

STATE OF CALIFORNIA
DEPARTMENT OF FOOD AND AGRICULTURE

PUBLIC HEARING
TO CONSIDER AMENDMENTS
TO THE STABILIZATION AND MARKETING PLANS
FOR MARKET MILK FOR THE
NORTHERN AND SOUTHERN CALIFORNIA
MARKETING AREAS

CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE
AUDITORIUM
1220 N STREET
SACRAMENTO, CALIFORNIA

THURSDAY, JUNE 30, 2011
9:00 A.M.

1 equipment was going to run. But those costs are going
2 to be there, the volumes are going to be lower, and
3 eventually those are going to wash out over time.

4 Those plants started up in -- one started in
5 2008 and one started in 2009. So at some point those
6 will wash out of the costs as we perfect how those
7 plants are running.

8 MS. REED: Okay. So basically -- I was going
9 to ask you another question, but I guess that sort of
10 answers this. Basically when you feel that those
11 plants have reached full production, full capacity or
12 whatever, that will then wash out and basically lower
13 your costs is what you're saying. They will become
14 more even.

15 DR. ERBA: Right, right. But I do point out
16 that both those plants were very expensive to build,
17 much higher costs than any of our other plants by a
18 huge margin. And, no matter what, the depreciation
19 costs, the interest cost, because of the higher cost of
20 building it, that's going to be in there no matter
21 what. You're not going to be able to wash those out.

22 MS. REED: Exactly. And that -- yeah, it's
23 because those would affect a couple of areas within the
24 cost study --

25 DR. ERBA: Right.

1 MS. REED: -- but not all of the areas that
2 are being affected at this point.

3 DR. ERBA: Right. I would expect that some
4 of those costs would come down over time, but I would
5 not expect those to be huge numbers. Those costs were
6 expensive, those plants were expensive to build and
7 those costs are embedded in there.

8 MS. REED: Right, and I agree with that. I
9 think that, you know, you're right that the costs will
10 be there but I think as the production increases then
11 that's what will sort of wash those out and make it
12 more, you know, more uniform.

13 DR. ERBA: Sure. And we've already seen that
14 in the first of the two Visalia plants.

15 MS. REED: Exactly, yes. Okay. Also just
16 one final question. How do you feel that the costs in
17 the Department's 2009 exhibit represent the costs for
18 your plants?

19 DR. ERBA: Well, seeing as we make up most of
20 the plants in the study anyway, I would say they're
21 very representative.

22 MS. REED: Okay, yeah. They're
23 representative but you have to take into consideration
24 there are others also, so it's not going to be an exact
25 number but --

1 DR. ERBA: That's true.

2 MS. REED: -- you think it's falling in the
3 ballpark for where -- the weight of that, which is
4 falling in the ballpark, you're thinking.

5 DR. ERBA: Right. And the plants that we
6 have in the cost of these, we've got plants that are
7 above the weighted average and below the weighted
8 average.

9 MS. REED: Okay, thank you.

10 HEARING OFFICER MAXIE: Mr. Eastman?

11 MR. EASTMAN: Yes, I have a couple of
12 questions for you, Dr. Erba.

13 DR. ERBA: Sure.

14 MR. EASTMAN: You mentioned that in 2011 milk
15 production has been increasing, especially over the
16 last couple of months. There's obviously more cows
17 that are coming on, milk prices over the last number of
18 months have been increasing, and so prices paid to
19 dairy producers have gone up. How would you expect,
20 say, your membership to react to this? Do you think
21 they're going to be adding more cows to increase
22 production as we go throughout the summer and the rest
23 of the year? What would you estimate or guess that to
24 be knowing that, obviously, we don't have a crystal
25 ball and we can't predict the future, but what would

1 you anticipate?

2 DR. ERBA: That's a good question and a fair
3 question. (Indiscernible) brought 450 members and I
4 expect that that decision will range A to Z. We'll
5 have some members that are going to have a tough time
6 making it even with these kind of milk prices because
7 their costs are higher. Our costs, as you well know,
8 are extraordinary at this point. And we've got some
9 members who are probably a little bit better off in the
10 way they planned ahead, contracted for feed. And those
11 contracts are going to expire at some point, but at
12 this point, for this year, they're situated pretty
13 well. And we've got folks all the way in between.

14 So I don't know that I can give you a great
15 answer there because of the size of the co-op, the
16 diversity, kind of members we've got are, I think,
17 you'll see all kinds. You'll see some that are
18 trending toward the expansion mode and some that are
19 just trying to hold on.

20 MR. EASTMAN: Okay. So let's suppose that
21 over the next foreseeable few months or the rest of the
22 year, on average CDI's milk production of all of your
23 members in aggregate tend to start increasing now. Do
24 you think that's going to (indiscernible) issues of
25 handling milk? You mentioned before that you felt

1 these were times or were just demand going down, being
2 in crisis mode. Do you feel like even at milk plants
3 where they go down, do you think we could reach that
4 tipping point again?

5 DR. ERBA: Well, we have -- we have our own
6 supply management program at CDI. It's still in place.
7 It was put in back in 2008. And so we do have some
8 mechanism for monitoring and adjusting our milk supply
9 within our own co-op. I don't think we're in any
10 danger of getting past our theoretical handling
11 capacity, but that remains to be seen. As I told
12 Ms. Gates, we're one breakdown at a plant away from
13 having a fairly large disaster on our hands.

14 But back to your question, I don't think
15 we're going to have any real issues with that because
16 we do have a supply management program that's already
17 in place at CDI.

18 MR. EASTMAN: If maybe you could refresh my
19 memory. So with your supply management, your
20 production-based program, if you get too much
21 production and have problems placing that milk and,
22 say, you have to ship it out of state at discounts or
23 -- except, if I remember correctly, you charge them.
24 There's some sort of surcharge, a (indiscernible), or
25 something that's placed on those producers who have

1 grown.

2 DR. ERBA: That's right.

3 MR. EASTMAN: And so have you been, over the
4 last few months or lately at all, have you had to
5 implement any of those surcharges on your members?

6 DR. ERBA: We haven't had to do that since
7 2009.

8 MR. EASTMAN: Okay. So it's been a couple of
9 years. But from what you're stating now, if you were
10 to start creeping to that tipping point, so to speak,
11 you would implement those surcharges and try and have
12 your production base then function the way it's
13 supposed to with regards to limiting production then.

14 DR. ERBA: That's correct. The same
15 mechanism that we had available to us as a co-op in
16 2009 we still have available to us.

17 MR. EASTMAN: I think that's all the
18 questions I had.

19 HEARING OFFICER MAXIE: Any other questions?

20 (No audible response.)

21 HEARING OFFICER MAXIE: Thank you, Dr. Erba.

22 DR. ERBA: Thank you.

23 HEARING OFFICER MAXIE: I'd like now to call
24 the second Petitioner, Land O'Lakes. Land O'Lakes will
25 also have a period of 45 minutes to present testimony.

1 Could you state your name and spell your last
2 name for the hearing record.

3 MR. WEGNER: Thomas Wegner, W-E-G-N-E-R.

4 HEARING OFFICER MAXIE: Thank you. And you
5 handed a document just now. Is that a written copy of
6 your testimony?

7 MR. WEGNER: It is.

8 HEARING OFFICER MAXIE: Would you like that
9 testimony entered into the hearing record as an
10 exhibit?

11 MR. WEGNER: I would.

12 HEARING OFFICER MAXIE: Very good. It will
13 be entered in as Exhibit number 50.

14 (Thereupon, Exhibit 50

15 was received and entered into evidence.)

16 Whereupon,

17 THOMAS WEGNER

18 was sworn and duly testified as follows:

19 MR. WEGNER: Mr. Hearing Officer and members
20 of the panel, my name is Tom Wegner. I am here to
21 testify on behalf of Land O'Lakes, Inc. My business
22 address is 4001 Lexington Avenue North, Arden Hills,
23 Minnesota 55164. My current title is Director of
24 Economics and Dairy Policy.

25 We thank the Department for promptly calling

1 this hearing to address issues of critical importance
2 to the future of all of our California dairy producer
3 members.

4 Land O'Lakes is a dairy cooperation with
5 three thousand dairy farmer member-owners. Land
6 O'Lakes has a national membership base whose members
7 are pooled on the California State Program and five
8 different federal orders. Land O'Lakes members own and
9 operate several cheese, butter-powder, and value-added
10 plants in the upper Midwest, East, and California.

11 Currently our 275 California member owners supply us
12 with over 16-million pounds of milk per day that are
13 primarily processed at our Tulare and Orland plants.

14 Updating the whey portion of the Class 4B
15 formula: The current Class 4B formula contains a
16 factor that values whey at a fixed level of 25 cents
17 per hundredweight regardless of the price whey is
18 trading at in the Western whey markets. This fixed 25
19 cent value stands in stark contrast to the Federal
20 Order Class III formula, directly comparable to the
21 California Class 4B formula, containing a variable,
22 market-based whey factor that has effectively returned
23 values in excess of \$1.40 per hundredweight in recent
24 months. In fact, from January 2011 through April 2011
25 the federal whey formula added an average of \$1.46 per

1 hundredweight to the Class III prices in federal order
2 markets. The total difference between the Class 4B and
3 Class III prices was actually \$1.56 per hundredweight
4 due to the use of different cheese price series and the
5 f.o.b. adjuster in the Class 4B formula.

6 Land O'Lakes proposed changes would result in
7 a more equitable sharing of whey's market value. Land
8 O'Lakes proposes that the 25 cent fixed factor remain
9 in place when dry whey's market value, as measured by
10 the USDA's Dairy Market News Dry Whey Mostly Price,
11 averages 24.49 cents or lower. And when the average
12 market value of dry whey exceeds 24.5 cents per pound,
13 the whey portion of Class 4B will increase in
14 accordance with the following table.

15 I'm not going to read the following table.
16 It's right in the testimony.

17 Since fewer than three plants manufacture dry
18 whey in California, the Department no longer publishes
19 whey manufacturing costs to utilize in an end-product
20 pricing formula. In the absence of manufacturing cost
21 data for whey, the industry has proposed other
22 methodologies to share the market value of whey between
23 producers and processors. The Department has rejected
24 these methodologies in favor of the 25 cent fixed
25 factor

1 With the goal of a more equitable sharing of
2 whey's market value in mind, while considering the
3 constraints of incomplete whey manufacturing cost data,
4 Land O'Lakes believes the best approach is one that
5 will roughly approximate the value of whey in the Class
6 4B formula, based on the market value of dry whey. The
7 approach strikes a reasonable, logical, and equitable
8 sharing of whey values between producers and
9 processors. At the same time, the proposal limits the
10 financial exposure to cheese plants when whey market
11 prices exceed 38.5 cents per pound.

12 Our proposal approximates the value of whey by
13 retaining the 25 cent fixed factor and modestly
14 increasing the whey value in Class 4B by five cent
15 increments based on the Western Dry Whey Mostly. The
16 increase, in five cent increments, begins when whey
17 prices rise to 24.5 cents per pound. The value of whey
18 in the Class 4B formula increases to a maximum value of
19 one dollar when the Western Dry Whey Mostly averages
20 38.5 cents per pound.

21 Our proposal returns an increasing whey value
22 to milk producers when the whey market trades in the
23 range of 24.5 cents to 38.5 cents per pound. During
24 the 60 months, May 2006 through April 2011, prices of
25 the Western Dry Whey Mostly ranged from 24.50 to 38.50

1 38 percent of the time. By contrast, during the same
2 60 month period, dry whey prices ranged from 38.50 to
3 83 cents per pound roughly 47 percent of the time. The
4 other nine months Western Whey traded at less than
5 24.49 cents per pound. Our proposal strives to
6 equitably share the value of whey processes and
7 acknowledges the challenges in finding whey processing
8 options by limiting the financial exposure to cheese
9 plants at one dollar per hundredweight.

10 The maximum value of one dollar in the Class
11 4B formula would still fall 13 cents below the value
12 whey in the Federal Order Class III formula when the
13 whey market is trading at 38.5 cents per pound. As
14 whey market prices rise about 38.5 cents per pound, the
15 value of whey in the Class 4B formula remains at a
16 dollar per hundredweight, effectively capping the
17 exposure to California's cheese processors. By
18 contrast, the Federal Order Class III formula puts no
19 limit on the exposure to cheese plants from whey prices
20 exceeding 38.5 cents per pound.

21 This one dollar maximum, an effective
22 ceiling, will likely become more important in the
23 immediate future if dry whey prices continue to trade
24 in the 50 cents per pound range. At the close of the
25 Chicago Mercantile Exchange on June 27, 2011, futures

1 for dry whey averaged 48 cents per pound during the
2 next nine months, July 2011 through March 2012.

3 Assuming a dry whey price of 50 cents per pound, the
4 value of whey in the Class III federal order formula
5 would be an estimated \$1.83 per hundredweight. By
6 contrast, and again assuming a dry whey price of 50
7 cents per pound, the value of whey in the Class 4B
8 formula would still be one dollar. Thus, under the
9 Land O'Lakes proposal the whey contribution for the
10 Class 4B price would be 83 cents per hundredweight
11 lower than the whey contribution to the Federal Order
12 Class III when whey prices average 50 cents a pound.

13 Why update the whey factor? In short, the
14 Class 4B price is out of alignment with the Federal
15 Order Class III price. As a result, California
16 producers are not being treated fairly compared to
17 producers shipping to processors regulated under
18 federal milk marketing orders. Adopting the Land
19 O'Lakes proposal help to bring the Class 4B price into
20 better alignment with the Federal Order Class III price
21 and reduce this price inequity.

22 As you know, the California Food and
23 Agricultural Code, Section 62062, states with respect
24 to classified prices, including Class 4B, that "The
25 methods or formulas shall be reasonably calculated to

1 result in prices that are in a reasonable and sound
2 economic relationship with the national value of
3 manufactured milk products."

4 Currently whey markets have been trading at
5 nearly 50 cents per pound, adding over -- and here I
6 have a change -- \$1.80 per hundredweight to the Federal
7 Order Class III price -- instead of \$1.50. By stark
8 contrast, even though whey markets have been trading at
9 nearly 50 cents per pound, the contribution of whey's
10 value to the California Class 4B price remains fixed at
11 25 cents per hundredweight. Clearly, the relationship
12 between the Federal Order Class III price and the
13 California Class 4B has not, is not, and will not meet
14 this requirement of the Food and Agricultural Code if
15 the 25 cent fixed factor remains in place. Thus,
16 California producers are not being treated equitably
17 when compared to producers shipping to processors
18 regulated under federal milk marketing orders or when
19 compared to cheese processors who buy milk from
20 handlers who typically pool this milk on federal
21 orders.

22 Milk sold to unregulated cheese plants in
23 federal order marketing areas: Testimony by
24 participants in previous Department hearings asserted
25 that cheese plants outside of California are able to

1 buy milk below the Federal Order Class III price. This
2 testimony -- the testimony may have been referring to
3 milk purchased by cheese plants in unregulated areas
4 like Idaho, but I'd like to focus my comments on sales
5 of regulated producer milk to unregulated cheese plants
6 in federal order markets.

7 As previously noted, Land O'Lakes pools
8 producers' milk in several federal milk marketing
9 orders each month. In fact, Land O'Lakes pools
10 producer milk on the upper Midwest, Central, Northeast,
11 Appalachian, and Southeast federal milk orders.
12 Combined, these five orders accounted for over 70
13 percent of the 57.3-billion pounds of Class III milk
14 pooled in the entire federal order system during 2010.
15 In the upper Midwest federal order alone, the Class III
16 utilization averaged 83.7 percent in 2010.

17 Land O'Lakes sells Class III -- I think I've
18 got IV there; that should be III -- milk to cheese
19 plants not regulated under federal orders and also buys
20 milk from cooperatives and nonmember producers for use
21 in our own cheese plants located in the upper Midwest.
22 Typically, in almost every case, the price charged for
23 milk sold to unregulated cheese plants exceeds the
24 Federal Order Class III minimum price.

25 It only makes economic sense that the milk

1 sold to unregulated cheese plants by cooperatives that
2 pool this milk on a federal order is not priced at
3 levels below the Class III minimum price, since the
4 cooperative must account to the federal order pool for
5 Class III sales at the Federal Order Class III price.
6 The price charged for milk sold to unregulated cheese
7 plants has direct consequences on the handler's ability
8 to pay a competitive price to successfully retain
9 existing and attract new producers. It makes
10 absolutely no sense to charge below the Federal Order
11 Class III prices when the cooperative handler must
12 account to the federal order at Class III minimum
13 prices.

14 Previous hearings have also included
15 statements about the advantages of depooling or the
16 voluntary choosing by handlers to remove a portion of
17 their milk from a federal milk order. Let me offer
18 another perspective on how depooling impacts prices
19 paid to producers.

20 Firstly, there has been an assertion that
21 processors who depool milk have an advantage over
22 California processors. Land O'Lakes and other handlers
23 who depool milk must continue to compete for milk
24 supplies. They must remain competitive in their
25 markets to retain their milk supply. Plants buying

1 milk depooled by a federal order handler must still pay
2 the going market value, which is at least the Federal
3 Order Class III price. By depooling, handling forego
4 receipt of the producer price differential, the PPD,
5 but must still typically pay the Class III minimum
6 price for milk sold to and processed at cheese plants.

7 Secondly, the volume of depooled milk has
8 dropped considerably in recent year, in part resulting
9 from amendments proposed by processors and cooperatives
10 and adopted by producers in the upper Midwest, Central,
11 and Mideast federal orders. These are the three
12 federal orders -- federal order markets where the vast
13 majority of depooling has occurred. The amendments
14 limit the volume of milk a handler may pool during most
15 months to 125 percent of the volume of milk pooled in
16 the immediately preceding month. Handlers can still
17 depool milk, but the volume a handler chooses to depool
18 will directly limit the volume that the handler can
19 pool in the following month.

20 Evidence of this decreasing volume of
21 depooled milk can be found by comparing volumes
22 depooled in 2009 under the federal orders to volumes
23 depooled in 2010. For example, in 2009 USDA estimated
24 that handlers chose to depool 4.4-billion pounds of
25 milk, representing just over 3.3 percent of the total

1 volume of milk pooled and priced under federal orders.
2 In calendar year 2010, the USDA estimated that handlers
3 chose to depool 2.8-billion pounds of milk,
4 representing just over two percent of the total volume
5 of milk pooled and priced under federal orders.

6 Updating the manufacturing cost allowance for
7 cheese: Land O'Lakes proposes that the Class 4B formula
8 be updated to reflect the most currently available
9 manufacturing cost data for cheese. Land O'Lakes
10 proposes that the Class 4B formula be amended to the
11 most current weighted average cost for cheese published
12 in the November 2010 Manufacturing Cost Exhibit for the
13 period January through December 2009. The Department
14 reported that the weighted average cheese manufacturing
15 cost in 2009 was 19.6 cents per pound, a decrease --
16 excuse me -- a decrease of .22 cents per pound compared
17 to the current manufacturing cost for cheese in the
18 Class 4B formula. Thus, Land O'Lakes proposes that the
19 Department consider reducing the cheese manufacturing
20 costs to 19.66 cents in the Class 4B formula.

21 Updating the f.o.b. adjuster for cheese: Land
22 O'Lakes proposes that the Department consider adjusting
23 the f.o.b. price adjuster for cheese to be consistent
24 with the most current data reported by the Department
25 in November 2010. The Department reported that the

1 difference between cheddar cheese prices from the
2 Chicago Mercantile Exchange and prices from audited
3 sales of California cheddar cheese for the 24 month
4 period from July 2008 through June 2010 to be negative
5 .18 cents per pound. Land O'Lakes proposes that the
6 Department consider reducing the f.o.b. cheese adjuster
7 from 2.52 cents per pound to .18 cents per pound in the
8 Class 4B formula.

9 Market conditions have changed on California
10 dairy farmers since 2007. California dairy farms have
11 gone through very trying financial times over the past
12 four years. In 2008 income over feed dropped 32
13 percent from 2007 levels, and in 2009 margins over feed
14 dropped to a catastrophically low level of \$2.74 per
15 hundredweight, representing a decrease of 73 percent
16 from 2007 levels.

17 The financial train wreck of 2009 left many
18 California dairy farmers with severely reduced equity,
19 mounting debt, and tightening credit lines. Margins in
20 2010 rose back to profitable levels for most, but
21 didn't come close to repairing the financial damage
22 inflicted in 2009. We understand that cow and facility
23 values on some California dairies have been improving,
24 but we suspect that overall the equity position of
25 California's dairy farmers has still not even come

1 close to a full recovery from 2009. This weakened
2 equity position makes them much more financially
3 vulnerable in the event that we go through another
4 period of catastrophically low margins like 2009.

5 Land O'Lakes has concerns about feed costs,
6 which have risen dramatically in 2011. Current corn
7 prices are about 83 percent higher than a year earlier,
8 rising by nearly \$3.00 per bushel from \$3.49 per bushel
9 in 2010 to \$6.40 in 2011, according to the USDA
10 Agricultural Prices Report for May 2011. This is even
11 before taking into account the California local basis
12 for corn that can add as much as \$2.00 more per bushel.
13 Hay prices have also risen to dramatically high levels.
14 USDA reported a price of \$305.89 per ton for the week
15 ending June 17 for premium alfalfa in the Tulare-
16 Visalia-Hanford-Bakersfield region.

17 The data collected by the Department for the
18 first quarter of 2011 reveal that feed costs increased
19 by 17.9 cents -- 17.9 percent from Q1 2010 to Q1 2011,
20 to represent slightly more than 61 percent of total
21 costs on California dairy farms. More specifically,
22 and still comparing Quarter 1 2011 to Quarter 1 2010,
23 dry roughage costs rose 10.7 percent, wet feed and wet
24 roughage increased 24.7 percent, and concentrates rose
25 26.9 percent. The Q1 2011 feed costs of 903 per

1 hundredweight -- \$9.03 per hundredweight represented an
2 increase of \$1.34 per hundredweight over Q1 2010, and
3 has already surpassed the 2009 average feed cost of
4 \$8.77 per hundredweight.

5 Up to this point in 2011, milk prices have
6 kept margins over feed above levels experienced in
7 2009. Even if margins over feed remain at current
8 levels, it will take more time for California dairy
9 farmers to recoup the equity lost in 2009. We have
10 concerns that feed costs have risen in Q2 2011 and will
11 continue to rise through 2011, especially in the corn
12 market as U.S. corn stocks have fallen to 35 year lows
13 and in light of the challenging weather conditions
14 prevailing in the Corn Belt.

15 Feed cost projections for 2011-12 offer
16 little relief. USDA projects corn prices remaining in
17 the \$6.50 range, corn futures continue to trade in the
18 \$7.00 range for 2012, putting more pressure on
19 California dairies that purchase the bulk of their
20 feeds.

21 Adding to the financial stress at the farm
22 level is the fact that California dairy farmers have
23 limited opportunities to protect themselves from the
24 negative impacts of volatile milk prices and rising
25 feed costs. The fixed whey factor severely hinders a

1 California dairy farmer's ability to make effective use
2 of dairy futures to hedge their milk.

3 For example, the Class III futures contract
4 offered by the Chicago Mercantile Exchange is the most
5 heavily used of the dairy product futures contracts.
6 As noted earlier, the Class 4B price and the Federal
7 Order Class III price differed by an average of \$1.56
8 per hundredweight from January through April 2011.
9 This difference, the basis, drastically increases the
10 risk that a California dairy farmer takes on when
11 entering a Class III futures contract to hedge their
12 milk. Price movements in the Class III futures market
13 may not be offset on a one-to-one basis in the cash 4B
14 market.

15 Accordingly, the size of the basis can be
16 quite volatile, even from month to month, due to the
17 stark differences between whey values in each of the
18 formulas. For example, the Class 4B basis -- the Class
19 4B price minus the Federal Order Class III price -- in
20 February 2011 was negative eight cents. In March 2011
21 the Class 4B basis ballooned to negative \$2.64 per
22 hundredweight. This gross mismatch between the Class
23 III futures prices and the 4B cash price, coupled with
24 the high level of volatility of the Class 4B basis,
25 prevents California dairy farmers from making effective

1 use of Class III futures as a hedging tool.

2 On the feed side, cotton and corn has been
3 outbidding hay acreage in California. An export demand
4 for hay has pressured prices up, as well. This
5 additional acreage in cotton and corn has reduced the
6 hay supply and has led to higher hay prices. There are
7 no established futures markets for hay, and the cool,
8 wet spring in the Corn Belt has limited opportunities
9 to lock in feed at price levels that ensure an adequate
10 income over feed margin.

11 Additionally, dairy farmers need a hedge line
12 of credit to make effective use of futures markets as a
13 tool to ensure their future margins. Since many
14 California dairies lost significant equity in 2009 that
15 has not been recovered, the availability of hedge lines
16 to these farms has been severely limited.

17 Market conditions have changed in the whey
18 market since 2007. As you know, the federal orders use
19 the National Agriculture Statistic Service's, or NASS',
20 monthly whey prices and NASS cheese prices to calculate
21 the Federal Order Class III price. From June 2009
22 through May 2011 the NASS whey price averaged 37 cents
23 per pound and the Western whey market averaged 39 cents
24 per pound. From June 2009 through May 2011 the whey
25 contribution in the federal order formula exceeded the

1 fixed whey factor of 25 cents in each and every month.
2 From December 2007 through May 2011 the NASS whey
3 market averaged 31.6 cents per pound and the Western
4 whey market averaged 32.8 cents per pound. Even though
5 the Western whey market price was slightly higher than
6 the NASS whey market price, California's dairy farmers
7 received far less value from the whey market in the
8 Class 4B price than dairy farmers delivering milk in
9 federal order markets.

10 During the period June 2009 through May 2011
11 the whey contribution to Class III averaged \$1.07, or
12 82 cents more per hundredweight, than the fixed whey
13 factor of 25 cents per hundredweight. For the entire
14 period since the last hearing results were effective,
15 the whey contribution to Class III averaged 75 cents
16 per hundredweight, or 50 cents more than the fixed
17 factor of 25 cents per hundredweight.

18 But the real advantage, or disadvantage, for
19 cheese makers would be reflected in the price paid for
20 cheese milk. For the period June 2009 through May
21 2011, the Federal Order Class III price averaged \$14.22
22 per hundredweight compared to the current Class 4B
23 price of \$13.18 per hundredweight, or \$1.04 per
24 hundredweight less. For the period December 2007
25 through May 2011, the Federal Order Class III price

1 averaged \$14.82 per hundredweight compared to the
2 current 4B formula at \$13.97 per hundredweight. The
3 Class 4B price has averaged 85 cents per hundredweight
4 less than the Federal Order Class III price since the
5 25 cent fixed whey factor was implemented by the
6 Department in December 2007.

7 Small cheese plants have had the opportunity
8 to develop their whey business since 2007. All cheese
9 plants, large and small, have benefitted from the fixed
10 whey factor since 2007. From December 2007 through
11 April 2011 the 25 cent fixed factor has benefitted
12 cheese plants over 80 percent of the time. By limiting
13 the financial exposure to a maximum value of 25 cents
14 for a product with the potential for capturing far more
15 than that value in the market, the 25 cent fixed whey
16 factor has provided a huge incentive and a golden
17 opportunity for small cheese makers to develop a whey
18 business.

19 We encourage, respectfully encourage, the
20 Department to ask small cheese processors how they
21 handle their whey and if they have pursued new ways to
22 take advantage of the rising values in the whey market.
23 We would also be curious to know how small cheese
24 processors manage to compete for milk supplies if they
25 have no outlet for their whey.

1 Since 2007 Land O'Lakes has had first-hand
2 experience with the issue of a small cheese plant
3 finding an outlet for whey processing. Our Orland
4 cheese plant had been condensing and trucking the whey
5 to our Tulare plant for further processing. This ended
6 in 2010 when we chose to idle our cheese and whey
7 processing facility in Tulare. We continue to condense
8 Orland's whey into whey protein concentrate and have
9 established a new relationship with a cheese
10 manufacturer in California for further processing. We
11 don't capture the full value of the lactose in the
12 permeate, which is sold to area dairy farmers, but we
13 have found an outlet for our condensed whey.

14 We also respectfully encourage the Department
15 to ask large California cheese makers how their whey
16 enterprises have performed since December 2007 and to
17 compare and contrast their California plants to cheese
18 plants operating in federal order markets. On the
19 surface, it appears that the California cheese plants
20 have had a significant advantage over cheese plants
21 operating in federal order markets because of the fixed
22 whey factor.

23 Processing capacity has changed since 2007
24 and 2008. In 2007 we raised concerns about the lack of
25 processing capacity in California. This developed

1 because new plants were not coming on line fast enough
2 to accommodate the growth in milk production. We
3 testified that through August 2007 milk production had
4 increased year-to-date by 4.7 percent, and we stated
5 that if milk production increases continued at that
6 pace there would be five million pounds of additional
7 milk per day in 2007 compared to the previous year. As
8 a result, the state's processing capacity was being
9 pressured and, in fact, milk had to be shipped out-of-
10 state and, in some cases, less attractive alternatives
11 were instituted. The situation in 2007 through 2008
12 was precarious. Certainly one could argue that
13 California's milk processing capacity was in deficit.

14 Things have changed since 2007 and 2008.
15 Currently there is adequate capacity to handle and
16 process California's milk supply. This does not mean
17 that there could be short-term problems on certain
18 weekends and/or holidays when milk backs up or when one
19 of the large manufacturing plants goes down for
20 maintenance. But even in those cases, while some out-
21 of-state shipments may be necessary, we are not aware
22 of milk finding its way to less attractive alternatives
23 nor being shipped out-of-state on a regular basis. The
24 current market conditions differ significantly from
25 market conditions of 2007 and 2008.

1 What has changed?

2 Number one, during the peak of the crises, a
3 large proportion of the cooperatives and some
4 proprietary firms with direct shippers adopted a base
5 plan and, in some cases, producers were assessed for
6 the cost of disposing of milk in excess of their base
7 production.

8 Number two, milk production has declined in
9 California since 2008. In fact, average milk output
10 per day was 4.3-million pounds less in 2009 than it was
11 in 2008. This occurred for at least two reasons: One
12 was the base plans that were put in place; secondly,
13 the milk prices declined sharply from their peak in
14 2007 and 2008. In fact, the average over base price in
15 2007 was \$17.27 and by July 2009 the over base price
16 dropped to \$9.60 per hundredweight, and the average for
17 2009 was only \$10.81 per hundredweight. From August
18 2007 to July 2009, the over base price dropped by 52
19 percent.

20 Number three, milk processing capacity on a
21 net basis is significantly larger today than it was in
22 2007 and 2008. There was an expansion in cheese
23 processing capacity on the part of two firms for a
24 total of 67 loads of milk per day, and a combination of
25 new powder plants, expansion of current capacity for

1 Land O'Lakes, and a reopening of an old plant that
2 processes powder, condensed, and cream cheese, which
3 added a total of 287 loads a days.

4 There were also some losses in processing
5 capacity. Land O'Lakes idling a cheddar plant, and
6 another large cheese plant was closed, for a total loss
7 in processing of 145 loads of milk per day.

8 In sum, this means that California has
9 experienced a net increase in processing capacity of
10 about 209 loads of milk per day than at the time of the
11 fall 2007 hearing. It's true that in 2007 and 2008 the
12 California milk supply exceeded processing capacity so
13 we had deficit processing capacity. Because the
14 processing capacity was deficit in 2007 and 2008, it
15 would be inaccurate to say that we have excess
16 processing capacity of 209 loads per day. Taking into
17 account the deficit processing capacity and the growth
18 in processing capacity on a net basis, and based upon
19 industry sources, we believe California has excess
20 processing capacity of an estimated 80 to 90 loads of
21 milk per day as of April 2011. We believe this to be a
22 conservative estimate. At this point in time the
23 manufacturing capacity in California can adequately
24 handle and process California's milk output.

25 Position on CDI's 4A petition: Regarding the

1 petition by CDI to update the make allowances for
2 butter and nonfat dry milk, Land O'Lakes respectfully
3 requests that the Department conduct a thorough review
4 of the reported manufacturing costs for 2009.

5 Specifically we encourage the Department to consider
6 the level of plant capacity utilized. Land O'Lakes
7 would like to remind the Department that the
8 manufacturing cost data upon which the make allowances
9 are based need to represent costs in plants operating
10 at full utilization of the plant's capacity.

11 We know that from our own butter and nonfat
12 dry milk plant operations in Tulare that our 2009 costs
13 were impacted by startup costs, reduced milk volumes
14 through the plant, and underutilization of plant
15 capacities. Additionally, Land O'Lakes would like to
16 note that the 2010 survey of manufacturing costs will
17 come out within the next few months, providing the
18 Department and the industry with the most current data
19 available on such costs.

20 We support the CDI petition to update the
21 f.o.b. adjuster on butter. We have no concerns about
22 how the f.o.b. adjuster for butter was compiled. The
23 reported f.o.b. adjuster is based upon audited numbers
24 from butter plants and represents the cost of moving
25 butter east. We need to stay competitive with butter

1 processors located outside of California.

2 Position on alternative proposals: Land
3 O'Lakes supports the Department's alternative proposal
4 to make administrative changes to the Class 4A and 4B
5 pricing formulas to include language to implement the
6 collection of security charges provided by the Milk
7 Producers Security Trust Fund.

8 We support the Western United Dairymen
9 proposal, but prefer our proposal.

10 We oppose the Dairy Institute's alternative
11 proposal. We are pleased to see the Dairy Institute
12 recognizes the inadequacy of and inequity resulting
13 from the current 25 cent fixed whey factor; however,
14 the proposal would not do enough to bring the Class 4B
15 price into better alignment with the Federal Order
16 Class III price.

17 Conclusion: We thank the Secretary for
18 calling this hearing. We thank you for your
19 consideration and Land O'Lakes would like to request
20 the opportunity to file a post-hearing brief.

21 HEARING OFFICER MAXIE: Your request to file
22 a post-hearing brief is granted.

23 Are there any questions from the panel?

24 MS. GATES: Mr. Wegner, I have a couple of
25 questions for you.

1 Going back to your position on the 4A
2 petition that's out there, did I understand correctly
3 that you didn't take a position on the f.o.b. adjuster
4 for 4A, it was just 4B?

5 MR. WEGNER: We did take a position on the
6 f.o.b. adjuster for 4A. We support that.

7 MS. GATES: You support that. So it's just
8 the cost, net efficient costs that you're --

9 MR. WEGNER: Raising.

10 MS. GATES: -- raising.

11 MR. WEGNER: Raising questions about, yes.

12 MS. GATES: Raising concerns with. Okay.

13 MR. WEGNER: Yes.

14 MS. GATES: Okay, all right. Does Land
15 O'Lakes still have a base plan in effect?

16 MR. WEGNER: Yes, we do.

17 MS. GATES: Okay. Could you speak a little
18 bit to why Land O'Lakes chose the Dairy Market News
19 Price series versus NASS series?

20 MR. WEGNER: Well, we thought that from a
21 Department perspective in terms of what you've used,
22 you'd prefer to have a California market price. That's
23 why we chose that one.

24 MS. GATES: And you feel that that more
25 accurately reflects the California price versus the

1 NASS.

2 MR. WEGNER: Yes.

3 MS. GATES: I understand it correctly. Okay.

4 One more.

5 How did Land O'Lakes come to the floor and
6 the ceiling on this scale, the graduated scale that you
7 guys have proposed?

8 MR. WEGNER: We looked at what we thought was
9 fair. We felt that the -- since there had been no
10 stated opposition to the 25 cent fixed floor that it
11 would be best to retain that in the event that they
12 would drop out again. We felt that the dollar ceiling
13 was a fair number and it was important to max -- to
14 minimize or -- excuse me -- to limit the exposure to a
15 dollar. We felt that that was a fair number,
16 especially at it relates to the two factors, especially
17 as it relates to the federal order whey formula and the
18 other being that we've got, is it, 40-41 months with a
19 25 cent fixed factor had been in place. We thought it
20 was time for cheese prices to recognize that value and
21 share it a bit more.

22 MS. GATES: Okay, thank you.

23 MS. REED: Mr. Wegner, I have a couple
24 questions to ask you.

25 You're talking then, on page 10, about how

1 you feel that your costs have been impacted by startup,
2 you know, fees, and reduced milk and all. And I will
3 ask the same question that I asked of CDI. So how do
4 you feel those things that happened that year as far as
5 fluctuation in volumes and expansions affected your
6 plant, in what way?

7 MR. WEGNER: I think our costs were higher
8 due to the startup costs, the lower (indiscernible), we
9 were getting used to the efficiency of moving product
10 through in a new system.

11 MS. REED: Okay. Also, do you feel that the
12 costs and the Department's -- you're going to, I
13 already know what your answer's going to be -- the
14 Department's 2009 exhibit reflect your costs, how do
15 you feel it reflects your costs in all areas, because
16 you do butter, powder, and cheese? And if you could,
17 speak to each one of those.

18 MR. WEGNER: Well, I think the point we're
19 raising is that they may, in fact, represent the costs
20 at the plant. Do they represent plant costs when a
21 plant is running at full capacity is our point. We
22 would definitely raise those concerns about the butter
23 and powder operations specifically.

24 MS. REED: Okay. And then one final
25 question. Knowing that you guys do still process

1 cheese in California, but you're asking for a reduction
2 in the make allowance and also the f.o.b. adjuster.
3 Could you explain why you're going in that route?

4 MR. WEGNER: Well, we felt that the survey
5 numbers weren't affected by startups, weren't affected
6 by through put, and they did represent where the costs
7 are for the industry.

8 MS. REED: Okay, thank you.

9 HEARING OFFICER MAXIE: Mr. Eastman?

10 MR. EASTMAN: Thanks. I have just a couple
11 questions.

12 So piggybacking on what Venetta just asked,
13 you mentioned you still make cheese. And how will your
14 (indiscernible) proposal affect you as a processor of
15 cheese? Obviously Land O'Lakes is a processing
16 cooperative, so you kind of wear dual hats where you
17 have interests on dairy farmers but then also you are a
18 processor of butter, powder, and cheese. How does your
19 forby (phonetic) formula affect you as a processor in
20 marketing, a marketer of cheese?

21 MR. WEGNER: Well, it will certainly impact
22 our Orland facility. We're well aware of the impact
23 there, it would be. But again from a cooperative
24 member-owner perspective the inequity between the Class
25 III and the 4B is a very important point for our

1 member-owners. We understand the impact, the negative
2 impact on our plant but a very positive impact to our
3 producers, our producer-owners. So we're well aware of
4 that.

5 MR. EASTMAN: All right. And as a national
6 organization you do mention that you make cheese in
7 California but you also make cheese in the upper
8 Midwest, other areas of the country. When you look at
9 the price alignment issue that you've raised in your
10 testimony, and you've mentioned that possibly
11 California cheese processors, due to that price
12 alignment issue, had some sort of maybe advantage. Do
13 you feel that you've been able to take advantage of
14 that in the sense that you've mentioned in your
15 testimony you pay the Class III or above Class III
16 price in -- outside of California, but you've had a
17 lower price in California. Have you been able to
18 leverage that?

19 MR. WEGNER: Well, no secret, we have a much
20 smaller footprint in cheese at this point and a lot of
21 the cheese that we use out of Orland is within an
22 internal process within our own plants. It certainly
23 has helped. I won't deny that fact. Whether it's been
24 a big advantage with the small stake we have in cheese,
25 I wouldn't say it has been.

1 MR. EASTMAN: Okay. In your testimony you
2 raise an issue of price alignment between the cheese
3 price in California and federal orders, and you focus a
4 lot on the whey values. Did you look at or consider
5 the other aspects of the (indiscernible) and formulas?
6 For example, the cheese price series, butter price
7 series. Did you look at the formula constructs, things
8 of that nature when you were looking at pricing line
9 (indiscernible) or did you just focus on the whey?

10 MR. WEGNER: Well, certainly we looked at the
11 other components within the formula, but the bulk of
12 the difference, the majority of the lion's share is
13 certainly in the whey factor. So that's why we focused
14 on that whey factor. And in light of all the
15 discussions we've had here, and as Mr. Erba pointed
16 out, the temporary sort of option that was put in
17 place, the 25 cent fixed factor, clearly needed some
18 updating with the strength that we'd seen since
19 December of 2007. So we -- it's pretty glaring when
20 you look at the amount of the difference between Class
21 III and 4B, that the whey factor is a pretty obvious
22 one to address.

23 MR. EASTMAN: I apologize. I'm going to
24 start writing really quickly, but apparently you can
25 speak faster than I can write.

1 You mentioned in your testimony that in the
2 past there's been statements at hearings, at federal
3 orders there's the depooling option and (indiscernible)
4 and provides an advantage in federal orders. You also
5 mentioned a statement that cooperatives in federal
6 orders are responsible for the Class III
7 (indiscernible) with regards -- probably the pooling.
8 Do you feel there's ever any circumstances where maybe
9 milk is long or there's some sort of distressed milk
10 and the cooperative could, say, offer milk to cheese
11 plants at a price below the Class III price and eat the
12 difference and blend it to the members maybe?

13 MR. WEGNER: It's very possible. The spot
14 market is very different from the -- having established
15 full supply contracts that are in place. But yes, that
16 is a possibility. How often? I can't give you a
17 number on how often that happens. A distress time,
18 like a holiday period, like a plant breakdown, then
19 that might be the case where you would move it. And
20 you're exactly right, though, it would come back in the
21 cooperative and their membership would, as you said,
22 eat the difference. Because you still have to account
23 to the pool at the Class III price.

24 MR. EASTMAN: Sure. Do you have any
25 anecdotal evidence, have you ever heard stories of

1 things like that happening?

2 MR. WEGNER: I know it happens on, like I
3 said, long times when you have holidays. We didn't
4 have much of a flux in the upper Midwest and East this
5 spring, but certainly other springs we'd had points
6 where you had to sell -- in order to find a place for
7 the milk you would offer it a bit lower.

8 MR. EASTMAN: Okay. Another question. And I
9 have another question. You mentioned that you much
10 favor a sliding scale with regards to whey values
11 rather than the fixed factor. And the question I have
12 is let's suppose there were a price alignment issue and
13 the Department were to seek to correct that issue. And
14 part of that, let's suppose, were to change the whey
15 value that's incorporated in the 4B formula in
16 California. Would it be your position that in your
17 mind a sliding scale would be better than, say, a fixed
18 factor even if on average over time the fixed factor
19 were to correct whatever price alignment there would
20 be? Or would it be the same for you?

21 MR. WEGNER: I'd need to see what you meant
22 by a fixed factor. And you probably are talking of
23 over a period of time that it would perform as well as
24 a sliding scale. From my vantage point I think the
25 sliding scale offers a clear indication of where

1 they're going, tied into that market a little more.
2 Maybe predictability isn't quite the right word, but a
3 little more fairness in terms of approximating. I
4 think we're in a tough spot here in approximating value
5 without the costs. We need -- from our vantage point
6 we need to have something that approximates value. I
7 would think that as value goes up in the marketplace
8 you'd like to see something connected to the producer
9 value as opposed to -- I won't argue, sure, you're
10 going to set it at a dollar, a fixed floor? I mean,
11 that's -- I don't think that's as good as moving it up
12 and down from a quarter to a dollar.

13 MR. EASTMAN: So in essence you'd rather see
14 those whey values rise and fall with the market then.

15 MR. WEGNER: Yes, that's what I'd prefer.

16 MR. EASTMAN: Even if -- I'm just going to
17 throw a number out, these are just hypothetical numbers
18 I'm pulling out of the air. Let's just suppose they
19 rose over a certain period of time, your sliding scale
20 were to provide, say, 50 cents a hundredweight, your
21 weight value. Let's suppose there was a fixed factor
22 that over the same period of time was set at 50 cents.
23 So on average both of those would perform over the long
24 haul the same, but obviously with regards to ups and
25 downs in the market they wouldn't. Would it still be

1 your position that you would prefer the sliding scale
2 just because it would follow the market even though the
3 end result could be the same? And hopefully that's not
4 (indiscernible), it's your hypothetical.

5 MR. WEGNER: Are we taking a bid here? In
6 all seriousness, from my vantage point as representing
7 Land O'Lakes, we try to strike something that had some
8 fairness to it and I think, from our vantage point, the
9 sliding scale is a bit more fair in being connected to
10 the whey market. Certainly at the end of the day we're
11 interested in seeing what the return would be as
12 compared to another alternative. But clearly the 25
13 cent fixed factor is not returning an equitable, fair,
14 logical, reasonable value to dairy farmers right now in
15 California.

16 MR. EASTMAN: Okay, I appreciate that answer.
17 I realize that question was a little wordy, but I
18 appreciate that. Let me just check one more thing.

19 MR. WEGNER: I guess I should ask if I
20 answered the question, right?

21 MR. EASTMAN: No, I thought that was a fair
22 answer.

23 MR. WEGNER: Okay.

24 MR. EASTMAN: I think that's all my
25 questions.

1 MS. GATES: I just have a couple more follow-
2 up.

3 On the last page of your testimony when you
4 were speaking to plant capacity and where the state was
5 at this point in time, and you felt that at this point
6 the capacity was find to handle what was going on.
7 What do you see moving forward? Do your, you know,
8 members want to grow? I mean, has that allowed for
9 that or what do you see, like in the next year or so?

10 MR. WEGNER: If you tell me the milk price,
11 I'll give you my response.

12 MS. GATES: Okay.

13 MR. WEGNER: But no, seriously, I think we're
14 cautiously optimistic, I think, but very cognizant of
15 the impact of rising feed costs. I'm hoping we can
16 hear a little bit more about equity on dairy farms,
17 because that's probably my biggest concerns is that
18 we're really in a very serious position regarding
19 equity, so that a dairy farmer can't withstand another
20 period of very low, much less catastrophically low,
21 margins.

22 So where are we going in the future really
23 depends. I'm very concerned about New Zealand milk
24 coming back onto the market this fall quarter. I'm
25 concerned about China deciding not to buy as much whole

1 milk powder and skim milk powder. That all impacts on
2 that butter/powder side. Will New Zealand go back to
3 cheese?

4 Lots of variables in places is what I'm
5 saying. Our dairy farmers continue to want to produce
6 milk, but I'm not sitting here thinking that there's
7 going to be expansion at this point. But a little bit
8 like Mr. Erba suggested, 275 dairy members, it's hard
9 to generalize what they're going to do. But right now
10 the prices are staying ahead of feed costs. I'm not
11 sure we're going to continue to see that as we go on to
12 the remainder of 2011, much less into 2012.

13 MS. GATES: Okay, thank you.

14 Back to the Dairy Market News versus the NASS
15 price. Was there any concern with the Dairy Market
16 News being a phone survey versus an audited type data
17 series that the NASS series is?

18 MR. WEGNER: We didn't raise that point
19 specifically. I know that's been talked about in
20 previous hearings. At this point, again, we're trying
21 to reflect the Western whey markets and --

22 MS. GATES: California price.

23 MR. WEGNER: -- that's the best number we can
24 find.

25 MS. GATES: Okay.

1 MR. WEGNER: It's in the California dairy
2 markets and that's the best market we can find for it.

3 MS. GATES: Okay, thank you.

4 MR. EASTMAN: I'm sorry, I have one more
5 question.

6 With regards to your testimony on the
7 manufacturing costs surveys and how that should be
8 implemented when studying make allowances, you
9 mentioned that you -- in your testimony you draw
10 concerns to the level of, say, butter and powder costs,
11 the manufacturing costs. Are you in favor, then, do
12 you support the idea of updating manufacturing cost
13 allowances in butter, powder in general --

14 MR. WEGNER: In general --

15 MR. EASTMAN: -- knowing that there are some
16 worries in your mind about the levels maybe?

17 MR. WEGNER: In general we support the idea,
18 specifically regarding 2009 when we had the concerns
19 we've raised earlier about capacity, startup costs,
20 through put.

21 MR. EASTMAN: Okay. So just like on
22 (indiscernible) you're supportive of changes to the
23 make allowances on both.

24 MR. WEGNER: On cheese we are specifically
25 supportive to the changes and have no concerns. On

1 butter and powder we have the concerns as I've stated
2 before.

3 MR. EASTMAN: Okay, thank you.

4 HEARING OFFICER MAXIE: Any other questions?

5 (No audible response.)

6 HEARING OFFICER MAXIE: Thank you,
7 Mr. Wegner.

8 We'll now call on the first alternative
9 proposal, and that came from Western United Dairymen.

10 We have some complaints on the panel of the
11 air conditioning being too cold up here.

12 UNIDENTIFIED SPEAKER: I agree with that.

13 MS. GATES: Would you? Okay.

14 HEARING OFFICER MAXIE: If there's anybody
15 back there that can adjust that.

16 MR. EASTMAN: That's not (indiscernible).

17 HEARING OFFICER MAXIE: All right. It's now
18 about two to two.

19 MS. REED: I'll take five votes for myself.
20 I don't have anybody over here to block the air.

21 HEARING OFFICER MAXIE: Mr. Marsh, would you
22 state your name and spell your last name for the
23 record.

24 MR. MARSH: Yes. Michael Marsh, M-A-R-S-H.

25 HEARING OFFICER MAXIE: Thank you for the