EXHIBIT

189

BEFORE THE UNITED STATES DEPARTMENT OF AGRICULTURE AGRICULTURAL MARKETING SERVICE

In the Matter of Milk in California; Notice of Hearing on a Proposal to Establish a Federal Milk Marketing Order	**7 CFR Part 1051** **Docket No.: AO-15-0071;** **AMS-DA-14-0095**

Fresno, California, November 17, 2015

Testimony of Pete Garbani

(Rebuttal)

In Support of Proposal 1 of California Dairies, Inc.,

Dairy Farmers of America, Inc., and Land O'Lakes, Inc.

Proposal to Establish a Federal Milk Marketing Order for the

State of California

Cooperatives' Exhibit 13

My name is Pete Garbani, Director Member Relations for Land O'Lakes, Inc. I have worked for Land O'Lakes in different capacities over the last 15 years. I began my career with Land O'Lakes within their accounting organization and have performed a variety of roles including strategy, milk sourcing and sales, ranch to plant transportation, regulatory and government affairs within California and general advocacy for our dairymen member/owners. I've served as a member of the California Department of Food and Agriculture (CDFA) Dairy Advisory Committee, a board member and Chairman of the Milk Producers Security Trust Fund, and a board member for the Dairy Council of California. Prior to joining Land O'Lakes in 2000, I spent nearly 11 years with the public accounting firm Deloitte & Touche, LLP, during which I obtained my CPA license. I have a Bachelor of Science degree, with an emphasis in accounting, from California State University Fresno.

I have attended many of the Federal Milk Marketing Order (FMMO) in California hearing sessions conducted thus far and have learned a great deal about FMMOs. This is my first experience with an FMMO hearing although I have participated in CDFA milk hearings in the past.

I'm here to testify in support of Proposal 1 offered by Land O'Lakes, Inc., Dairy Farmers of America, Inc., and California Dairies, Inc. My work as Director, Member Relations, with Land O'Lakes means that I am in daily contact with dairy producers in California. To know and understand their circumstances is my job. With that background, I have heard some testimony and seen several pieces of evidence provided in this hearing in opposition to Proposal 1 which I would like to discuss further from a producer's point of view. I will discuss three topics: first, the relationship between class prices and producer prices in California; second, the supply of milk in California and its expansion or contraction; and, third, cost of production and dairy farm numbers in California.

Class Prices and Over Order Premiums

At the top of page 8 of exhibit 98, Mr. DeJong points out that "...California's recent milk production slowdown is an expected response given the global over-supply of milk powder and lower California Class 4a price." Current lower producer prices may have contributed to the most recent milk production slow-down; however during the time period January 2008 – June 2015, California Class 4a minimum prices have contributed more to the California blend price than the California Class 4b price has, for the majority of the months. See **Exh. 13.A. Class Price & CA Blend Price Comparison, 2008 - 2015** (Source: Exh. 61 (CDFA-A; CDFA-C)) In essence, during the timeframe when the 4b discount has had its largest impact in California, the cheese processors have drawn money from the California pool, which has allowed them to pay their producers the Quota and Overbase values; at the same time they have retained the profits from their 4b discounted milk price to pay over order premiums to their producers.

During the period of January 2008 - June 2015, I estimated Hilmar's draw from the California pool to be $244.3 million. See **Exh. 13.B. Estimated Hilmar Pool Draw, 2008 – 2015.** The estimate was based on processing 12 million pounds of milk per day, 353 days per year, multiplied by the difference between the 4b price and the statewide blend, per the CDFA data indicated on Exhibit 61. While the cheese manufacturers in California would like to take credit for keeping the pay price to producers as high as possible, it is actually the butter/powder manufacturers who have contributed the bulk of the value that makes up the regulated price paid to all California's producers.

On exhibit 98, page 10, Mr. DeJong indicates Hilmar has paid $120 million in premiums over several years. Since he chose not to quantify the time represented by "several years", I estimated the value that Hilmar has gained from the difference between the California Class 4b and the FMMO Class III using 12 million lbs. per day of milk processed over a ninety-two month period from January 2008 to August 2015. See **Exh.13.C. Estimated Annual Hilmar Benefit based on CA Class 4b vs. FMMO III, 2008 – 2015.** This represents the discounted value Hilmar was able to pay for their milk vs. the FMMO Class III price from January 2008 through August 2015. The estimated value of the 4b discount is $467.2 million—just under one-half billion dollars.

Assuming Hilmar paid $120 million in premiums to supplier/producers, that left $347 million for Hilmar's return on investment over the eight plus years presented. Hilmar's ability to pay $120 million in premiums results directly from the regulated 4b price being too low. Continuing to give Hilmar Cheese Company and other cheese processors the ability to retain this 4b discount will only lead to more rapid consolidation and reductions in the supply of California milk.

<u>California Milk Supply Growth and Contraction</u>

During Mr. James DeJong's testimony on behalf of Hilmar Cheese Company, he showed us the growth of Hilmar's gross receipts, however he didn't show us how much of the growth came from their own contract producers and owners. As I understand, Hilmar used to contract annually for milk from cooperatives; but currently Hilmar purchases from cooperatives only on a spot basis. In fact, the extra milk needed for their soon-to-open powdered milk plant is coming from internal growth and producers they have garnered from the market which include former members of Land O'Lakes, Inc., Dairy Farmers of America, Inc. and California Dairies, Inc.

Dr. Bill Schiek provided a graph in Exhibit 80, Figure 3 page 7, beginning in 1970 through 2014 depicting the growth in California milk supply. Without more recent information from Hilmar representatives during the FMMO hearing, I turned to the following statement from David Ahlem, CEO, Hilmar Cheese, at the CDFA hearing held June 15, 2015, page 227:

> "Hilmar Cheese - our year over year milk supply of milk has increased. We are not having trouble sourcing milk or fulfilling commitments in the current environment. We have maintained our non-summer contract caps."

Mr. Ahlem went on to say,

> "Hilmar Cheese Company shipped nearly 400 loads out of state this spring because we were unable to find available processing capacity and willing buyers for milk in California."

During the questions from the CDFA hearing panel when asked about their new powder plant being built in Turlock, CA, Mr. Ahlem replied, page 240 & 241:

> "Well it certainly creates capacity so we have a growing supply. As we illustrated that our milk supply is up and we have been trying to grow it in preparation for this new asset coming on."

However he went on to answer the following question on page 243,

> "Mr. Shippelhoute: As you have started growing your milk supply has that contributed to the 400 loads that you mentioned that you had to ship out of state to find a home?
>
> Mr. Ahlem: Yes, I think this spring that did contribute to that some."

Based on Mr. Ahlem's testimony it appears that, while the Dairy Institute and its members would argue that any over-supply situation in California was due to the Cooperative (LOL, DFA & CDI) members growing their milk beyond processing capacity, leading to sales of distressed milk that finds its way into other states to compete with California finished goods, Hilmar in fact also contributed to the over-supply of milk in California and has shipped its excess milk to their plant in Texas to convert lower priced milk into cheese that competes with California cheese.

Clearly, the growth has been attributable to Hilmar as well, based on the following Testimony from Mr. John Jeter, CEO, Hilmar Cheese, during the 2007 CDFA hearing, pages 219 & 220:

> "You know, the old way we did it as we grew, and we've averaged almost 20 percent growth a year, although it slowed down dramatically recently, you know, we would let people ship what they wanted because we had markets for that milk."

As a result of this production growth, Hilmar by its own admission has instituted production limits with its milk suppliers. **Exhibits 13.D. Letter from Hilmar dated October 18, 2007** and **13.E. Letter from Hilmar dated August 21, 2009** are two letters distributed by Hilmar to their producer suppliers. The letter dated October 18, 2007, outlines the initiation of Hilmar's milk production limits to their producers, including penalties. In the letter dated August 21, 2009, Hilmar describes its need for additional milk above the then-contracted volumes, as long as the production is received prior to December 31, 2009. Hilmar then cautions its suppliers against making any major growth changes on their dairies that cannot be reversed in January 2010. This type of whipsaw growth opportunity has limited, if any, value to producers when it takes nearly 2 years to raise a calf into milk production and certainly could contribute to an over-supply situation, and to shipments of milk out of state.

I'd like to expand a bit on California milk production volumes using previously presented information in the hearing. The opponents of Proposal 1 have indicated California production growth has been significantly higher than other states in the U.S. as depicted in Exhibit 80, Figure 4, page 9. In the attached graphs, I've used the same information Dr. Schiek presented in Exhibit 80, Table 4, page 10 and Table 8, page 16, but have changed the index period to be 2008 instead of 1985 or 2003, respectively. I chose 2008 as an index period because 2008 is the year within Dr. Schiek's Exhibit 80, Figure 1, page 1, when the whey factor in the 4b formula was fixed by CDFA at $.25.

While **Exh. 13.F. Milk Production Index, Selected States and U.S. 2008 - 2014 (2008 = 100%)** has been entered into the record earlier in the hearing testimony, **Exh. 13.G. Dairy Farm Numbers by State as a Percent of 2008 Levels, 2008 - 2014** is new. Both Exhibit 13.F and Exhibit 13.G show a bit different picture of growth and dairy farm declines than Dr. Schiek suggested during his testimony, Exhibit 79, page 31, and Mr. Greg Dryer of Saputo also suggested on Exhibit 91 page 14. In their testimony, Dr. Schiek and Mr. Dryer both suggested that California growth has been larger than in all other states in the U.S., and the decreases in dairy farm numbers are not abnormal, and are a slower decline than in Idaho or Wisconsin. Their conclusions depend largely on the timeframe that the data represents and, more importantly, on the base year chosen. Using 2008 as the index for measurement of both growth in milk volumes and decline in dairy farm numbers, it is apparent 1) that California is not the leader in growth nor the state losing the least amount of dairy farms and 2) that market signals from the 4b price paid to producers in California have had an impact on both measurements.

In exhibit 98, page 8, towards the bottom of page, Mr. DeJong wrote, "In such instances, processing capacity can be needlessly shut down, resulting in loss of investment, lost jobs for plant workers, and lost avenues for dairymen to orderly and economically market their milk." But from a dairyman's perspective, if minimum milk prices are set too low, dairy farms will be needlessly shut down, (as we have heard from Mr. Fluegel, Mr. Medeiros, Ms. Medeiros, Ms. Lopes and other producers) resulting in loss of investment by dairymen, lost jobs for dairy and farm workers, and an opportunity for processors to enhance their profits. The Dairy Institute and its members suggest it is better to have lower minimum mandatory prices than minimum mandatory prices that are set too high. The assumption is that over order premiums will be offered to producers from manufacturers to supplement the minimum mandatory prices and that producers will ultimately receive a fair value for their milk. While the theory indicates manufacturers will "do the right thing" and pay additional premiums when warranted, there is no market mechanism to ensure it will happen.

Cost of Production (COP) and Producer Margins

Dairy Institute witnesses have used ERS and CDFA cost of production data to suggest farm net income is adequate, in spite of the basically unanimous testimony of the dairy farmers that things are not doing well on the farm in California. The Dairy Institute data should not over shadow the producer witnesses. First and foremost, use of ERS information to depict the COP in California and other states is minimally useful, whether trying to show total cost per hundredweight or relativity across selected states as depicted in Dr. Schiek's Exhibit 80, Figure 11, page 24 and the graphs within Mr. Greg Dryer's testimony, Exhibit 91, pages 10 & 11. **Exh. 13.H. 2014 Selected States Margin / cwt** illustrates the folly of relying on ERS COP information. It shows 2014 margin/cwt using Federal Order Mailbox Prices 2014 from www.fmma30.com/Homepage/FO30-MailboxPrices.html plus marketing costs, including a $.50/cwt estimate for hauling, less ERS COP from www.ers.usda.gov/datafiles/Milk_Cost_of_Production_Estimates/Milk_CostofProduction_Estimates2010_Base/Annual/MilkState2010%20base.xls. As several witnesses have testified, 2014 was one of the best years in recent history for dairy farm margins. Since the graph included on Exh. 13.H of my exhibits suggests excessive negative margins that year, it underlines the fact that ERS COP may not be a good source to use in assessing COP or resulting margins for producers.

Alternatively, review of CDFA COP feedback forms for Q4 2012, not adjusted for high components or organic operations, is captured on **Exh. 13.I CDFA's COP, Q4 - 2012** of my testimony. The variance between high and low COP is almost $30, from a high of $45.24 per hundredweight to a low of $15.39 per hundredweight. Correspondingly, the difference between the highest calculated margin of $11.89 per hundredweight and lowest calculated margin of minus $10.23 per hundredweight, shown on **Exh. 13.J CDFA's Net Margin Q4 - 2012** is in excess of $22 per hundredweight.

The reason for utilizing a different period than Dr. Schiek and including all dairies in the CDFA COP data is to underscore that indeed the COP and estimated margin in California have a wide range, especially depending on the period selected.

Fair and Equitable

The proponents of Proposal 1 are not trying to increase the milk price in California to cover the wide range of COP in the state. We are simply asking for prices available to other producers in FMMOs in the nation. This is in stark contrast to what the Dairy Institute supports in Proposal 2, which provides for additional shrink for extended shelf life products, a whey price that eases the burden within minimum milk prices for smaller cheese plants, freight costs to subsidize the spatial value of their finished goods, and processor-favorable changes to make allowances. In other words, the cooperatives recognize a FMMO isn't expected to cover all the costs related to producing milk for all California producers as they may or may not be efficient or may be covering their costs by marketing their milk in a manner that compensates them for their milk characteristics (components, organic, rBST free). At the same time, we do not believe it is appropriate for processors in the contemplated FMMO to deduct their inefficiencies, excess shrink, lack of whey processing investment, or (contradicting current USDA policy) spatial values for finished goods produced in California - from producers' minimum milk prices. We would point out that while producers' cost of production and margins are available within the COP data on the CDFA website, we have yet to see an income statement from any of the processors within California who claim they can't afford an increase in their milk cost that would result from adopting Proposal 1.

Summary

In summary I'd like to recap a few previously mentioned themes.

- Hilmar's milk is growing and in the past has added to the oversupply situation in California as well as to sales of milk to out of state processors, including themselves, creating a finished good product that competes for market share with California products.
- Hilmar and other cheese processors have financially benefited from the California pool over the last several years.
- Over order premiums can be paid by Hilmar due to the 4b discount.
- COP information available from ERS is misleading and it is difficult to get an accurate actual COP and margin value.
- As California producers have repeatedly testified, they want to be a part of the national milk marketplace with a milk price based on national product values.

Thank you for the opportunity to provide this rebuttal testimony.