

Thank you for the opportunity to testify before you today. My name is Jared Fernandes and I'm a 3<sup>rd</sup> generation dairyman operating just south of Tulare. My family partnership consists of myself and four brothers. Together we own and operate 3 dairy farms, with over 14,000 animals and collectively farm approximately 2,500 acres devoted primarily to forages for feeding our cows.

As a member owner of Land O'Lakes I support the proposal put forth by Land O'Lakes, Inc., Dairy Farmers of America and California Dairies Inc. to institute a Federal Milk Marketing Order (FMMO) in California (CA).

I'm here today to discuss the challenges the California 4b pricing has had on our operations both financially and with our hedging. First I'd like to look at the difference between CA Class 4b vs. FMMO Class III.

### **Analysis of 4b vs. Class III Pricing for California Dairy Producers**

As a California dairy producer who markets milk to handlers regulated under the California state milk order we are at a disadvantage in terms of managing price risk due to an inherent basis difference to the hedging instrument, the Class III milk futures contract through the Chicago Mercantile Exchange (CME).

As a general rule, producers outside of California who market their milk to handlers regulated under a federal milk marketing order (FMMO) have, as part of their value formula, Class III milk pricing. Recall that Class III milk within an FMMO refers to milk used to make cheese and whey products. The Class III pricing in FMMO's includes cheese and whey price factors and also represents the settlement value for the Class III milk futures contracts. For the Class III component of the FMMO pricing formula, the producer whose pricing is administered by an FMMO may directly hedge the Class III component of his overall price with the Class III futures contract on the CME. Thus, FMMO producers experience significantly less "basis" risk between his price and that of the hedging instrument.

By contrast, a dairyman in California, like myself, operating in the California state milk order that has a different formula for determining the price for milk used to make cheese and whey products. The California class 4b price includes different cheese and whey price factors than the FMMO Class III pricing formula. Since California uses its own pricing methods and price discovery series, a discrepancy or basis price difference is created between California 4b prices and FMMO Class III prices.

The difference between the two price series is almost always negative with California 4b pricing less than Class III pricing. More importantly for hedging and risk management purposes, the

basis is *highly volatile and unpredictable* month to month. For example, the annual average of this basis, calculated by subtracting the FMMO Class III price from the California Class 4b price, has ranged from a value of -\$1.24 in 2010 to a value of -\$2.41 in 2014. Within 2011, this basis ranged from -\$1.88 in November 2011, to -\$3.63 in December—a swing of -\$1.75 in just one month.

The table below illustrates the average annual basis values between the two series of announced prices and also offers the monthly minimum and maximum differences in each year.

<b>Year</b>	<b>Average</b>	<b>Maximum</b>	<b>Minimum</b>
2010	-\$1.24	-\$2.30	-\$0.37
2011	-\$2.00	-\$3.63	-\$0.08
2012	-\$1.91	-\$2.82	-\$0.98
2013	-\$1.57	-\$2.30	-\$0.67
2014	-\$2.41	-\$3.24	-\$0.84
2015	-\$1.49	-\$2.43	-\$0.53

As the table suggests, the swings in basis values throughout any given year are quite significant and at times are north of \$3/cwt. Given that there is no available or liquid financial hedging instrument that tracks either absolute California 4b pricing or the basis difference to Class III, the California producer has no legitimate vehicle to lay off this significant portion of his price risk. Instead, we typically hedge with Class III futures to the extent cheese and whey influence our pay price and hope for the best in terms of our forecast of basis risk versus what actually occurs. The transition from the California milk order to an FMMO system will add another tool for California dairy farmers to manage our milk price risk. Moving to a CA FMMO will:

1. Erase the current 4b basis risk attributable to announced class pricing
2. Place the California producer on a level playing field with the rest of the country in terms of available risk management tools
3. Allow California producers to receive substantially the same price as producers outside of CA operating in an FMMO
4. Raise CA producers' All Milk Price allowing for less margin risk within the Margin Protection Program

### **My Journey**

Given the volatility in the market place I realized our family's dairy operation needed to evaluate a risk management strategy. We started slowly in 2009, before the basis between CA Class 4b vs. FMMO Class III was considerable. I enrolled into a 2 year risk management class

and began understanding the tools available to producers to minimize the volatility in the marketplace. While I have learned a tremendous amount about the complicated world of risk hedging I have to say much of the time I've been frustrated with our ability to off-set the basis I described above. There have been many instances when I gave up opportunity because my settlement price was above the ceiling I had locked in, however my cash price was well below my ceiling. I have also had my floor protected but not realized. For example this past July 2015, I had purchased \$15.50 puts and sold \$20 calls on half my class 3 usages. This position cost our operation \$.31 cents paying \$.52 for the put and selling the top off for \$.21 cents. The July Class 3 settle price was \$16.33, well above my put. However the California 4b settle price was \$14.98, below my floor price. I have currently hired a risk management consultant to assist us with our hedging strategies. This consultant works with dairies throughout the USA, and has repeatedly indicated hedging would be more straightforward with reduced basis risk if California could adopt the same value as a FMMO for whey in the CA 4b formula price or have California institute a FMMO.

In addition to the factors I've described in my testimony and perhaps paramount to the longevity of my family's future dairy operations I looked at our milk production volume for the period of Jan 2010 through June 2015 and applied the average difference between the FMMO Class III price and the California Class 4b of \$1.80 per hundredweight. Realizing that the milk used in class 4b represented roughly 40% of the milk pooled in the California state milk order, the \$1.80 discount of the price of milk used to make cheese and whey products translates into a California overbase impact of \$.72 cents per hundredweight. To summarize, this \$.72 cents per hundredweight discount resulted in a cumulative difference of 6.6 million fewer dollars for our milk production than what my FMMO counterparts would have received for milk used to make the same products with similar production.

For the reasons I've outlined in my testimony, I strongly urge the USDA to accept and implement the proposal put forth by Land O'Lakes, Inc., Dairy Farmers of America and California Dairies Inc. to institute a Federal Milk Marketing Order in California, in its entirety.