EXHIBIT

46

PENGAD 800-631-6989

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.

Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER MAXIE: Thank you. Are there -- are there any questions of the witness before she escapes us?

(No audible response.)

HEARING OFFICER MAXIE: Hearing none, thank you very much.

MS. RANKIN: Thank you.

HEARING OFFICER MAXIE: At this time I'd like to call the first Petitioner, California Dairies Incorporated. Petitioner will have 45 minutes to submit testimony. You will notice that we have a time clock, again to my right, to help you time your testimony.

Thank you, sir. Thank you. For the record would you state your full name and spell your last name.

DR. ERBA: My name is Eric Matthew Erba. Last name's spelled E-R-B-A.

HEARING OFFICER MAXIE: You distributed a document to us. Is that a copy of your written testimony for this morning?

DR. ERBA: Yes, it is.

HEARING OFFICER MAXIE: Would you like that document entered as a hearing exhibit?

DR. ERBA: Yes, I would. Thank you.

HEARING OFFICER MAXIE: All right. The exhibit will be entered as Exhibit number 49.

(Thereupon, Exhibit 49 was received and entered into evidence.)

Whereupon,

DR. ERIC MATTHEW ERBA

was sworn and duly testified as follows:

DR. ERBA: Good morning Mr. Hearing Officer and members of the panel. My name is Eric Erba. I hold the position of Senior Vice President of Administrative Affairs for California Dairies, Inc., whom I am representing here today.

California Dairies is a full-service milk processing cooperative owned by approximately 450 producer-members located throughout the State of California. They collectively produce almost 17-billion pounds of milk per year, or 42 percent of the milk produced in California. Our producer-members have invested of $500-million in large processing plants at six locations, which are projected to produce about 350-million pounds of butter and 725-million pounds of powdered milk products in 2011.

On June 23rd, 2011, the Board of Directors for California Dairies unanimously approved the position that I will be presenting here today.

We thank the Department for calling this hearing and allowing us the opportunity to explain our proposal and the reasons for submitting the petition for the hearing. The testimony that I will present today will be consistent with the idea of maintaining current plant capacity in California by adjusting the manufacturing cost allowances appropriately.

We recognize that many of the factors that companies consider before investing in new facilities or expanding current facilities will not be influenced by the Department's decision. However, the results of this hearing do determination whether or not plan margins are adequate to ensure each plant's continued operation. The California dairy industry is not far removed from a critical tipping point where milk production outpaces processing capacity. While we have not reached the crisis that we experienced in 2008, we do see pockets of imbalance. Since the spring of this year we have verified with processing facilities outside of California that some California milk is, in fact, moving out of California to other states for processing. It seems clear that California cannot afford to lose any more of its processing capacity.

For decades California has established minimum milk prices through the use of end product pricing formulas. End product pricing formulas depend on a variety of factors including established manufacturing cost allowances. The Department has long held that those manufacturing cost allowances need to be representative of verified processing costs incurrent by California processing plans. Fortunately, the Department has conducted cost studies of California manufacturing plans for years, and the published studies allow for regular review and discussion of manufacturing costs by the industry. More recently, the Department has collected and published information on the prices actually received by cheddar cheese manufacturers and butter manufacturers in California so that a comparison to the average prices at the Chicago Mercantile Exchange can be made. The results of these comparisons are manifested in the pricing formulas as f.o.b. price adjusters. We fully support the regular review and updating of cheese and butter f.o.b. price adjusters based on the most current information available.

The latest cost studies conducted by the Department were released in November 2010 and they indicate that adjustments are warranted and justified for the manufacturing cost allowances and f.o.b. price adjusters. That is to say they do not continue to reflect the current marketing conditions in California's dairy manufacturing sector. As you are aware, the manufacturing cost allowance and f.o.b. price adjusters for Class 4A have not been adjusted since December of 2007 and the amendments to the pricing formulas according to the record that time were based on data from, 2006, and the early part of 2007.

The proposed Class 4A pricing formula: California Dairies proposed that the following formula for Class 4A milk be adopted.

On the Fat price the CME AA butter price, minus 4.85 cents for the f.o.b. price adjuster, minus 11 -- or it should be 18.11 cents for the manufacturing cost allowance, multiplied by a yield factor of 1.2. On the Solids-Not-Fats side a California weighted average nonfat dried milk price less the manufacturing cost allowance of 19.84 cents multiplied by a yield factor of one.

The proposal simply amends the Class 4A pricing formula to increase -- by increasing the butter and nonfat dry milk manufacturing cost allowance to the weighted average cost for both commodities, as published in the November 2010 Manufacturing Cost

Exhibit. The Department's data verified that the cost of manufacture butter is 18.11 cents per pound, and increase of 2.51 cents per pound over the current manufacturing cost allowance for butter. Similarly, the cost exhibit verifies that the cost to produce nonfat dry milk is 19.84 cents per pound, an increase of 2.86 per pound over the current manufacturing cost allowance for nonfat dry milk.

California Dairies' plants handle large volumes of milk and are well managed and operate efficiently. More importantly, all of our plants operate every day because of our commitment and responsibility to balance most of the state's milk supply We make our proposal with full understanding that our proposed manufacturing cost allowances will leave some of our manufacturing plants uncovered. However, we think it is appropriate that the manufacturing cost allowance be set so that our largest and most efficient plants are covered. It is axiomatic that establishing manufacturing cost allowance that do not cover the costs incurred by the largest and most efficient plants has grave ramifications for processing capacity in the state.

To be consistent with past practices, the Department should also consider adjustments to the f.o.b. price adjuster for butter at the same time that it is considering changes to the manufacturing cost allowances contained in the Class 4A pricing formula. The Department's data shows that the difference is 4.85 cents per pound for the 24-month period ended June 2010, an increase of 1.76 per pound over the current f.o.b. price adjuster. The Department has a long history of using the results of a 24-month of pricing data collected, published every year, and the Department itself has stated that the method for a recent 24-month period provides the most objective information available on California cheddar cheese and Grade AA butter sales.

Changes in the Class 4A manufacturing cost allowances that do not allow the results of the Department's -- do not follow the results of the Department's cost studies, that is to say increasing them by less than what is justified, reduces the value of the investment in milk processing facilities made by our member-owners. It would also differentially benefit those producers in California who do not have investments in butter and nonfat dry milk processing facilities and, therefore, carry no responsibility of costs in balancing and stabilizing the state's enormous milk supply.

On the percent of volume covered, prior panel reports have typically references the volume of product in the cost studies that would have been covered at a given level of manufacturing cost allowance. The Department has repeatedly stated in its panel reports that the level of volume covered is not predetermined and has attempted to choose manufacturing cost allowances such that 50 to 80 percent of cost study product volume is covered. Reporting the percentage of volume covered is not at issue here today. However, selecting manufacturing cost allowances using a percentage of volume covered as a guiding principle is at issue because the process is problematic, in part because of small number of plants involved in the cost studies.

Using the percent of volume covered as a guideline, even one as loose the Department has used in the past, has a built-in circularity to it. Let me provide you with an example. Say initially that the manufacturing cost allowance is set to cover 70 percent of the volume of product produced. In subsequent cost studies the plants that were less efficient and had higher costs may have exited the business, leaving only those plants that were considered to be the most efficient plants in the study. If the percent of volume covered guideline is applied to this group in subsequent cost studies, a plant -- a plant once considered to be efficient will then be deemed to be a higher cost plant or cost inefficient. This result is simply because the percent of volume covered guideline, by construct, draws a line under which some of the plants will necessarily have to fall.

The obvious question is, what then should the Department consider as an alternative to the volume covered rule of thumb. Eliminating the percent of volume covered guideline will shift a great deal of responsibility to the Department's staff for knowing intimately the plants in the cost study. If the higher cost plans in the cost study do, in fact, drop out and there are only efficient plants left, which can be verified by Department staff, then setting the manufacturing cost allowance to cover all of the volume, or most of it, would be an acceptable and correct decision, and far preferred to blindly striking a line at 60 percent, or 70 percent, or 80 percent of the volume covered. Consequently, the panel should give serious consideration to eliminating the percent of volume covered guideline as a criteria to be used in the decision-making process.

Other proposals that are under consideration:

administrative amendments by CDFA. The Department submitted an alternative proposal for administrative changes to the Class 4A and Class 4B pricing formulas. The intent is to include language to implement the collection of securing charges provided by the Milk Products Security Trust Fund and to eliminate the conflicting language contained in the Stabilization and Marketing Plans relative to the Food and Agricultural Code. We recognize the need to keep regulations aligned with state laws and support those changes needed to maintain that consistency.

On the Class 4B proposals, manufacturing cost allowance and f.o.b. price adjuster, Land O'Lakes submitted a proposal to adjust the manufacturing cost allowance for cheese and the f.o.b. price adjuster for cheese in accord with the Department's cost studies that were released in November of 2010. We note that the approach used by Land O'Lakes in their proposal mirrors what California Dairies has proposed for the Class A formula. The method of relying on the Department's cost studies to update the pricing formulas is understandable, reasonable, and justifiable, and we support those changes to the Class 4B pricing formula.

Class 4B proposals, whey factor: It should be clear that the fixed factor of 25 cents per hundredweight to represent the value of whey in the Class 4B pricing formula was never intended to be permanent. The fixed factor was not a proposal from the dairy industry; it was a placeholder set in place by the Department to give the industry the time and opportunity to work out a mutually agreeable solution. A solution was not arrived at by the industry despite the considerable time and effort put forth by the Department and many key representatives of the dairy industry. Consequently, as the market price for dry whey has increased, California producers have seen the spread between the prices generated by the Class 4B and federal Class III pricing formulas grow over the past two years, largely the result of the difference in the manner in which whey is valued. I personally participated in several discussions that began months that favored a sliding scale for the whey contribution to the Class 4B formula. The mechanism is easily understood. When the market price for whey increases, the contribution to the Class 4B formula increases as well. I point out that there are proposals from both producer representatives and processor representatives under consideration that follow this exact same sliding scale concept.

We recognize that cheese processors of all sizes would be impacted by all the proposals that have been submitted to the Department. The Alliance of Western Milk Products, of whom California Dairies is a member, attempted to introduce a concept of dry whey credit for smaller cheese plans in 2007, but the Department steadfastly refused to accept the concept, citing lack of authorities in the Food and Agriculture Code. We remain convinced that no specific authorization is required to implement and administer a dry whey credit for smaller cheese plants. Both the Stabilization and Marketing Act and the Milk Pooling Act give the Secretary broad discretion regarding pricing and related matters. The Acts are intended as broad policy guidelines and not every detail as to how to administer the dairy programs must be spelled out in the Food and Agricultural Code.

It is unfortunate that no resolution to this general disagreement on Departmental authority has surfaced. However, the issue of the whey contribution to the Class 4B pricing formula and the subsequent value to produce as a whole cannot be ignored any longer.

Therefore, we support the Land O'Lakes proposal on the sliding scale for the whey factor in the Class 4B formula.

Concluding remarks: As the largest supplier of milk to California dairy processing plants, California Dairies balances milk on a daily basis. Any change in our producer-owners' milk production or in our customers' orders must be accommodated by using the capacity in our plants 24 hours a day, seven days a week, and 365 days a year. We also help to balance milk supplies for other cooperatives and other processing plants on nearly a daily basis.

It is critical that the Department's decision maintain standby balancing capacity in California, particularly when we, as an industry, are looking at relatively stagnant plant processing capacities in the near future. To do so, the Department must follow its own cost studies and make the adjustment to the manufacturing cost allowances and f.o.b. prices adjusters whenever the data are available. California Dairies' proposal does just that for the Class 4A formula, and we support the same method being applied to the Class 4B formula as proposed by Land O'Lakes. We also support the Land O'Lakes proposal of using a sliding scale to value whey in the Class 4B pricing formula as a replacement for the fixed factor that exists currently.

Thank you for your attention. I'm happy to answer any questions that you may have. I request the opportunity to file a post-hearing brief.

HEARING OFFICER MAXIE: Thank you, Dr. Erba. Your request for a post-hearing brief is granted.

Are there any questions from the panel?

MS. GATES: Dr. Erba, on page one of your testimony you speak to the California dairy industry is not far removed from a critical tipping point where milk production is outpacing the processing capacity. And you speak to -- that you verified that with processing facilities outside California. Do you know what volume of milk we're moving at this point out?

DR. ERBA: Well, it's variable. I think you can understand that and it's going to probably go down as the future months come. I can get the actual numbers for you in a post-hearing brief if you wish, but it's probably on the order of a million pounds a day at its peak.

MS. GATES: Okay. Yeah, I'd appreciate that, thank you.

Kind of speaking to that issue, compared to 2007, you know, at that time when we had the hearing there were certain landscapes that the dairy industry looked at at that time with regards to production, plant capacity, milk movement. You know, at that point in time we had -- we were short on plant capacity, production was high. What do we see different today or is everything the same? It's kind of speaking to that same issue.

DR. ERBA: Well, I don't think that much has changed, Ms. Gates. We took a little bit of a downturn in production over the last couple of years but, if you look at milk production in the last 12 months in California, especially the last few months, it's been a very strong increase. Cow numbers are up. We really didn't go down that far in milk production in the last couple of years compared with what the capacity is. We're continuing in danger of losing processing capacity in the state and part of that is going to be supported by the manufacturing cost allowance and where that -- where that level is set. So even though we're maybe not at the danger zone where we were a couple years ago, we're really not that far removed.

And I think the example that I provided of milk moving out-of-state verifies that we are, we're already close. And spring has already passed, we're into hot weather now, we should be in okay shape through the rest of the year. The hard fact that we had milk in California moving out-of-state to get processed this year indicates that we are close to that tipping point again.

MS. GATES: What percentage of capacity is CDI at at this point? Are you guys at capacity, processing at capacity?

DR. ERBA: Capacity's kind of a funny question. We've discussed this quite a bit internally. It's you don't receive milk continually on the same uniform volume every day, day end and day out. You have peaks and valleys. You may be under capacity during the week and over capacity on the weekends. So, I mean, overall we probably have a little bit of room right now but again it's peaks and valleys. We're one breakdown away from a plant on our customer, our own plants, affecting a fairly major crisis. We're that tight.

MS. GATES: Okay. CDI has significant year-end payouts -- was retained to the end of 2010. How did that affect the Board's decision to call for an adjustment to the pricing formulas?

DR. ERBA: I don't think it was related at all. We looked at the historical information provided by the Department of the cost studies. It is a pretty well held belief that we should have these kinds of hearings on a regular basis. As soon as the cost studies come out, a hearing ought to be called to discuss it. And it could be an adjustment up, it could be an adjustment down. The fact that we haven't had a hearing to address this for several years, to me personally, is a little bit alarming because the numbers have gotten quite a ways away from the cost of where they are today, quite a ways away from what the manufacturing -- our cost allowances are in the formula.

So I don't think they're related at all. I think it's always been in my mind that we should have had this hearing, despite how well or how poorly we did as a company.

MS. GATES: Thank you.

MS. REED: Okay, I have a couple of questions for you and this is going to be more related to the -- your costs, manufacturing costs, since you talk about that quite a bit.

How do you feel that your startup expenses and lower production have impacted the cost for your plants?

DR. ERBA: Well, there's going to be some of that, to be sure. Startup costs, we had some of that with our first plant in Visalia. Had less of it in the second plant because we had some experience of how that equipment was going to run. But those costs are going to be there, the volumes are going to be lower, and eventually those are going to wash out over time.

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

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

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

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

DR. ERBA: Right.

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

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

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

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

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

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

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

DR. ERBA: That’s true.

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

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

MS. REED: Okay, thank you.

HEARING OFFICER MAXIE: Mr. Eastman?

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

DR. ERBA: Sure.

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

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

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

MR. EASTMAN: Okay. So let's suppose that over the next foreseeable few months or the rest of the year, on average CDI's milk production of all of your members in aggregate tend to start increasing now. Do you think that's going to (indiscernible) issues of handling milk? You mentioned before that you felt these were times or were just demand going down, being in crisis mode. Do you feel like even at milk plants where they go down, do you think we could reach that tipping point again?

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

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

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

DR. ERBA: That's right.

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

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

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

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

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

HEARING OFFICER MAXIE: Any other questions?

(No audible response.)

HEARING OFFICER MAXIE: Thank you, Dr. Erba.

DR. ERBA: Thank you.

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