



BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURE MARKETING SERVICE

In the Matter of Milk in California  
Notice of Hearing on a Proposal to  
Establish a Federal Milk Marketing  
Order

7 CFR Part 1051  
Docket No.: AO-15-0071  
AMS-DA-14-0095

Clovis, California  
November 4, 2015

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Testimony of Sue M. Taylor  
on behalf of Leprino Foods Company

Part 2

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I am Sue Taylor, Vice President of Dairy Economics and Policy for Leprino Foods Company ("Leprino"), headquartered in Denver, Colorado. I previously testified at this hearing so will forego the company and personal background.

Position

Leprino supports the adoption of proposal number 2, developed by Dairy Institute of California, if USDA ("Department") promulgates a Federal Milk Marketing Order that includes California. I previously testified in support of Dairy Institute's proposal regarding pool plant definitions and in opposition to the pool plant definition found in §~~1050.7(c)~~ of the cooperative proposal (Proposal 1).  
1051.7(c)

My testimony today will focus more broadly on regulated milk price policy and specifically in support of Dairy Institute's Class III price proposal (Proposal 2) and in opposition to the Class III price proposal found in Proposal 1.

### Today's Dairy Industry Context

In today's domestic and international environments, it is more critical than ever that the minimum regulated pricing system influence be minimized. Competition across the entire food complex for "share of stomach" is very high. Whether innovating a new dairy product or seeking dairy's space as an ingredient in the development of a new innovative food, it is important that dairy demand not be constrained by overly burdensome price regulations.

The US dairy industry is increasingly integrated with global dairy markets. US exports were minimal in the mid-nineties before the Uruguay round of the WTO introduced disciplines that led to growth in developing economies and rising global prices for dairy. Over 15% of US milk solids are now exported in the form of various dairy products. Leprino and many other manufacturers, along with producers through their check-off dollars, have made significant investments in developing exports that will drive up demand for US dairy products and, along with it, the demand and price for raw milk to dairy farmers. These are the opportunities that will raise all ships for the industry. As the Department considers its decision from this hearing, it is important to ensure that a California Federal Milk Marketing Order facilitates rather than inhibits the collective industry's ability to leverage this opportunity.

### Importance of Market Clearing Prices

Regulated milk price policy must be set at levels that contribute to orderly marketing of milk. This necessitates that the regulated minimum milk prices for the manufacture of hard manufactured products be set at levels that clear milk in the market in an orderly fashion. To do so, the minimum regulated price of milk in California must be set at a level that does not exceed values after allowing for reasonable returns that are achievable under good management practices by the California manufacturers.

Milk used for manufacturing, whether for cheeses or for butter and dry milks, is the primary method for California dairy farmers to market the volume of milk that is produced beyond the milk required for the higher priced and more perishable Class I and II products. The utilization

of nearly 80% of California's milk production in Classes III and IV highlights the importance of these manufacturing outlets in marketing California's milk production. Because of the critical role that Class III and IV products play in marketing producer milk components beyond the borders of California, it is crucial that the price formulas be market-oriented, reflecting the values of California-manufactured products, f.o.b. manufacturing plant.

The importance of setting the regulated price at a level that is not intrusive on the market is increased when the regulated price is based on an end product price formula. End product price formulas contrast with survey-based milk prices like the old M-W and BFP price series previously used in FMMOs in their rigidity. The previous surveyed milk price would flex with market conditions and had the flexibility to reflect changes in manufacturing costs on a real time basis. In contrast, manufacturing cost allowances in the end product price formulas are only changed through rulemaking processes. The cumbersome process for adjusting these allowances necessitates that regulated price formulas be set at a level that allows other market forces to work and adjustments to occur outside of the regulated system.

There is substantial risk in setting the regulated price too high. Over-regulating prices results in disorderly marketing by encouraging additional milk production that the market does not have a ready outlet for while decreasing demand at the processor level. Additionally, the setting of regulated prices at too high of a level discourages investment in innovative technology the industry requires to develop commercially viable new products. However, there is little risk in setting the regulated price too low since the market compensates through the development of premiums.

The University BFP Committee commissioned to advise USDA during the FMMO Reform process echoed the need to view regulated pricing as market clearing minimums in stating that:

*Minimum pricing reduces the need for the Secretary to fine tune the price of milk to reflect local or regional uniquenesses in a market setting that is national in scope. Regional price*

*differentials for manufactured products, which may vary seasonally and over time, can be set by market forces where over-order premiums are warranted.<sup>1</sup>*

Additionally, the FMMO Reform Final Decision, on BFP replacement and make allowances, reveals that the policy decision is premised upon the ability of milk to escape the application of minimum regulated milk prices. It states that:

*Manufacturing plant operators who find the level of make allowances inadequate compared to their actual costs also have the alternative to not participate in a Federal order marketable pool.<sup>2</sup>*

This ability for a manufacturing plant operator to step outside of the Federal Order marketable pool that was anticipated by the Department in the Reform Final Rule is not provided under Proposal 1. The importance of setting the regulated price at a market clearing level is even more critical given that suggested change in policy.

#### Dairy Institute (Proposal 2) Class III Formula

The Class prices that apply to milk for hard product manufacturing (Classes III and IV) should be set no higher than the levels that are reflective of the value that can be returned through good management practices in the lowest value order to which the regulations apply. The promulgation of an Order for California necessitates that the Class III formula be revisited in the California context. My preference is that USDA suspend this hearing or defer the outcome's implementation until a national hearing can be held to review and revise the existing Class III formula in light of today's costs and other market factors along with the potential inclusion of California in the FMMO system. In the absence of a suspension of this hearing until a national hearing can be held, it is very important that the Class III price formula that is adopted through

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<sup>1</sup>BFP University Study Committee Report, "An Economic Evaluation of Basic Formula Price (BFP) Alternatives", June 1997, ("BFP Report"), Page 147.

the California promulgation proceeding be set in relationship to achievable returns in California using the most recent available data. It will be important to proceed to a Class III / IV national hearing on a timely basis after the California rulemaking, both because those formulas are based upon nearly ten year old data and to consider the implications of the outcome of this proceeding on other parts of the country. Additionally, this hearing record has already revealed that the whey factor in the current Class III price formula overvalues whey relative to what can be achieved by small cheesemakers. A national hearing should be held to correct the factor across the system.

The Class III price formula can be dissected by products and their price discovery reference, yields, and make allowances for each. The Class III formulas that currently exist in the FMMO system look to cheddar cheese, butter, and dry whey to establish the minimum regulated Class III price. The products represented in the formula should represent the most generic commodity value within the products subject to that Class's price regulation. Those products must have clearly identifiable specifications that can be associated with prices received and cost of manufacturing products of the same specifications. The product yields should represent the yields that are reasonably attained by the regulated entities and the make allowances should reflect at least the cost of converting milk into those products with an<sup>2</sup> return on investment and marketing allowance.

Price Discovery. Dairy Institute's primary proposal is to use a western NDPSR price series for the price discovery mechanism for each of the product prices. The proposal also contains default equations to use as a surrogate if USDA determines that confidentiality concerns limit the Department's ability to release a western price series. Discussions with AMS staff prior to the call of hearing revealed that there may be confidentiality concerns. I recently learned that the confidentiality restrictions may relate more to confidentiality concerns in the area outside of the Dairy Institute proposed geography for the western price series than confidentiality concerns

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<sup>2</sup> 64 Fed. Reg. 16025, 16097 (col. 2) (April 2, 1999).



regarding the release of the western area data. Dairy Institute's intent while selecting the states for inclusion in the western NDPSR price series was to start along the Pacific. The inclusion of states beyond the Pacific was intended to address the confidentiality concerns that USDA might have regarding the release of the western price series. If the inclusion of the additional states has inadvertently created a confidentiality issue for the balance of the country, USDA should consider defining an area that includes the Pacific states of California, Oregon, and Washington and only add contiguous states to the extent that the addition of those states contributes to the ability to eliminate the confidentiality constraints. The Department should not add states beyond the geography defined in the Dairy Institute proposal.

If the Department determines that adjusting the region defined for price discovery does not overcome the confidentiality concerns, the Department should adopt the surrogate formulas as defined in Dr. Schiek's testimony. These factors were generally derived by comparing the relevant NDPSR survey prices with CDFA audited reports of prices received for the commodities in California.

Proponents of Proposal 1 have questioned the existence of a spatial price pattern for dairy commodities that is essentially west coast plus transportation cost to markets in the east. This price surface is the market reflection of the supply and demand balance where there are disproportionately high volumes of production of those products in the west and the disproportionately high consumption of those products in the population centers of the east. The spatial relationship was reflected in the publication of regional prices in the NASS price survey when they published the regional data. It also is reflected in the comparison of the audited prices received data published by CDFA that was used by Dr. Schiek to calculate the price formula factors for the respective products. And it is reflected in the spatial equilibrium model results that were introduced into the hearing record by Dr. Stephenson of University of Wisconsin.

The concept of location value of a commodity is not unique to dairy commodities. It is commonly referred to as basis and can be described as the difference between the local market

and a reference price. Basis is common in most commodity markets, it is not a new term and it is not a synonym for disorderly market conditions. Most farmers are familiar with the term basis as it is common in the grain markets (difference between Iowa/Illinois corn prices and New Orleans, etc) as well as the energy markets (Texas oil vs. Brent oil). Because basis reflects local market conditions, it is directly influenced by several factors including:

- Local supply and demand conditions. Local supply and demand conditions impact basis. The prices in deficit areas generally reflect the price required to attract the product from the surplus supply region for the commodity.

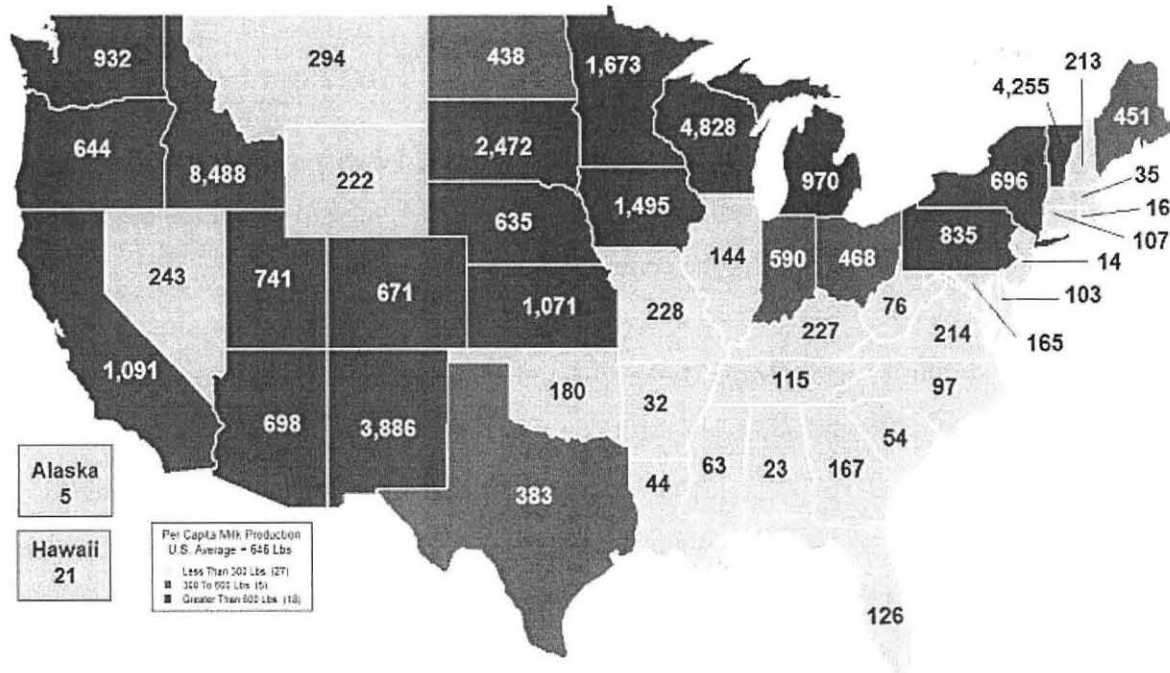
USDA's Central Federal Milk Market Administrator's staff publishes annually a map showing the milk production per capita by state. The map from the February 2015 Marketing Service Bulletin<sup>3</sup> from the Central Milk Marketing Order is reproduced below as Figure 1. The US average per capita milk production shown in the map legend is 646 pounds. I calculated an estimated per capita milk need to serve the domestic market at 549 pounds (646 reduced by 15% exports). States that produce less than 600 pounds per capita are pictured on the Central Order's map in light or medium gray and are considered "deficit" states. States that produce more than 600 pounds milk per capita are shaded in dark gray and are considered "surplus" states. It is easy to see that most of the deficit states are in the Eastern part of the country, which means that efficient and orderly movement of dairy products needs to take place to supply the needs of the population in those areas. Although specific products, particularly branded retail products, may be produced in a deficit area and be distributed nationally, the flow of dairy commodities is largely from the surplus areas to the deficit areas.

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<sup>3</sup> [www.fmmacentral.com/publications](http://www.fmmacentral.com/publications)

Figure 1. 2014 Per Capita Milk Production

## 2014 Per Capita Milk Production



- Transportation costs. California is relatively isolated from the rest of the country, being located on the western edge of the mainland. A California manufacturing plant must compete for sales on a delivered price basis with manufacturers in other parts of the country. This may be manifested by the manufacturer arranging the transportation and pricing the product at the customer's location or selling f.o.b. manufacturing plant at a discount related to transportation cost to what would otherwise be a delivered price. In either case, the all-in price to the customer must be competitive with the supply alternatives and the net price to the manufacturer is reflective of that competition and the cost to transport the product to the customer. Even many of the dairy products marketed at retail within California are first delivered to converting facilities to the east of



California before being cut or shredded, packaged and delivered to the retailer's distribution center for further distribution back into California.

California values are lower than parts of the country further east because more milk is produced in California than is consumed in California and surplus milk in the form of manufactured products is cleared into the deficit areas of the country.

Leprino's Distribution and Transportation Costs. Leprino's California production is sold worldwide. Over 13% of our California cheese production and nearly 90% of our California whey products are exported. Nearly half of our California cheese volume that is sold domestically is shipped east of the Mississippi. Much of this cheese is shipped into the milk and cheese deficit southeast market.

The cost of trucking cheese from our California plants to the Midwest where many of our customers who produce frozen foods or shred and package cheese for retail distribution around the country are located is in excess of \$0.10 per pound and the cost of trucking to the northeast and southeast is roughly \$0.15 per pound, plus or minus a penny depending upon location. In order to compete for those customers, our pricing needs to be competitive with the alternative supply sources in other parts of the country, most importantly in the midwest.

Cheese Valuation. Both the current Class III formula and Dairy Institute's proposal is based upon a cheddar cheese production model. Cheddar cheese has formed the basis of regulated cheese milk end product price formulas since California developed a separate Class 4b milk price formula in 1989 and USDA replaced the old BFP with the end-product price formula in 2000. Cheddar cheese was historically the most common cheese produced and was the market clearing product within the complex as reflected by its inclusion in the Dairy Price Support Program that was terminated in the 2014 Farm Bill. The specifications for Cheddar cheese are clearly identified in FDA's standard of identity and large volumes of bulk cheddar cheese continue to be produced.

Given the increases in mozzarella production for which the volume now exceeds cheddar production both in California and in the US, some have suggested that the Class III formula be based upon mozzarella. In contrast with cheddar cheese, mozzarella specifications vary significantly in order to optimize the performance within a customer's application. FDA's standard of identity breaks the mozzarella category into eight products. Attachment A is a table that shows the name, moisture range, fat on a dry basis (FDB), wet fat, and CFR reference for the various products. The complexity of using mozzarella in the regulated pricing model should be clear on its face. To satisfy the need to have a clearly specified product in the Class III price formula, one product, such as low moisture part skim mozzarella, would need to be selected from within the broader mozzarella group.

The next filter that would need to be applied to the eligible product definitions is form. The product form is intended to be bulk and not differentiated with value added processes. This eliminates the inclusion of retail product and shredded product as well as other value added processes. After narrowing the mozzarella that would be eligible for reporting to low-moisture part skim mozzarella that is sold in unshredded form of bulk size, the eligible volume is much smaller than that represented in the bulk cheddar category. We reviewed our California production and identified the proportion that would be ineligible for reporting during our FY14 fiscal year. That volume represented in excess of 80% of our California mozzarella production. I do not have visibility to our competitor's production profile, but expect that much of their mozzarella is similarly sold in shredded form given the nature of the mozzarella market. If that is the case, the volume of mozzarella that would be reportable is roughly 60% of the volume of cheddar cheese production in California within the same period. Cheddar remains the dominant form of uniform bulk cheese produced in California.

Bulk cheddar remains the best product upon which to build the Class III price formula. The price for most commodity cheeses produced within the US is referenced to the price of spot cheddar cheese traded at the Chicago Mercantile Exchange (CME).

The form of bulk cheddar that should be used in the California FMMO Class III formula is 40 pound block cheddar. To my knowledge, all bulk cheddar production in California is produced in the block format. Additionally, most other commodity cheeses, including mozzarella, reference to the block price on the CME. Therefore, use of the 40 pound block price in the formula is consistent with California production and returns.

Cheddar yields. Dairy Institute's proposal incorporates the yield factor for cheddar cheese that is embedded in the FMMO Class III formula. Fat capture and yields range with vat configuration. The range of fat capture and yields in California can be expected to be similar to that reflected in the hearing records that established the yield assumptions in the current Class III formulas.

Cheddar make allowance. Dairy Institute's proposed cheddar make allowance should be amended from the \$0.2291 included in Dr. Schiek's testimony to \$0.2306 per pound cheddar. The \$0.2306 make allowance is calculated by adding California's costs from the CDFA most recent audited cost studies of \$0.2291 per pound cheddar and an administrative and additional marketing cost allowance of \$0.15 cents per pound. This proposed make allowance is both consistent with the principle that the make allowance should be reflective of the most current cost data available and is consistent with USDA's methodology from the 2008 Class III/IV Final Decision. Specifically, that Decision adopted a cheddar make allowance based upon the CDFA weighted average cost from its audited cost study released September 2007 (covering cheddar cheese plant costs for January through December 2006) of \$0.1988 plus a sales and administrative cost allowance of \$0.0015 per pound. The sales and administrative cost is added because none is captured in the underlying CDFA cost study.

#### Whey Cream Valuation

The Dairy Institute proposal contained in the notice of hearing does not address errors in the valuation of whey cream in the Class III price formula. The issue remains a problem but the economic impact of the error varies around the country. This is an issue that should be addressed through a national Class III/IV hearing in the near future. The overvaluation is rooted in both

volume and value assumptions embedded in the current Class III formula.

The current formula assumes that all of the fat received at the plant that is not captured in cheddar cheese is recovered and converted to grade AA butter. That assumption is inconsistent with manufacturing realities and it is inconsistent with the record from the 2006 / 2007 Class III / IV price formula hearing. The existing Class III price formula also assumes that the whey cream is used to produce grade AA butter which is not permitted by USDA's own regulations.

Whey cream outlets are very limited in California. Our whey cream sales from our California locations are generally to one of three markets, one in California that seems to have very limited demand and two in Wisconsin. Our prices net well below the CME AA <sup>Butter</sup> market price regardless of outlet for our whey cream. Pricing in Wisconsin is at or below flat market (CME grade AA butter) depending upon the market conditions. The cost of transport on our whey cream delivered to Wisconsin exceeds \$0.54 per pound fat. The number of buyers for whey cream nationally continues to shrink, placing additional downward pressure on whey cream returns as sellers are forced to ship whey cream greater distances to find markets.

While we are waiting patiently for a national Class III / IV hearing to address this, the Department should be cognizant in this promulgation proceeding of the overvaluation as they consider factors adopted in the balance of the Class III formula.

Separate from the whey cream technical error is the need to amend the Dairy Institute butter make allowance to include the \$0.15 cent administrative and marketing cost adjustment. The butter make allowance would be amended from \$0.1724 per pound butter to \$0.1739 per pound.

#### Whey Valuation

The California cheese industry experience of 2007 is a case study in the setting of minimum regulated prices above market clearing levels. The cheese industry stress was manifested in California by consolidation, producer payment defaults, and reductions in plant throughput.

Although often characterized as a “small cheesemaker issue”, it clearly was not. Several large cheese plants with whey processing capacity also experienced significant challenges. Land O Lakes was very public about the financial difficulties at their CPI plant in Tulare and subsequently sold that plant. Dairy Farmers of America (“DFA”) was similarly quite clear that their Corona plant had been a financial drain. Their August 8, 2007 press release (Attachment B) announcing the reduction in throughput August 31, 2007 and planned closure January 1, 2008 indicated that “Market conditions and operating results have hindered success at our Corona plant and in our American Cheese Division. We constantly look for ways to end losses, and stimulate profitability.” In a conversation that I had the prior day with a senior executive of DFA, I was told that the September 1 reduction was designed to reduce the plant throughput to a level at which the processing of their whey stream into any products other than dry whey could be eliminated thereby eliminating the losses on the other, more specialized whey products produced at the plant. Although I am not privy to the magnitude of the losses on these other specialized whey products, one can assume that they had to be very significant to have justified the increased plant overhead costs per unit of production that is associated with the reduced throughput.

Additionally, several of the petitioners at the September 2007 CDFA hearing testified that they curtailed cheese production due to the poor whey economics. Three cheese plants struggled to fulfill producer payment obligations and were placed on the ineligible list for the CDFA Producer Security Trust Fund. All of these changes were reflective of the stress that had been created because the Class 4b price generated a milk price that exceeded the revenue stream of the finished products being produced by many of the state’s cheesemakers.

### Whey Factor

The inclusion of an explicit whey factor in regulated pricing had its origin with the implementation of Federal Order reform in January 2000. Similar to California, many cheese plants outside California did not and do not have whey processing capacity. However, the



inclusion of the whey factor within the Federal Order system was expected to boost the Class III price by a modest enough amount that a small cheese maker that lacked sufficient scale to cost-effectively process whey was perceived to be able to cover the whey portion of the milk price through premiums garnered on the specialty cheeses it produced. In its first year of implementation, the whey factor contributed \$0.29 per cwt to the Federal Order Class III formula.

The explicit inclusion of a whey factor became an increasing challenge for those without whey processing capacity as whey prices strengthened a few years later. With whey driving up regulated minimums by over \$3.00 per cwt at times in 2007, plants without processing capacity struggled and some were shuttered. In Federal Order areas, some plants that are located in dense cheese production regions were able to recoup some value by the sale of whey to consolidators as prices increased. But, as Wisconsin cheesemakers Mr. Buholzer and Mr. Stettler testified earlier in this hearing, the whey factor was even problematic for those cheese makers selling to whey consolidators in Wisconsin. The whey factor was also problematic for manufacturers of whey proteins because dry whey values in the milk price formulas outstripped returns for protein and lactose. It was not uncommon in that timeframe for cheese makers unable to recover the whey value assumed in the Class III milk price formula to negotiate with their suppliers for relief from the full Class III price.

The existence of an explicit whey factor has been problematic for cheese makers without whey processing capacity regardless of whether they are operating in the Federal Orders or California. However, the binding nature of the current California State Order and the cooperatives' Proposal 1 under which minimum regulated prices are enforced on all grade A milk manufactured in California limits market-based approaches to relief. This lack of a pressure relief valve severely limits the range of milk values that can be ascribed to whey without risking significant damage to plant capacity.



Much testimony has been incorporated into this hearing record regarding the inability to economically process whey in smaller cheese plants. Whey processing is highly capital intensive. The extraordinarily high capital costs create a barrier to entry for small cheese plants. In its raw form, dilute whey from a cheese vat has limited value in the marketplace. Skim whey, prior to condensing, is typically around 6% solids. At this low level of concentration, transportation costs quickly consume the historic market value above costs of processing. Some intermediate size plants can condense their whey for more economic transport for further processing at a larger plant. However, the returns achieved for any intermediate products short of the finished whey that is used in the milk price formulas fall short of finished product value.

The diversity of whey products also creates challenges relative to explicit inclusion of a whey factor in the regulated pricing system. Dry whey was historically viewed as the lowest common denominator amongst all whey products. This was because it is the most generic whey product requiring the least advanced technology and returns were generally lower than those for the more highly refined whey proteins. It was thought that, so long as the milk price was based upon dry whey prices, the whey contribution to the milk price would not be overstated for those who process whey. This long-held assumption is challenged from time to time and was proven to be incorrect in 2007. As more processors invested in whey fractionation technology, the increased production of whey protein concentrates depressed those prices. Simultaneously, as older plants producing dry whey were mothballed, the supply and demand balance pushed dry whey prices up. Consequently, the portion of the milk price attributable to the dry whey value outstripped the returns from whey protein concentrate, particularly in operations that did not also produce lactose. It was one contributing factor to replacing the explicit whey factor within the California Class 4b formula with the \$0.25 fixed factor in 2007.

#### Proposal 2 Whey Valuation

The Dairy Institute proposal appropriately caps the whey contribution in the Class III formula in recognition that <sup>36</sup>44 Class 4b plants do not even recover a liquid whey value and the viability of some of those plants will likely be threatened by the increased cost burden related to a product

that they cannot, even under best management practices, extract a value from the whey stream. Many small cheesemakers have testified at prior CDFA hearings that they cannot sustain their operations at an incremental milk cost of \$1.50 per hundredweight of milk attributable to whey. They cannot achieve the plant efficiencies assumed in the formula make allowance for cheese, so our "outsider" perspective of their potential margins based upon local specialty cheese sale prices at retail is likely unrealistic. I cannot speak to how many of these cheese makers are at risk of closing if the incremental milk cost generated by the whey factor in the formula is sustained at \$1.50. But I will note that, based upon prior testimony at CDFA hearings, even the \$1.50 per hundredweight milk may challenge their viability.

Proposal 2 Alternate Whey Valuation. The Dairy Institute proposal to value the whey portion of the Class III milk formula relative to its concentrated liquid whey value is consistent with a philosophy that the order will value the most generic product within a product group. The record clearly shows that there are scale barriers to recovering full finished product value from the whey market. Some plants without sufficient scale to process their own whey dispose of the whey into their waste treatment solutions. Others sell concentrated whey, either before or after ultrafiltration, to other cheese plants or whey consolidators.

The WPC-34 price index is the most common reference used for the sale of liquid concentrated whey by cheese plants selling concentrated whey within California. As many witnesses have testified at this hearing, the prices received for that liquid whey are discounted to reflect that the liquid concentrated whey requires additional processing with highly specialized and capital intensive equipment in order to produce a full value product. If sold f.o.b. seller plant, the price is discounted by the buyer for the cost of transport. If sold on a delivered basis, the net return to the selling plant would be the invoice price less the cost of transport. The Class III formula should reflect the returns achievable at the concentrated whey seller's plant.

The Dairy Institute proposal reflects a survey of cheese plants and was corroborated by Mr. Barry Murphy, a consultant working with many of the cheesemakers with insufficient capacity to have

economically viable whey processing operations producing dry products, at this hearing.

Whey Make Allowance. To remedy the omission of the 0.15 cents per pound administrative and marketing allowance in the Dairy Institute proposal, the whey make allowance outlined <sup>in</sup> Dr. Schiek's testimony should be increased by that amount. The revised proposed whey make allowance is \$0.2310 (before including transportation and cooling costs in the formula).

USDA should not adopt the cooperative Class III formula

The Department should not adopt the cooperative's proposal for Class III and IV pricing. In essence, the cooperatives are asking for price equality with other FMMOs without allowing for equality in the way the price applies. The proposal sets the Class III and IV prices in California equal to what was set in the balance of the FMMOs based upon a hearing in 2006 / 2007. This proposal was supported simply by the rationale that prices should not be different. They have not entered evidence specific to the relevance of the formula factors to California.

The price levels generated by the cooperatives' proposal (Proposal 1) have already proven untenable in a less onerous version. The price levels exceed those that were generated by the Class 4b formula ~~did~~ before December 2007, when overvaluation led to the financial difficulties and closure of cheese plants, three cheese plants being placed on the ineligible list for the Producer Security Trust Fund for failure to pay timely, and the sale of a proprietary cheese company referenced earlier in my testimony.

It is not difficult to anticipate the damage that would be done if Proposal 1 is adopted. The proposal once again sets up the scenario of signals to producers to increase milk production while signaling to cheesemakers to reduce manufacturing capacity. Based upon history, that signal will be once again manifested in increased cheese plant bankruptcies, plant closures, and a shift in manufacturing volumes from California to other states by multistate operators. The proposal would set up a scenario in which even those of us with the scale and capability to economically process whey would be better off shifting production. In addition to our cheese making assets,



we have invested hundreds of millions of dollars in capital to produce specialized whey products in our California plants and continue to need to reinvest in order to maintain markets in a highly dynamic marketplace. Adoption of the proposal would, over the long term, result in a loss of reinvestment in California facilities and their eventual obsolescence and closure.

#### Class IV Formulas

Leprino encourages USDA to apply the same principles to the Class IV price formula as are advocated for Class III. Regulated prices must not provide artificial financial incentives between the manufacture of Class III and IV products. The very intent and nature of pooling is to mute the competition for market outlets from various uses of milk. However, a pricing and pooling system that completely eliminates the incentive to place milk in its highest and best use, or which provides an incentive to manufacture milk into lower valued uses does not serve dairy producers, manufacturers, or consumers well. To accomplish neutrality, the pricing formulae must be established by consistently applying the same principles to both manufacturing complexes. The Dairy Institute proposal takes an even-handed approach to the two manufacturing Classes, utilizing western-based price and California-based make allowances. Consistent with that, the nonfat dry milk and butter make allowances should be increased from those contained in Dr. Schiek's testimony by an administrative and marketing allowance of 0.15 cents, resulting in revised proposed make allowance of \$0.1739 for butter and of \$0.2012 for nonfat dry milk.

#### Conclusion

If the Department promulgates an Order that is adopted through a producer referendum, the outcome of this hearing will have significant impacts throughout both the US and global dairy industries. The production within California of 20% of the US milk supply and significant volumes of dairy commodities that also serve the global market makes it a significant force across broad geographies.

If the Department promulgates an Order from this proceeding, it should adopt the Dairy Institute proposal (Proposal 2). This proposal will allow milk for manufacturing to move more freely to its higher and better use. That, in turn, will lead to reduced price volatility and provide a more stable

platform with which the industry can grow demand. It also sets prices at market-clearing levels that allow for orderly marketing. These are critical elements that will contribute to the broader industry's ability to drive demand to the benefit of producers, processors, and consumers.

**Attachment A: Standard of Identity Classifications for Mozzarella Cheese**

DESCRIPTION	MOISTURE	FDB (FAT DRY BASIS)	WET FAT	REFERENCE (Code of Federal Regulations)
Nonfat Mozzarella Cheese	N/A	N/A	< 1.67%	21 CFR 101.62 ...the food contains less than 0.5% of fat per reference amount (28g in the case of mozzarella cheese)
Lowfat Mozzarella Cheese	N/A	N/A	≤ 6%	21 CFR 101.62...contains 3g or less of fat per reference amount (50g in the case of Lowfat Mozzarella cheese)
Lite Mozzarella Cheese	N/A	N/A	≤ 10.20%	21 CFR 101.62 <u>The food's fat content is reduced by 50 percent or more per reference amount. The identity of the reference food and the percent (or fraction) that the fat was reduced are declared in the immediate proximity to the most prominent such claim, (e.g. "50 percent less fat than our regular mozzarella cheese").</u>
Reduced Fat Mozzarella Cheese	N/A	N/A	≤ 15.30%	21 CFR 101.62 ...contains at least 25% less fat per reference amount customarily consumed...
Low-Moisture Part Skim Mozzarella Cheese	> 45% ≤ 52% <del>(46-52)</del>	≥ 30% < 45% <del>(30-44)</del>	N/A	21 CFR 133.158
Part Skim Mozzarella Cheese	> 52% ≤ 60% <del>(53-60)</del>	≥ 30% < 45% <del>(30-44)</del>	N/A	21 CFR 133.157
Low-Moisture Mozzarella Cheese (Whole Milk)	> 45% ≤ 52% <del>(46-52)</del>	≥ 45%	N/A	21 CFR 133.156
Mozzarella Cheese	> 52% ≤ 60% <del>(53-60)</del>	≥ 45%	N/A	21 CFR <del>CFR 21</del> 133.155



## Dairy Farmers of America Announces Changes to American Cheese Division

### New Alliance with Schreiber Foods Formed August 8, 2007

Kansas City, Mo. - Dairy Farmers of America, Inc. (DFA) has announced changes to its American Cheese division, including the closure of the cooperative's Corona, Calif., facility and the transfer of DFA's American cheese (large-bag shredded and packaged) business in Corona and Zumbrota, Minn., to Wisconsin-based Schreiber Foods Inc.

More than 300 employees at DFA's Corona facility were notified that the facility will operate at a reduced capacity beginning Aug. 31 and cease production of American block cheese and whey products by Dec. 31. An additional 70 employees at the Zumbrota facility and 11 employees at DFA's headquarters in Kansas City, Mo., also were notified that their positions would be eliminated. A comprehensive effort is underway to ease the burden on workers and their families.

According to Tom Camerlo, chairman of DFA's Board of Directors and a dairy farmer from Florence, Colo., the decision to cease operations in Corona and to enter into an alliance with Schreiber Foods reflects DFA's ongoing commitment to reduce or eliminate economic vulnerabilities within its business structure.

"DFA exists to serve its dairy-farmer owners. Although it is difficult to make decisions that result in the elimination of jobs, we have an obligation to our members to make decisions that benefit them," he said. "Market conditions and operating results have hindered success at our Corona plant and in our American Cheese Division. We constantly look for ways to end losses, and stimulate profitability."

David Parrish, chief operating officer of DFA's Western Area Council, which supplies milk to the Corona facility, noted that the members support the changes in the American Cheese Division.

"Although dairy farmers never want to see the plant they ship milk to close its doors, our member-owners understand that we need to operate profitably," he said. "With many DFA customers providing multiple outlets for milk, our members will continue to have a market for their milk. This is the very nature of cooperative membership."

DFA and Schreiber officials offer the following comments about their new endeavor.

"DFA is fortunate to have the opportunity to align itself with a first-class company," Camerlo said. "We can trust that Schreiber will continue to produce top quality products for our customers."

"We're pleased that DFA has provided this opportunity to extend Schreiber's capabilities deeper into the shred sector of the cheese business," said Larry Ferguson, president and chief executive officer of Schreiber Foods.

Block cheese and whey production employees in Zumbrota and Monett, Mo., will not be affected as DFA plans to continue its commodity American cheese operations in these facilities. Additionally, these changes will have no impact on DFA's Borden branded or private label retail cheese business.

Attachment B