



July 11, 2011

Ms. Candace Gates, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
560 J Street, Suite 150
Sacramento, CA 95814

RE: Post Hearing Brief for the June 30th – July 1st Class 4a and 4b Hearing

Dear Ms. Gates and Members of the Hearing Panel:

California Dairies, Inc. (CDI) appreciates the opportunity to submit the following post-hearing brief to amplify portions of our testimony presented in Sacramento on June 30th, 2011 and to attempt to address the questions posed by members of the Hearing Panel.

The Hearing Process and the Cost Studies

The Department of Food and Agriculture (Department) has been heavily involved in dairy regulation and, more specifically, milk pricing, for decades. The appropriate level of milk price has been asked and answered on multiple occasions over that time period. Each administration that has been asked to address the appropriate level of milk price has done so with the best resources available. At the forefront of the information available is the manufacturing cost studies conducted by the Department, which have been the cornerstone of California's milk pricing foundation. The cost studies have provided unparalleled credibility to the milk pricing system in California, and their importance to the milk pricing process is unquestioned.

The procedure used to conduct milk pricing hearings has evolved over time, and slight adjustments to that process have been made as issues have arisen. A few years ago, the Department instituted pre-hearing workshops because of the tendency for hearing participants to not share ideas, concepts or data with other parties (including Department staff) prior to the hearing, which served to add a layer of chaos to an already complex process. The Department's introduction of the pre-hearing workshops provided an appropriate forum for industry discussion and dialogue. It is critical to note that *neither discussion nor dialogue can be accomplished in a formal hearing setting*. At that same time, the Department also instituted a policy that ideas or concepts that were not made available for questions and discussion at the pre-hearing workshop and that were subsequently presented at the hearing would be discounted significantly.

ARTESIA
11709 E Artesia Blvd.
PO Box 6210
Artesia, CA 90702-6210
Telephone: 562-865-1291
FAX: 562-860-8633

FRESNO
755 "F" Street
PO Box 11865
Fresno, CA 93775-1865
Telephone: 559-233-5154
FAX: 559-268-5101

LOS BANOS
1175 Pacheco Blvd.
PO Box 2198
Los Banos, CA 93635-2198
Telephone: 209-826-4901
FAX: 209-826-4294

TIPTON
11894 Avenue 120
PO Box 837
Tipton, CA 93272-0837
Telephone: 559-752-5200
FAX: 559-752-5201

TURLOCK
475 South Tegner
Turlock, CA 95380
Telephone:
209-668-6150
FAX: 209-668-6162

**CORPORATE OFFICE
VISALIA**
2000 N. Plaza Drive
Visalia, CA 93291
Telephone:
559-625-2200
FAX: 559-625-5433

It was alarming and dismaying to hear the negative and counterproductive comments made by some hearing participants about the Department's manufacturing cost studies *on the day of the hearing*. The emphasis is necessary for precisely this reason; there are far better and more appropriate venues for making comments or highlighting concerns. The most obvious, of course, is the pre-hearing workshop, which I will address shortly. However, in the case of the manufacturing cost studies, there have been other opportunities for questions, comments, discussion, and debate. These are highlighted below.

- All companies that operate processing plants and participate in the cost studies meet with Department staff for an exit interview at the conclusion of the cost studies. These are typically scheduled during August, September and October, prior to the release of the cost studies. There were no concerns from participants noted in the cost studies when they were released in November 2010, which would logically indicate that all participating companies were satisfied with the methods used and even the results themselves.
- Any party that did not have a plant involved in the cost studies had the opportunity to bring to the attention of the Department staff any issues discovered as soon as the cost studies were released. Again, no such concerns were voiced.
- Finally, after the Department called a hearing specifically to consider adjustments to the manufacturing cost allowances based on the Department's cost studies, the pre-hearing workshop would have made an ideal forum to discuss any concerns about the cost studies. The pre-hearing workshop allows and encourages open dialogue so that any participant has the opportunity to present his or her point of view. Similarly, other participants have an equal opportunity to address any questions or concerns brought forth. And again, there was not one question about the conduct of the cost studies, the evaluation process used by the Department's staff or the results of the cost studies.

No party should be in a position to make unconfirmed claims on the day of the hearing about Departmental evidence in an attempt to invalidate that entire body of work. This applies particularly to those who are less familiar with the procedures used in the cost studies, to those who have had no direct involvement in the cost studies, and to those who have never participated in the exit interview process. And yet, on the day of the hearing, several parties attempted to cast doubt upon the cost study results (including the f.o.b. price adjusters) by simply including inaccurate, inflammatory and unsubstantiated comments in their testimony. At no time was there any quantitative evidence introduced into the hearing record by any party to validate the concerns about the cost studies. For example, in an apparent collaborative effort, several parties suggested that the butter and powder manufacturing costs were inflated because of "start up" costs and "running at less than full capacity". The comments indicate that those parties were speaking from an uninformed position and have no direct knowledge of the anatomy of a cost study, particularly the cost study that was completed using 2009 data. A detailed discussion follows.

Start Up Costs

There is no line item for "start up" costs in a cost study; those costs of operation are inextricably linked to all other costs for operating a plant. Simply put, those costs cannot be identified and

cannot be disentangled from all other costs. Because the “start up” costs are not discernible in the cost studies, there is no logical or defensible means of adjusting the cost study results because of them. Had the matter been brought to light in an appropriate venue, what constitutes “start up” costs and whether or not they should be treated differently than operating costs could have been discussed.

From CDI’s perspective, the first phase of the Visalia location started operation in February 2008; clearly that plant was running as an established plant in 2009, i.e., the plant had no “start up” costs in 2009. Visalia’s second plant started trial runs of powder production in December 2009 (i.e., the volume of product processed was very small). On a weighted average basis, the costs associated with the powder production from the second plant had minimal impact on the cost study results. It is also a fact that Visalia’s second plant was not capitalized until January 2010 so that the largest individual component for operating costs associated with this plant (depreciation) was not included in the 2009 cost data. That is to say, the costs for Visalia’s second plant used in the 2009 cost study underestimate the plant’s underlying costs because depreciation was not included. Moreover, the butter operation in Visalia’s second plant had zero production in 2009. Again, all of these facts could have been presented at the pre-hearing workshop or at another appropriate venue if the parties who attempted to undermine the credibility of the cost studies in their testimony had asked their questions or voiced their concerns prior to the day of the hearing.

Plant Processing Capacities

Plant processing capacities fluctuate day to day, week to week, month to month, and season to season. There is no single preferred or ideal level of capacity at which every plant should operate because so many other situational factors must be considered – plant location, equipment age and capability, energy consumption, plant loss, cost of transportation, labor expertise and availability, types of products for which there are sales, etc. It is absurd to suggest that the only applicable processing costs that should be considered are those that are incurred when a plant is running at “full capacity”.

Perhaps the most logical and defensible statement about the cost studies is that the manufacturing costs captured in the cost studies are the best representation of the true manufacturing costs, and they must be considered as they were published. Rightly so, the Department has never attempted to adjust cost study results because such factors as “start up” costs and “running at less than full capacity”. The Department staff who are involved in the cost studies recognize that making adjustments to the cost study results without a defensible method runs the risk of being arbitrary and capricious. It is appalling that any hearing participants would ask the Department to damage the credibility of the cost studies in an effort to achieve a result that furthers their own individual agenda.

CDI’s Petition for a Hearing

There seemed to be some question as to why CDI filed a petition for a hearing to consider adjustments to the Class 4a manufacturing cost allowances and butter f.o.b. price adjuster. Anyone who has questions does not need to look any further than the results of the last two

manufacturing cost studies published by the Department. Both cost studies showed unequivocally that the principal components of the Class 4a formula, i.e., the manufacturing cost allowances and butter f.o.b. price adjuster, are not in any kind of reasonable relationship with the Department's own findings. The cost studies released in November 2010 underscore a simple fact – the current manufacturing cost allowances for butter and powder and the f.o.b. price adjuster for butter do not continue to reflect the current conditions in California's dairy manufacturing sector. This should surprise no one. The manufacturing cost allowance and f.o.b. price adjusters for Class 4a have not been adjusted since December 2007, and the amendments to the pricing formulas at that time were based on data from 2005, 2006 and the early part of 2007.

The representatives from Challenge Dairy Products, Inc. and DairyAmerica, Inc. provided additional reasons why manufacturing costs for butter and powder were higher in 2009 based on their first-hand marketing experiences. Without duplicating their testimony, they both stated that as California transitions into a larger and more consistent supplier of dairy products to international customers, the specifications on the products being marketed are tougher and more costly to meet. International customers require expanded product testing and have different packaging requirements than domestic customers, and meeting those customer demands comes at a cost to California processors. Fortunately, the Department's cost studies provide an ideal tool for tracking those additional costs and allowing for a comparison to the manufacturing costs allowances in the pricing formulas. As stated at the hearing, CDI fully supports the regular review and updating of manufacturing costs allowances and f.o.b. price adjusters based on the most current information available.

Milk Shipped Out of California

During my testimony, I made the following statement:

“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 of 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.”

I was asked to estimate the volume of milk that has been moved out of state for processing by the Panel. I contacted the processor outside of California that stated in the month of June, they had received 81 loads of milk and 12 loads of condensed milk from California. This was described as distressed milk by the out-of-state processor, not milk that was fulfilling a contract as a regular sale. I make this distinction because some hearing participants appeared to be confused about what milk is actually moving out of state and for what reason. I believe these facts dispel the notion that California processing capacity is more than adequate, as claimed by some hearing participants, and that California milk can always find a home in-state.

Concluding Remarks

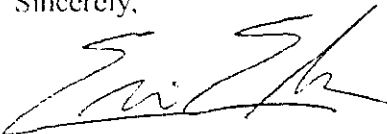
Milk pricing hearings in California have a historical tradition of allowing for participation by anyone. They also have a noble goal of identifying and adopting policy changes that are fair and

reasonable for all. However, that does not mean that the Department should ignore its foundational work and respond to popular opinion. First and foremost, the Department needs to trust in its own manufacturing cost studies that were conducted by its own auditors and completed in accord with its time-tested methods. The Department has never disregarded or even strayed far from the results of its most recent manufacturing cost studies whenever a hearing has been called to address those specific issues. Second, unsubstantiated testimony about plant “start up” costs, underutilization of plants and even plant profits (OR losses!) has not ever had any bearing on the Department’s decision, nor should it ever. Testimony submitted without a shred of quantitative evidence or confirmation should not be allowed to cloud the unmistakable and inarguable fact that butter and powder manufacturing costs have increased significantly since 2007. Finally, the Department should not establish a poor precedent by acknowledging and responding to the last-minute concerns brought forth by numerous hearing participants about the manufacturing cost studies. Such action by the Department would be prejudicial against those who are affected by the inaccurate statements because there is no possibility of addressing those statements adequately. It should be clear that there was ample time and many possible venues over the last several years for concerned parties to address any issues publicly and well in advance of the date of the hearing. Delaying or altering a decision by the Department because of unconfirmed statements made in testimony on the day of the hearing would not only set an untenable precedent, it would also unravel years of effort put forth by the Department to establish proper public hearing decorum.

Therefore, it seems perfectly clear and consistent with past Departmental practices to **reject any of the unsubstantiated concerns about the cost studies.** Furthermore, any testimony that recommended adopting cost study results differentially (i.e., supporting favorable results and opposing less favorable results) despite the fact that cost study methods were applied consistently across all products that were evaluated should be firmly rejected. The Department should proceed, as it always has, with a decision that relies heavily on all the cost study results as the most accurate and credible means for determining the true underlying costs of manufacturing dairy products in California. To do less would damage the sterling reputation that the cost studies have achieved over several decades.

Thank you for allowing us the opportunity to submit this post-hearing brief.

Sincerely,



Dr. Eric M. Erba
Sr. VP Administrative Affairs