difference is zero. However the Northern California price compared to the Reno FMMO price averages a negative 23 cents per hundredweight for the August 2012 – July 2015 period. All period measures are negative.

In each case of comparison the CSO pricing system returns a different (lower) price to producers in the proposed marketing area than an FMMO price would yield. In addition the market to market comparison does not yield the results provided by the FMMO Class I pricing grid as established in the FMMO Reform process. These price differences contribute to a marketing situation where milk buyers are impacted by different minimum pricing conditions instead of a single uniform pricing grid.

1. Pricing of Out of State Milk

There are additional disorderly marketing conditions present in the California market that cannot be cured by the presence of a state Order and in fact are caused by the presence of the state Order. First, there is milk produced on dairy farms located outside the state that is marketed to Class I processing plants. These deliveries cannot be regulated by the state Order. This practice removes Class I revenues from the CSO as well as lowering the price for the purchasing handler who would not make the purchase if it cost more than the CSO minimum. This is a regular occurrence in the marketing area. CDFA data has indicated that this volume totaled 547 million pounds in 2014. Ponderosa Dairy has in fact proposed at this Hearing that they be allowed to continue this practice if an FMMO is implemented and have their milk priced by the FMMO at terms preferential to other producers in the Order.

The disorderly situation arising from the inability of the CSO to price milk produced out of the state and delivered to processors in the state would be cured by the implementation of a California FMMO.

Additionally, producer milk regularly leaves the California market and in our estimation delivers to a plant or plants pooled by FMMO 131 that market the milk back into the California market. The returns from this transaction are pooled in FMMO 131 due to the requirements of

the Milk Regulatory Equity Act. These actions also constitute disorderly marketing conditions and would be cured by the implementation of a California FMMO.

B. Price Misalignment for Manufacturing Class Markets

This proposal uses the FMMO manufacturing class prices. These prices are different from the CSO prices and the differences are one of the reasons for this proposal and a source of disorderly marketing. The FMMO manufactured products pricing grid, that is, the prices for Class II (CII), Class III (CIII) and Class IV (CIV) are clearly national prices – there is only one monthly price of each for the entire grid. They are national prices because the markets they compete in are national in nature and in many, if not most cases, the raw materials they are produced from are bought and sold on a national basis. Based on NASS dairy product production data there are clear regional differences in where dairy products are produced. Regional population density does not match production density data, thus product must move between regions to satisfy demand. A California FMMO would assure that California FMMO regulated handlers pooling milk sold to manufacturing class processors pay the same uniform minimum prices.

Traditional fluid milk commerce however remains regional in nature chiefly due to the perishability of the finished product. While labels or brands may be national for these products - Borden's or Dairy Pure - for example, the procurement of the raw material and the processing and distribution of the finished product are most generally regional. And in many cases the predominance of retail sales is composed of local brands or store brands that are processed within the region.

Manufactured dairy products can easily be produced in one region of the US and marketed in other regions. Examples are many and product brand names might include

Tillamook cheese, Blue Bunny ice cream, Yoplait, Chobani or Dannon yogurt, Eagle Brand sweetened condensed milk, Crystal Farms cheese, Ben and Jerry's ice cream or Land O' Lakes, Challenge and Plugra butter.

This concept of a national supply and demand relationship is clearly articulated in the Reform Decision when the manufacturing class prices are discussed.

The formulas in this decision use national commodity price series, thereby reflecting the national supply and demand for dairy products and the national demand for milk.”

64 Fed Reg. at 16096 (1999) (emphasis added)

1. Class II / Class 2/3 Price Misalignment for Similarly Situated Handlers

The FMMO Class II price is computed using the nationwide grid, and is the FMMO Class IV price plus a fixed 70 cents per hundredweight differential. While the CSO Class 2 and 3 classifications include essentially the same products as the FMMO Class II classification there are disorderly marketing implications resulting from regulatory differences which do not reflect market fundamentals. In the CSO system, announced Class 2 and 3 prices apply for two months at a time and are based on butter and milk powder commodity price averages from the prior two months. For example, the August and September Class 2 price is based on commodity price data from June and July. The FMMO Class II price is announced monthly and is based on data from the prior month. Market conditions can change swiftly, and, in some cases, noticeably over the four-month period spanned by this calculation. Perhaps the extreme example would be the August and September CSO Class 2 price (generally the lowest months of milk production in California) where calculations are based on market data for June and July, which are generally higher months for milk production. These cyclical production patterns over time are reflected in price differences.

An example of a large Class II/2 price difference is for the months of July 2014 – December 2014 where the CSO price was lower than the FMMO price by \$.96 per hundredweight in July; \$1.37 in August; \$2.14 in September; and then higher by \$2.01 in October; \$4.03 in November; \$1.39 in December, and \$4.30 in January 2015.

Cream, condensed skim milk (CSM) and sweetened condensed skim milk (SCSM) are dairy ingredients commonly used in many products and product formulations and carry CII / Class 2 or 3 classifications. They are transported long distances in bulk tankers and hundreds or even thousands of mile deliveries are not uncommon.

Because of the bulk nature of these condensed products they are more prone to opportunistic situations. These price differences can create disorderly marketing conditions when dairy ingredients enter markets generally on a spot basis to exploit short term price disparities. Additionally there are classification differences which cause further disorderly marketing conditions when these types of ingredient products cross the different classification definitions and boundaries. As the two major proponent proposals seek to unify the classification definitions using the FMMO terms, these classification differences should dissolve.

Table 1.F (5 pgs.) “Comparison of FMMO Class II Announced Prices, CSO Announced Class 2 and 3 Prices 2000 – July 2015” captures these announced price differences from 2000 to July 2015. Column D, F, and J compare the differences between the CSO Southern California, Northern California Class 2 price and the respective FMMO Class II price and the CSO Class 3 price with the FMMO Class II price. After January 2009 the CSO Class III prices are the same for both Northern and Southern California. The CSO price Class 2 and 3 was lower than the FMMO Class II price in all the compared average periods except during 09/2011 – 07/2012.

Over the entire time period 2000 – July 2015, the FMMO Class II price versus the CSO Southern California Class 2 price difference averaged minus 24 cents per hundredweight. Between 01/2000 and 11/2007, the difference averaged minus 24 cents; between 12/2007 and 08/2011 the average difference was minus 30 cents; between 09/2011 and 07/2012 the average difference was positive 50 cents; and between 08/2012 and 07/2015 the average difference was minus 39 cents. The largest positive difference (FMMO > CSO) was \$4.30 in January 2015 and the largest negative difference was minus (CSO > FMMO) \$3.05 in September 2012. The primary reason for the wide range in prices is the two month pricing period in the CSO price formula. The trends for the Northern California FMMO II / CSO 2 price series were similar.

Trends for the FMMO Class II price and the CSO Class 3 price for the same comparison periods are also similar and noted in Table 1.F (Col. J.)

2. Class IV / Class 4a Price Misalignment for Similarly Situated Handlers

The FMMO Class IV and the CSO Class 4a prices are used to value milk used in the manufacture of butter and milk powders. The FMMO price is a nationwide price for similar reasons as noted for Class II products. The FMMO and CSO price differences are shown in Table 1.G (5 pgs.) “Comparison of FMMO Class III and IV Announced Prices, and CSO Class 4a and 4b Price, 2000 – July 2015.” Column E is the FMMO Class IV price, column F is the CSO Class 4a price and column G is the difference between the two (CSO less FMMO). There are no years where the annual average CSO price was greater than the FMMO price. Over the entire time period 2000 – July 2015, the difference averaged minus 29 cents per hundredweight. Between 01/2000 and 11/2007, the difference averaged minus 38 cents; between 12/2007 and 08/2011 the average difference was minus 19 cents; between 09/2011 and 07/2012 the average difference was minus \$.26; and between 08/2012 and 07/2015 the average difference was minus

\$.20. This difference is reflected in Chart 1.H “CSO Class 4a less FMMO Class IV” showing annual variations from 2000 to 2014. With the exception of 2007, the variations in the differences are similar.

3. Class III / Class 4b Price Misalignment for Similarly Situated Handlers

The FMMO Class III and the CSO Class 4b prices are used to value milk used in the manufacture of cheese and whey products. The FMMO price is a nationwide price for similar reasons as noted for the other Classes of manufacturing products.

The FMMO and CSO price differences are shown in Table 1.G (5 pgs.) “Comparison of FMMO Class III and IV Announced Prices, and CSO Class 4a and 4b Price, 2000 – July 2015.” Column B is the FMMO Class III price, column C the CSO Class 4b price and column D the difference between the two (CSO less FMMO). In the 187 months between January 2000 and July 2015, the Class III price has exceeded the Class 4b price 161 times. For the entire period January 2000 – July 2015, the difference averaged minus 91 cents per hundredweight, but the range of difference has increased significantly in recent years. Between 01/2000 and 11/2007, the difference averaged minus 39 cents; between 12/2007 and 08/2011 the average difference was minus 91 cents; between 09/2011 and 07/2012 the average difference was minus \$2.22; and between 08/2012 and 07/2015 the average difference was minus \$1.89.

There are no years where the annual difference shows the CSO price greater than the FMMO price. The widest difference was in November 2014 where the CSO 4b price was \$3.24 per hundredweight less than the FMMO Class III price. Chart 1.I “CSO 4b less FMMO Class III” depicts the annual price differences over the 2000 – 2014 periods.

a. Whey Contribution to the Class III / 4b price

From Chart 1.I there is a clear difference in trend that appears in 2010. This difference is best explained by noting the changes in the manner in which the CSO computes the whey contribution to the 4b price versus the way the FMMO performs the similar contribution calculation. The resulting difference between the two whey calculation methods ranges from significant to extraordinary. The FMMO whey contribution calculation uses the product price formula method generally described as (market price less cost to make) times (yield factor.) This method moves “penny for penny” with changes in whey market prices. When whey prices are at their high the contribution to the Class III price is high; and conversely, when low the contribution is reduced.

The CSO formula has a look-up table structure that assigns a “contribution to the milk value” based on the relationship of the whey price bracket to the associated contribution rate. However, the CSO table caps the contribution at 75 cents per hundredweight. This value is reached when the whey price is 60 cents per pound or higher. (It also floors the low end of the contribution at 25 cents on any whey price level below 25 cents.) Note that the temporary adjustment in place currently in the CSO regulations has a zero contribution value if whey is below 21 cents, contributes \$2.005 per hundredweight to the Class 4b price if whey is 60 cents or more and has a higher contribution value in the intervening brackets than any prior bracket structures.

Dry whey’s market prices reached extended periods of higher prices for the period August 2012 – July 2015. Since August 2012 the CSO’s average “26th to 25th ” Western Dry Whey Mostly Average Price published by USDA/AMS/Dairy Market News whey price has averaged \$.57 per pound with a range from \$.40 to \$.67 and nine consecutive months where the

price was above 60 cents. The CSO formula cap at a whey price of \$.60 per pound vastly undervalued the Class 4b price in relation to the Class III price. Table 1.J (5 pgs.) “Comparison of Monthly NDPSR and DMN Western Mostly 26th to 25th Whey Prices and the Value Contribution to the FMMO Class III and CSO Class 4b Price 2000 – July 2015” details the extent of the difference in contribution in whey value for the period August 2012 – July 2015. While the average differences in the underlying commodity whey prices were approximately two cents, the contribution of the NDPSR price to the FMMO Class III price averaged \$2.38 per hundredweight. Over the same time, the CSO calculation using the Western Whey Mostly price averaged from the 26th of the prior month to the 25th of the current month contributed \$.68 per hundredweight to the CSO Class 4b price. The difference was \$1.70. The smallest difference was \$.68 in July 2015 and the largest \$2.23 in July of 2014.

V. Consequences of the Class Price Misalignment

It is difficult to accept or explain the Class price differences of this magnitude for what amounts to deliveries to plants manufacturing identical products and sold into similarly situated markets. Cheese and whey products produced in California plants and priced using the CSO prices are marketed and sold nationwide directly alongside similar products produced in FMMO areas priced under FMMO terms. The difference in pricing may cause marketplace decisions that are solely due to different regulations and not to market fundamentals. This clearly does not promote orderly marketing conditions.

Said another way, a dairy farm operator with two facilities, one in California priced at Class 4b and one in a FMMO area priced at Class III, would have experienced two vastly different regulatory minimum prices for milk used to produce similar cheese and whey products. On average, this difference would be \$1.89 per hundredweight lower for milk from the

California dairy than milk from the dairy operating in an FMMO for the period August 2012 – July 2015. This is the most significant reason for the difference in producer mailbox price between farms located in California and those located in FMMO areas. This difference places the California farmer in a much less competitive position to bid for land, cattle, feed, facilities, services, operating capital and labor than his counterpart whose milk is priced by FMMO regulation. This disorderly marketing condition should be remedied by having the FMMO pricing grid include the California market.

Class pricing following CSO provisions results in different and lower minimum prices than does FMMO Class prices for each Class. The price differences can be significant for the Class III / Class 4b relationship in terms of both multi month periods and at times with only a few months of comparisons. While not as great over most of the multi month periods, there are nonetheless many monthly periods where the comparisons are significant and impact market place decisions solely on the basis of regulatory differences and not based on market place differences.

The Class price differences we have demonstrated ultimately result in producer prices for California dairy farm businesses that are significantly below those of similarly situated dairy farm businesses whose milk is priced by FMMO provisions. We demonstrated earlier that producer prices, as measured by component standardized AMS MMPs vary widely in markets that similarly to California have high utilizations of manufactured products and additionally, in the case of the Northwest States, geographic similarity. This difference results in marketing conditions which do not effectuate the purposes of the underlying FMMO enabling legislation.

VI. Impact on Price Risk Management Strategies

If a CA FMMO utilizes the same Class price formulas as the rest of the country, we feel the implementation of a CA FMMO will increase futures market liquidity in Class III and IV. This will lead to increased use of hedging strategies by CA dairyman – helping them reduce their financial operating risk.

The use of hedging by CA dairy farmers has been limited, in part, because of the uncertainty of using a FMMO based price to hedge a CA class price due to the overall difference in the two pricing series. This difference in the two price series creates greater basis risk that is the difference between the hedged instrument which would be the FMMO Class III or IV price and the actual pay price in a CA dairy farmer's milk check. This is a significant contributing cause to why there is a lower use of hedging by CA dairy farms.

Thus, a benefit of a CA FMMO may be more and greater applications of hedging by CA dairy farms which brings better long-run financial stability to them and ultimately to the processors that buy their milk.

VII. Conclusion

Current prices for both producers and handlers in California are out of line with national prices and national values for producer milk. A California federal order is necessary to bring the California dairy industry into the federal system of national class prices for dairy farmers and processors in the state, and to enhance and maintain orderly marketing conditions.