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VIA FEDERAL EXPRESS
AND FACSIMILE (202.690.0552)

Mr. John R. Mengel, Chief Economist
USDA/AMS/Dairy Programs
Office of the Chief Economist
STOP 0229 - Room 2753
1400 Independence Avenue, S.W.
Washington, D.C. 20250-0229

RE: Comments Submitted on Behalf of DairyAmerica, Inc. Regarding Dairy Product Mandatory Reporting
Docket No. AMS-07-0047, DA-06-07
Federal Register July 3, 2007, Volume 72, Page 36341

Dear Mr. Mengel:

Enclosed for filing please find an original and three copies of DairyAmerica's comments regarding dairy product mandatory reporting in the above-reference matter.

If you have any questions, please feel free to call me.

Very truly yours,

Charles M. English, Jr.

Charles M. English, Jr.

cc: Ken Clayton (via e-mail)
Dana Coale (via e-mail)
Keith Collins (via e-mail)
Lloyd Day (via e-mail)
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Enclosures

DC #343377 v1

BEFORE THE AGRICULTURAL MARKETING SERVICE
UNITED STATES DEPARTMENT OF AGRICULTURE

DAIRY PRODUCT MANDATORY REPORTING Interim Final Rule and Opportunity for Submitting Comments	)	Doc. AMS-07-0047
	)	DA-06-07
Federal Register – Volume 72, Number 127 Pages 36341-36345	)	

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COMMENTS SUBMITTED ON BEHALF OF DAIRYAMERICA, INC.

I. SUMMARY OF POSITION

These comments are submitted on behalf of DairyAmerica, Inc. in response to the July 3, 2007 Federal Register publication by the Agricultural Marketing Service ("AMS"), an agency of the United States Department of Agriculture ("USDA"), of an Interim Final Rule regarding Dairy Product Mandatory Reporting regulations. The primary focus of these comments is on that portion of the Interim Rule that addresses the reporting of nonfat dry milk and in particular, but not exclusively, the issue of which sales of nonfat dry milk should be reportable and which sales should be excluded in reporting to USDA's National Agricultural Statistics Service ("NASS"). DairyAmerica respectfully disagrees with AMS' Interim Rule provision that limits the reporting to sales of nonfat dry milk where the price is fixed (and not adjusted) 30 days before the product is shipped and title transfers to the buyer. While such a provision may apply reliably to one or more other products without substantially lessening the number and volume of reported transactions, AMS, perhaps without fully recognizing the prevalence and use of long-term fixed price contracts in the international market for nonfat dry milk, has inadvertently eliminated a significant portion of market transactions.

This result does not accurately convey the supply and demand functions of the market for nonfat dry milk. This result introduces statistical bias and is not statistically valid. This result can and has already altered the long-standing international market for nonfat dry milk (at least as United States players attempt to compete) rather than reflecting market conditions. DairyAmerica understands, as described below, the goals and objectives of AMS' product price reporting and proposes a compromise between the present reporting rule and a rule that would (as is presently permitted in California) require instead the reporting of all transactions regardless of contract length and fixed price provisions. Even though buyers in the international market can and do demand contracts with nine month and even one year set price terms, DairyAmerica respectfully requests that the Department reject the 30-day rule and instead adopt a statistically sound reporting rule that recognizes international transactions. A contract length rule that fails to account for real world, economic contracts is inappropriate.

II. DAIRYAMERICA

DairyAmerica is a Capper-Volstead, federated, non-profit, marketing cooperative association organized for the purpose of marketing dry dairy products. It is wholly owned by: Agri-Mark, Inc., California Dairies, Inc., Land O'Lakes, Inc., Maryland & Virginia Milk Producers Association, O-AT-KA Milk Producers, Inc., United Dairymen of Arizona, Dairy Farmers of America, Lone Star Milk Producers, and St. Albans Cooperative Creamery, Inc. DairyAmerica was organized in 1995 by three California dairy cooperatives for the purpose of an orderly and specialized marketing of the dehydrated dairy products manufactured by its member organizations. It is the largest seller of these products in the world. DairyAmerica's members produce approximately 75% of the U.S. nonfat dry milk. AMS should note that nonfat dry milk ("NFDM") and skim milk powder ("SMP") are not interchangeable terms in the international market. SMP has an international, although not U.S., standard of identity that is different from

NFDM. Although some may imprecisely use the terms interchangeably, in the real world in which DairyAmerica operates, the manufacturers of true SMP are producing a product that is not reportable to NASS because it does not meet NASS specifications. Thus, these comments do not discuss SMP, but rather NFDM. DairyAmerica believes that two other manufacturers and marketers of NFDM in the U.S. account for much of the remaining NFDM market and the balance is produced by a number of smaller suppliers, both Cooperative owned and proprietary manufacturers.

DairyAmerica has reported to NASS under NASS' voluntary dairy product price program from October 1998 through July 2007, and since August 2, 2007 DairyAmerica reports to NASS under the now mandatory product price regime. DairyAmerica and its predecessor California cooperatives has also reported consistently to the California Department of Food and Agriculture ("CDFA") under its California Weighted Average Price ("CWAP") program since 1973. CWAP has from 1973 through the present required the reporting of all nonfat dry milk sales regardless of the contract length or fixed price provisions. While not dispositive, AMS should consider CDFA's long and successful history of using dairy product price reporting in its regulatory program. AMS' use of voluntary dairy product price reporting for setting its regulated minimum class prices for milk began January 1, 2000. Thus, California has a richer and longer history of both collecting and auditing the product price data and applying it in its regulated minimum pricing program. The fact that California has successfully utilized all contracts for product price reporting is indicative of the fact that AMS should seriously consider modifying its informal policy which is now more formally adopted through implementation of the Interim Rule. Neither the informal policy in existence prior to August 2, 2007 nor the Interim Rule provide any discussion of the workings of the international market for nonfat dry milk. Neither provides a rationale for a "30-day rule" applied to sales in the international arena.

III. INTERNATIONAL MARKET FOR NONFAT DRY MILK

DairyAmerica knows that the international and domestic markets for nonfat dry milk operate differently. Moreover, the market for nonfat dry milk does not necessarily operate like the market for cheese, butter and whey. The United States dairy industry can benefit from making sales in the international market because the additional demand for dairy products especially protein is substantial and growing. According to National Milk Producers Federation information supplied to DairyAmerica, during the first six months of 2007, U.S. dairy exports represented the following percentages of domestic production of milk components:

2.3 percent of all butterfat production;
9.3 percent of all protein production;
18.0 percent of all other milk solids (lactose and minerals) production;
15.0 percent of all nonfat milk solids (protein, lactose and minerals) production; and
11.2 percent of total milk solids production.

These are very significant "removals" of dairy supply and cannot be ignored. However, the United States industry cannot simply assert its presence and claim the market. Economic logic dictates that the industry must be competitive with existing and prospective market players. And competition is based upon price and ability to serve the market and to meet legitimate customer demand. Thus, one must first examine the market before one discusses how AMS rules regarding product price reporting should operate. These regulations should reflect market conditions and characteristics, not dictate them.

As a supplier of NFDM in the world market, DairyAmerica knows that international buyers prefer long-term contracts, usually from six to nine months, some even prefer a year.

This in turn leads U.S. sellers attempting to compete in this market also to sell using fixed price contracts because the large buyers have learned to prefer that. *Id.* Economic logic suggests that the United States is not going to be able to build or sustain its position in this market if it is only going to be in the spot market business. "An incumbent seller who faces a threat to entry into his or her market will sign long-term contracts that prevent the entry of some lower-cost producers even though they do not preclude entry completely." *Contracts as a Barrier to Entry*, Amann, Erwin and Dalia Marin. Center for Economic Policy Research Discussion Papers. April 1990. *See* Attachment A, p.4.

Fluctuating dairy product prices are another reason why long-term contracts have long been the staple of the international market. Again Fonterra has informed DairyAmerica that long-term fixed price contracts have been the norm for NFDM in the export market for time immemorial. Without a viable futures market for NFDM (notwithstanding comments to the contrary, there is simply no existing viable futures market for NFDM – any claim that DairyAmerica should go create such a market instead of selling product for longer than 30 days or in lieu of being able to report such product simply misses the point that no such market is presently viable especially to a marketer as large as DairyAmerica), the only real alternative to deal with variable commodity pricing is long term contracts. *Contracts as a Barrier to Entry, supra. See, also, World Agriculture, Toward 2010: An FAO Study,* FAO Corporate Document Repository. 1995 ("There has been the development in trading techniques that offer exporting countries new ways to counter the fluctuations in their commodity prices. These include long-term contracts with fixed prices, forward contracts, the use of options or hedge prices through commodity exchanges, over-the-counter markets and the use of swaps and commodity-linked bonds."). Given the lack of an international commodity or futures market, this breadth of

DairyAmerica knows this from its own first hand information and from the separately filed comments submitted by Fonterra (formerly New Zealand Milk Producers), another marketer of NFDM in international markets. Moreover, Matt McKnight (USDEC) recently explained to CDFA his understanding of the international market for NFDM. *See* CDFA Background on Exports and Contracts (Information gathered July 12 to July 26, 2007) attached as Attachment A (CDFA for its recent hearing on CWAP reporting, as is its usual and ordinary practice for such a proceeding, collected and provided industry with Workshop documents including both agency and market background information on this issue now before AMS – this CDFA information is presumptively balanced and unbiased). Mr. McKnight explained the nine month preference by buyers by referencing the lowest price producer (Oceania). Since that production is seasonal, buyers believe they can get a better price by signing up product at the beginning of the season and running nine months. Attachment A, p. 3.

USDEC further stated that without a Commodity Credit Corporation or European Union stock intervention (presently halted) providing a market stop-gap, Oceania producers of NFDM have to sell NFDM all the time to the commercial market which leads the seller to enter into long-term, fixed price contracts in order to assure suppliers of a ready market for NFDM. The spot market simply cannot support the volumes of NFDM sold in these markets because it is financially intractable for dairy processors who want or need to export product to hold inventory and wait for prices to rise to a threshold that will trigger sales. The cost to store and carry product would be crushing, and if the markets took a serious downturn while the company was holding inventory, the company could be wiped out. These sales must be accomplished on a continuing basis.

academic agreement and the reality of the NFDM international market, the legitimacy of long-term fixed price contracts for NFDM as a valid economic and business tool simply cannot be second-guessed. These regulations should reflect market conditions as they exist, not some hypothetical future widely available market that does not actually exist.

Finally, dairy industry players not engaged in NFDM export contracts simply may not be aware of the intricacies involved and these export transactions are simply not as easy as taking an order and filling it with existing product as is implied by a no more than 30 day fixed price contract rule. DairyAmerica incorporates by reference the comments of Fonterra including especially its analysis of international dairy trading and how it works. DairyAmerica is in the business of selling nonfat dry milk every day. That means that DairyAmerica can readily and accurately comment on how that market operates in both the domestic and international arenas. Some in industry without actual NFDM sales experience appear to believe erroneously that nonfat dry milk can and should be sold in contracts that are under 30 days for price term regardless of being export or domestic.

Summarizing the Fonterra comments, the international dairy commodity market works very differently from the U.S. domestic market which drives off an exchange and weekly price announcements. Nonfat dry milk sales in export market are also different from other dairy commodities. Customers outside the United States are accustomed (after many decades) to working constructively within standard contractual arrangements with three to six month delivery timeframes that are long established with a core group of suppliers. Deviations from those established patterns would act as a disincentive to contract with U.S. exporters/suppliers who cannot accommodate established contractual delivery timeframes. This puts the seller at great risk with respect to export contracts and may well lead the seller to choose to avoid exports entirely if the seller is unable to force the world market to match AMS' regulatory reporting requirement. But the real question is why create this impediment to international trade?

IV. REAL WORLD IMPACTS OF NASS REPORTING RULES

As will be discussed more fully below, if U.S. dairy exporters cannot manage the risk associated with export contract conditions due to the statistical requirements of NASS reporting this will ultimately drive reliance on the Commodity Credit Corporation ("CCC") at a time when that safety net is no longer required or necessary. It would be unfortunate to say the least for the U.S. dairy industry and the U.S. taxpayer if statistical reporting dictates drove U.S. dairy manufacturers back to the CCC rather than managing a degree of risk and exposure for all U.S. dairy industry participants in the international market. Permitting reporting of export contracts with a term significantly longer than 30 days from contract date through final shipment date would support growth of U.S. dairy commodity exports. Anything less then the real world of export contracts would be an impediment to growth which seems to contradict U.S. Administration export policy and Congressional policy supporting the Dairy Export Incentive Program ("DEIP"). These markets should encourage market reliance, not the reverse.

The overall size of the export market for NFDM is difficult to measure precisely. However, AMS is in possession of information that suggests that the portion of the NFDM market represented by long-term fixed price contracts was in 2006 and early 2007 rather substantial. Earlier this year, DairyAmerica initiated discussions with NASS regarding export contracts that led to re reported published data for the weeks of March 17, 24 and 31 (April 7 was re-reported before NASS published that week's data and so the public record does not contain both original and re-reported data). The public data indicates that exclusions for exports reduced reported volumes by more than 35% for those three weeks. See NASS Dairy Product Prices, April 13, 2007. DairyAmerica concedes that the 35% figure is quite clearly on the high side relative to overall contracts so an examination of a larger timeframe is useful. NASS later requested all NFDM manufacturing plants to review a 52-week period for potential revisions to NASS reporting with a particular examination of those portions of completed sales that contained a fixed (not adjustable) price that was set more than 30 days before shipment and title transferred. NASS published that revised data on June 28. Attachment B is a summary of the change and original data submitted through March 10, 2007 (the remaining weeks are excluded because some revisions for the weeks of March 17, 24, 31 and April 7 had already been submitted). The percentage of total NFDM sales excluded after that review (likely mostly subject to long-term contracts and sold more than 30 days after shipment and title transferred) is approximately 25 percent of all NFDM NASS reported sales for this period.

DairyAmerica submits that with the export market being this important, with long-term, fixed price contracts the long-standing norm established before DairyAmerica existed or sold product to the international market, and with this kind of percentage of NFDM sales subject to long-term contracts, exclusion of the prices paid for such contracts raises significant questions regarding the statistical validity of a price announcement that fails to take these sales into account. The proposed NASS sample that leaves out the critical supply and demand for milk represented by the export market raises the question of "unbiasedness" – that is does the sample of price data give an unbiased estimate of the true underlying price? Statistically speaking, unbiasedness is held in high regard, i.e., most researchers would agree that an unbiased estimator is far preferred to one that is biased. So, then, what USDA should really want is a consistent estimator of the underlying price for NFDM that is also unbiased. By excluding a manifestly significant subset of price data, the remaining sample will be prone to giving biased results, no matter what is done to assure the reliability of the estimate. It's really not any different than getting a 20% response rate to a survey, and assuming that the 80% that did **not** respond would have responded in the same manner as the 20% that did. If there is something among the 20% that led to their responding as they did (like location of the responder), one will have introduced bias into the sample and into the subsequent estimators produced from the sample data. No amount of manipulation can remove this bias once it is in the sample. Simply put, the results of the data collection procedure are only as good as the quality of the data that was collected.

It is for this very reason that AMS in announcing the Interim Rule asserted: "[t]he largest possible response to the survey by processors will provide more reliable dairy product prices for use in establishing minimum prices for Class III and Class IV milk under the Federal milk marketing order program." 72 Fed. Reg. 36341 (July 3, 2007). Excluding approximately 25% of the product from the survey hardly counts as the largest possible response resulting in unbiased, reliable prices. To the contrary, including validly adopted, economically supportable, historically consistent long-term fixed price contracts can only enhance the statistical validity and in announced prices by reducing (or eliminating) bias.

The 30-day rule contained first in the voluntary reporting guidelines and then adopted without detailed discussion in the Interim Rule is not required, or even suggested, by the enabling statute. 7 U.S.C. 1637(b) (2007). That statute provides only for "timely, accurate and reliable market information." DairyAmerica submits that a quarter of the NFDM sales should be included, not excluded, in order to enhance, not subtract from, reliable market information. Indeed, as discussed below in Part VI. C., a 30-day rule creates an incentive to create contracts that are reportable or not reportable based upon individual economic motivations. That is not the purpose of the mandatory reporting required by the Statute. Moreover, AMS in the Final Rule indicated that the replacement for the Basic Formula Price necessarily needed to be reflective of supply and demand conditions for all milk. 64 Fed. Reg. 16026, 16095, c.3 (April 2, 1999). Negating the supply and demand conditions of more than one quarter of NFDM sales hardly meets that AMS test. The international market for NFDM is a long-term, market reality. The buyers' (and other sellers') commitment to long-term, fixed price contracts is a reality that should be accounted for not ignored by AMS.

The ultimate question is what should the NASS price that underlies producer pricing be based on - what manufacturers actually sell manufactured dairy products for or the "spot" price. The spot price can be all over the place and not really represent at what price the majority of product is moving. Indeed the spot price may represent an extremely thin volume or merely offers for sale or purchase. The spot price can be either higher or lower than the prevailing price depending on how markets are moving. This is truly different for products that either move in international trade or do not have a quoted exchange price (like cheese and butter) off which products are sold. As discussed in greater detail below, if USDA uses the spot concept, it is going to have manufacturers either paying more or less for milk then they are getting for the products made from the milk. And yet, the Agency has repeatedly (and as recently as late last year) decided in formal rulemaking to clearly link prices received to prices paid. The present NASS reporting rules are at odds with that prevailing policy.

V. NASS REPORTING AND AMS MINIMUM PRICING

A. NASS reporting is linked to the cost of milk used to produce NFDM.

The issue of what contracts will be reportable to NASS is not academic. Prices reported to NASS are used by AMS to establish and announce minimum prices paid by handlers pursuant to 7 C.F.R. §§ 1000.50 and 1000.53. There is a direct relationship between the NASS prices reported and the prices announced by AMS for regulated minimum price purposes. While these prices also are directly tied to what dairy farmers receive, this discussion focuses on what handlers (in this case handlers owned by dairy farmers) must pay for milk. A manufacturer of NFDM will be required to account to the pool (in effect pay for the milk) on all pool milk for the announced regulated minimum Class IV price. With fixed make allowances and yield factors, the plant's margin is fixed so long as the plant receives for its product the same value as what is actually announced by NASS. With most NFDM facilities owned by dairy farmer owned cooperatives, this means that the dairy farmers owning that plant have as investors, per USDA formal rule, a fixed return on investment ("ROI") for NFDM produced from milk received as producer milk at that plant. 71 Fed. Reg. 67467, 67486 (November 22, 2006). As discussed more fully below, these farmer owned NFDM facilities provide a critical market clearing function in federal orders; this balancing function of NFDM necessarily assists the entire market, and AMS has repeatedly found that the costs of this critical function should be shared marketwide.

If a plant receives more for the NFDM than the announced NASS price, it will effectively increase its ROI for its dairy farmers on that plant; however, if a plant receives less than the NASS announced price, its ROI is reduced below that as fixed by USDA as recently as 2006 and its members carry the burden of that entire loss for the benefit of the entire market. As discussed below, excluding export contracts with a fixed price term of longer than 30 days, will result in elimination of a substantial percentage of NFDM sales or will alter the market for NFDM (as opposed to reflecting it) because dairy farmer owners of NFDM plants will need to minimize the risk of losses incurred in operating NFDM facilities. These results are inconsistent with AMS' past rulemaking and announced purposes for Class IV milk pricing. Thus, the 30-day fixed price contract rule should be modified to include real world export contracts reducing the bias otherwise introduced into NASS reporting.

B. Critical history of NFDM federal milk order pricing cannot be ignored.

Today's Class IV product classification for milk used to produce nonfat dry milk is a direct descendent of AMS' adoption of Class III-A pricing in the early 1990's. Prior to adoption of Class III-A, the competitive price series for all manufactured milk products was so heavily weighted toward cheese production in the Upper Midwest that NFDM processors urged AMS to adopt a separate manufactured milk class for NFDM. In most, but not all, months, manufacturers of NFDM required to account to the pool at the Class III price would suffer losses because they were unable to recover the value of the milk through sales of NFDM. In agreeing to adopt a separate Class III-A based upon product price returns, AMS recognized, accepted and argued (including in various federal courts in defense of Class III-A) that "the entire purpose of the [Class III-A] hearing and the need for the pricing change is based on the need to minimize the losses that occurred in processing NFDM." 58 Fed. Reg. 58112, 58117, c.3 (Oct. 29, 1993).

The predicate for Class III-A and today's Class IV pricing may be summarized as follows: (a) [T]he Minnesota-Wisconsin (M-W) price, which is an average of prices paid for manufacturing grade milk regardless of its use, does not represent the value of milk in any one particular use, such as NFDM; (b) the magnitude of the difference for NFDM warranted a separate class; (c) that NFDM was the product of last resort; and (d) that there was an inequitable sharing among dairy farmers of the burden of disposing of reserve milk supplies as a result of NFDM (product of last resort) production. *Id.* at 58114, c.2. AMS has never rejected these findings and in fact in adopting amended rules during Federal Order Reform continued the policy in renaming Class III-A, Class IV and in adding other products to the classified product definition (e.g. butter).

Most importantly, nonfat dry milk remains the product of last resort and the principle owners of NFDM plants remain dairy farmers who would but for Class IV inequitably share in the losses of these reserve supply facilities such that AMS should remain vigilant in its policy "to minimize the losses that occur[] in processing NFDM."

Taking the second point – inequitable sharing of losses – first, little if anything has changed with respect to NFDM plant ownership by dairy farmers since the 1993 Class III-A decision. AMS expressly rejected critics of a special Class III-A price and the adopted formula who argued that cooperatives operated such plants not to make profits but to guarantee a market for all of the association's members and thus assumed the responsibility of such **risks** (emphasis supplied) and losses:

> While these plants definitely perform a market-clearing function, they certainly are not operated by cooperatives to lose money for their members. Many of these plants handle milk associated with other markets and/or from dairy farmers who do not belong to the cooperatives operating the manufacturing plants. In so doing, they are providing a benefit for the entire marketing order system. It seems unduly harsh to penalize cooperatives performing this valuable marketing function by charging them under the order far more for the milk they process into NFDM than they can obtain from the sale of such product in the marketplace.

Id. at 58123, c. 1. AMS' analysis above is of paramount importance to the issue of reportability of NFDM products sold in the export market. AMS recognizes that cooperatives operating

NFDM facilities are providing a valuable marketing function that benefits all dairy farmers in the marketing order system. And AMS recognizes that it would be "unduly harsh" to penalize these cooperatives for performing this function. And yet, as discussed above, the real life business environment faced by these cooperatives when seeking to market NFDM for the benefit of all dairy farmers is an export market where long-term fixed price contracts are the norm. The impacts of not permitting reporting of these sales will be discussed below, but the process by which they are excluded appears to DairyAmerica to be wholly at odds with AMS support of Class III-A in 1993.

Nor can anyone seriously argue against the proposition that NFDM remains the product of last resort for federal order production. AMS regularly publishes valuable federal order market statistics that are instructive here. For 2006, the annual summary available on the internet includes both producer milk used to produce Class III and producer milk used to produce Class IV products. http://www.ams.usda.gov/dyfmos/mib/tbl_22_ann_2006.pdf; http://www.ams.usda.gov/dyfmos/mib/tbl_26_ann_2006.pdf. An examination of these two charts reveals (notwithstanding any voluntary election not to pool milk used to produce such products) that Class III monthly production while variable does not approach in any way the variability in production of Class IV products. The reason for this greater variability in Class IV is quite clear. NFDM plants, unlike cheese plants on a general and large scale, serve as balancing plants receiving variable amounts of reserve supply milk on a monthly, weekly or daily basis. AMS accepted in 1993 that this variability in milk receipts function increases the operating costs of the operation of such facilities and thus reduces the amount that these plants are able to pay for raw milk. 58 Fed. Reg. at 58116, c. 1-2.

AMS should similarly recognize that a significant element of sales from these plants (long-term fixed price export contracts) should be included in reportable transactions, otherwise exclusion of those contracts would increase the risks to those plants. That increased risk in 1993 was and is today still recognized in the form of the Class IV pricing AMS should not undercut its own reasoned decision resulting from formal rulemaking through this informal rulemaking process.

Moreover, as has been discussed in Federal Order rulemaking proceedings, since federal orders establish minimum (not average or maximum) regulated class prices, the risk (again as in the 1993 Class III-A hearing discussion of "risks" to plants providing market clearing functions) of regulatory error is far greater to these market clearing plants if the Agency adopts a pricing program that sets minimum prices too high (e.g. adopting too high a yield factor or too low a make allowance) as opposed to setting minimum prices too low (e.g. adopting too low a yield factor or too high a make allowance). *See e.g.* www.dairy.cornell.edu/CPDMP/Pages/Workshops/Syracuse00/Stephenson.ppt; AMS has made the following findings on this very issue:

> If make allowances are established at too low a level, manufacturers will fail to invest in plants and equipment, and reduced production capacity will result. [64 Fed. Reg. 16026] at 16097. "If processors are not provided enough of a manufacturing allowance to market the product they produce, or to earn any return on investment, they will not continue to provide processing capacity for producers' milk." 2002 Class III/IV decision, 67 Fed. Reg. 67906, 67916 (Nov. 7, 2002); See also, Nourse Report to the Secretary of Agriculture by the Federal Milk Order Study Committee (1962) at II-1-19 ("if surplus milk is priced too high, it may lead either to 'homeless' milk or place an undue burden on cooperatives to dispose of milk that handlers will not take.").

Excluding a quarter of the NFDM transactions not only reduces product price reliability, it also increases the risk to these very same cooperatives, providing a valuable market clearing function on behalf of all federal order participants, of losing money if they even continue to sell in the export market.

To see why this is so, one only has to reexamine the record of the Class III-A proceeding in the early 1990's. Class III-A pricing did not (and as Class IV does not) assure NFDM plants that they will pay less than Class III, only that the charge for the milk will reflect the marketplace for NFDM. But excluding a quarter of the transactions from reporting creates the very real world risk that entities engaged in those transactions will end up paying more for the milk than the sales can generate without their sales impacting that cost in any way. Isn't this precisely what Class III-A pricing was designed to alleviate? AMS concluded then that "the entire purpose of the [Class III-A] hearing and the need for the pricing change is based on the need to minimize the losses that occurred in processing NFDM." 58 Fed. Reg. at 58117, c.3. DairyAmerica respectfully submits that excluding long-term contracts in excess of 30 days simply reopens the risks that AMS said it would address in adopting Class III-A in the first instance.

C. <u>Impacts of NASS reporting NFDM facilities' costs crucial.</u>

The alternative for these facilities is of course to stop selling to the international market. In a very real way, this would be no different than had AMS in 1993 not adopted Class III-A and the cooperatives alternative then would have been to stop serving market clearing functions of NFDM plants. Of course in lieu of selling to non-reportable export markets, NFDM plants could simply produce for the CCC. While the prices would be lower, the non-preferable option is there. DairyAmerica submits that creating a preferred alternative of selling to the CCC runs counter to this Administration's policy supporting exports and also counter to the overall philosophy of Class III-A and Class IV.

With the adoption of Class IV and the ongoing reassessment by AMS in 2006 and 2007 of proper formulas for Class III and IV, all market participants benefit from operation of NFDM plants as plants of last resort serving to clear reserve supplies of milk. That is why AMS adopted Class IV during Federal Order Reform -- to have all market participants share in the cost of operating those reserve supply operations. But today, the critics of DairyAmerica's position, most, if not all of whom do not own and operate NFDM facilities and do not engage in this international market, want DairyAmerica to shoulder the burden and risk of selling to a market that demands long-term contracts but will not compensate DairyAmerica for any risk of doing so. Just as in the early 1990's when the issue of Class III-A was fought over long and hard, industry cannot and should not expect owners of NFDM plants to shoulder the risk of market price changes when all federal order producers benefit from both the availability of nonfat dry milk plants and export market sales. DairyAmerica for itself has concluded that any theoretical benefit of being able to sell NFDM in long-term fixed price contracts priced higher than market is more than offset by the real world risk of such a contract entered into if the reporting market rises. This is because of circularity of pricing inherent in the federal order system requiring DairyAmerica member plants to pay for the milk under such circumstances at a price that they will not be obtaining from the real world, reliable market.

For illustration purposes only, assume the following facts for a month (note that in this example to respond to critics, the export price for some of the product is at and some below the domestic market – as is now known from NASS 52-week review, that is simply not the case all the time as export contracts can and do lead the domestic market). There are two plants, each shipping and transferring title to 10,000,000 pounds of NFDM. Plant A sells all the product in the domestic market at $2.00 per pound. Plant B sells half its product in the international market at $1.90 per pound in a contract entered into 45 days ago. The other half of the product is sold at $2.00 and is otherwise reportable. With reporting all the NFDM under a rule that permits something longer than 30-fixed price contracts, the average weighted NFDM price would be $1.9750 (Example 1). If the 45-day international sale is excluded, the reported average is simply $2.00 (Example 2).

In Example 1, the nonfat solids price calculated pursuant to 7 C.F.R. § 1000.50(m) (2007) is $1.7998. In Example 2, the nonfat solids price is $1.8246. In example 1, plant A, unrelated to Plant B, would account to its pool based upon the $1.7998 number even though its cost structure is based upon the $1.8246 number from example 2 since it sold all its product at that $2.00 price. In a sense, its producer-farmer owners "benefit" from Plant B's sales in the international market. In example 1, plant B would account to the pool based upon the $1.7998, but its own internal plant structure with 50% of the product sold each at $1.90 and $2.00 is actually $1.95 which by itself would have resulted in a nonfat solids price of $1.7751 ($0.0247 less than the weighted average for both plants). Even in example 1, plant B is incurring a greater cost for the milk used to produce NFDM then the federal order applicable price for that milk. Thus, when critics charge that including long-term, fixed price contracts benefits such reporting NFDM manufacturers at no cost to themselves, they are very simply wrong. The incentive to both price it right and price it best are clearly there. In example 2, plant A accounts to the pool based upon a cost structure equal to the federal order value. But in example 2, plant B now accounts to the pool at the $1.8246 cost even though its federal order value is only $1.7751 ($0.0495 less). Plant B now incurs one percent of the risk that its prices are below the price resulting from the 30-day rule and loses an additional $0.0247 per pound of NFDM.

Two things are clear from this example. First, the incentive to sell in the export market even under a rule permitting reporting some longer-term sales, is muted by the cost imposed on a plant whenever its sales price is below the NASS average. Second, Plant B under a 30-day rule either must forego real world exports leading to additional domestic market sales and related price effects or must, contrary to AMS policy, account to the pool at prices in excess of what it can and does recover from the entire market. The present reporting rule and AMS policy regarding minimum prices designed to clear the market at prices that maintain productive capacity cannot be reconciled.

This point cannot be overstated: if NFDM manufacturers are not permitted to effectively engage in long-term fixed price contracts and thus provide a price hedge not available since there is no effective futures market for NFDM, then NFDM manufacturers should not be expected to carry inventories when prices are high and thus shoulder the risk of inventory write-downs; however, all dairy farmers should know that if NFDM manufacturers don't carry inventories under such circumstances then prices will likely go down. The solution of selling on a long-term basis to the export market that wants, desires and historically depends on the long-term contracts is far superior to the economic disincentives that will most clearly result if a 30-day rule is maintained. Unfortunately, the Interim Rule has already created such significant business risk for U.S. companies to enter into long-term contracts. As a result some export opportunities have already been foregone. And one expects this to continue, especially if USDA and/or California (CDFA is already facing pressure and will surely receive more pressure over time to mimic NASS reporting rules) gives short shrift to the realities of the export market.

For instance, since April, and now more certainly with adoption of mandatory reporting effective August 2, 2007, DairyAmerica has had to reexamine and rethink its approach to the export market. For those who maintain, that NFDM manufacturers can still enter long-term fixed price contracts and hedge any financial risk, DairyAmerica must answer, without breaching any business confidentiality, that it has sought out and reviewed hedging, and has concluded as a business and legal matter, that hedging of these contracts in NFDM is simply not available at this time. Moreover, DairyAmerica does not foresee any change in this situation. The existing market is far too thin to support hedging of these transactions; moreover, hedging requires liquid markets and by definition long-term fixed price contracts reduce, not increase, liquidity. Finally, large industry players face unique legal risks and industry complaints if they participate in these markets. Again, it is inconsistent with AMS precedent to expect NFDM manufacturers to increase their risks in order to benefit the entire dairy farmer community. Finally, it is insufficient for AMS to simply tell NFDM manufacturers "you must hedge" (on non-existent market) "because we are not going to include these contracts in NASS reporting."

There is a fundamental question that AMS needs to answer. DairyAmerica understands that AMS through product price formulas intends to reflect the existing market price, not affect them. The distinction is critical. For instance in Federal Order Reform process in the late 1990's, USDA rejected proposals to use Grade A milk (as opposed to shrinking supplies of Grade B milk that were wholly unregulated) for establishing a competitive price series precisely because AMS was properly concerned about the circularity problem that it saw as being inherent in such attempts. Simply put, if prices paid for Grade A milk were used to develop a competitive price series, regulation of prices paid for Grade A milk would necessarily impact the competitive price paid for Grade A milk. This circularity of pricing problem was unacceptable to AMS. AMS thus concluded that it could not, at that time, use such a price series to establish a statistically valid, non-regulation affected competitive pay price. Unfortunately, in adopting the existing product price formulas, there is a new circularity problem discussed at length in subsequent formal rulemaking proceedings in 2000, 2006 and 2007. *See* http://www.ams.usda.gov/dairy/hearings.htm (National Hearings). NFDM facilities subject to federal orders must account to the pool on producer milk based upon the price they receive for the NFDM. But NFDM plants attempting to supply the international market – providing both market clearing functions and opening the door to a valuable market on behalf of all federal order dairy farmers who benefit from enhanced prices resulting from sales to this commercial market – must bear the risk of unreportable long-term fixed price contracts, the obvious choice for these plants will be to cease entering into these contracts, and return solely to the domestic, DEIP and CCC markets that are reportable.

This means that AMS is no longer reflecting the market reality, but is in fact changing the market. And if AMS tells the markets how they must behave in order to have transactions that are reportable so that AMS can then establish a price, hasn't AMS (at the behest of those who demand that long-term fixed price contracts not be reportable) simply substituted a similar problem for the rejected circularity of Grade A competitive milk prices? A reexamination of the purposes of the present Class IV (adopted as Class III-A) should lead to the conclusion that this price risk should be accounted for by permitting product price reporting in order to eliminate the risk of loss due to pricing issues:

> The degree to which any losses associated with NFDM production are shared among producers is an equity issue that depends on the organizational structure of the producer milk supply. The argument is that if one organization incurs losses in manufacturing NFDM to clear the market of excess milk supplies, that organization bears the entire cost while other producers receive the benefits of the market clearing activity with none of the associated costs. If a Class III-A price is implemented to reflect the value of milk in NFDM, any loss on NFDM production would be reduced, while the lower blend price to producers would result in spreading

> the cost of the market clearing activity among all producers. The manner in which the costs and/or losses are shared is a function of the producer organizational structure that varies among the markets.
>
> The identified problem, however, is a pricing problem wherein milk is priced in excess of its value in a particular use. Over a period of time, handlers should not be required to pay a minimum price for milk that averages above the value that can be returned from the products made from such milk. In an individual-handler pool market, such an activity would result in the subsidization of producers from returns from other products or the unwillingness to accept and market reserve milk supplies. In a marketwide pool, such activity results in a disproportionate sharing of the costs among producers, the unwillingness to accept milk or attempts to pass the burden of marketing the surplus to others. None of these conditions is conducive to the maintenance of stable and orderly marketing conditions. The only manner to rectify the problem at hand is to deal with the pricing issue.

58 Fed. Reg. at 58116-58117. The only way to rectify the present reporting problem at hand is to recognize that this is a pricing issue and permit reporting of long-term, fixed price contracts.

D. Commercial export market is inherent to defining supply and demand for milk used to produce NFDM.

There is nothing about the commercial export market (long-term, fixed price contracts) that is any less indicative of supply and demand conditions for milk used to produce NFDM and more importantly all milk than domestic sales or sales to the CCC or through DEIP. Nothing in AMS' history of federal milk order rulemaking, including the Class III-A hearings and litigation, federal order reform, and other rulemakings suggests or intimates that the minimum price for Class IV should be based upon only a segment of the supply and demand equation; the contrary is true. Indeed, accounting for CCC and DEIP sales, as with all sales, is absolutely necessary in order to properly fulfill the mission of Class III-A and now Class IV minimum milk price formulas. AMS in the Interim Rule also solicited comments on reporting other transactions.

For the foregoing reasons, DEIP transactions should continue to be included as reportable. The U.S. Congress has made a policy decision to support exports with taxpayer dollars. It would be incongruous for AMS to conclude that notwithstanding this Congressional policy to support exports of dairy products that AMS will not permit the value of them to be reported as part of the NASS survey. The result of not allowing a DEIP transaction to be reportable, will in DairyAmerica's experience make such transactions riskier for the reporting manufacturer because that transaction will no longer factor into the NASS price series announced by AMS for that month. The risk for that manufacturer will be that engaging in such transactions will then require the manufacturer to account to the pool for more than the value of the product value from which the milk is derived. This will increase the risk that these manufacturers engaged in these transactions will suffer losses incurred as a result of the regulatory system.

Again, AMS would by denying reportability of DEIP transactions undermine (if not eliminate) the very purpose of adopting Class III-A, now Class IV price classification. That risk will translate into fewer DEIP (if any) transactions. Of course, the same Congressional policy supporting taxpayer funded support of dairy exports is instructive as to where AMS should come out on attempts to discourage non-taxpayer funded exports in the form of long-term, fixed price contracts. If Congress was willing to put taxpayer dollars on the table to support exports, it can hardly be said that free-market sales of NFDM without DEIP should be discouraged. The contrary is surely true.

CCC sales must also be reportable. Sales to the Commodity Credit Corporation are sales of last resort for the product of last resort. What sale could be more indicative of supply and demand conditions then when commercial demand has reached a point where Congressional policy says that the dairy farmer ultimate safety net should kick in? Moreover, non-reporting of sales to the CCC when market conditions drive the price to that level would greatly increase the possibility that minimum prices would fall below the government approved minimum price levels. To see why this is true, AMS should recall that even with price reporting for CCC product sales in early 2000, the announced price for Class III fell below support. *See* http://www.moomilk.com/archive/outlook_44.htm. If sales to CCC had been taken out of those reports, the resulting price would mathematically almost certainly have been less than it was. Moreover, selling to the CCC and not reporting is not the same as not making the sale at all. If the non-reporting discourages processors from selling into markets, including the CCC, there may be a different although equally bad outcome when market clearing functions fail entirely – resulting in the ultimate disorderly marketing conditions that federal orders are designed to avoid. 7 U.S.C. § 602 (2007).

Moreover, again, if a transaction is not reportable for the manufacturer that must account to the pool for that milk, the alternative would be to attempt to find a market (spot if feasible) that would purchase the product at a reportable level in order to make certain that a loss on the milk does not result from the circularity of product pricing. Most importantly, Congressional policy regarding support prices would most certainly be frustrated by excluding CCC transactions precisely because Congress intends through the Support Price program to put a floor on the price of milk. Prohibiting the reporting of these transactions would simply frustrate the purpose of having a price floor at all.

Having established that sales to CCC and DEIP ought to be reportable, AMS should once again recognize that those transactions can represent a significant element of legitimate reliable data regarding supply and demand conditions in the market. However, there is really no difference between a DEIP export transaction and a commercial long-term, fixed price contract also in the export market. Both will set the price well in advance of the shipment of the product. Both are sales to the same or similar buyers. Both are indicative of supply and demand conditions in the market. While DairyAmerica fully supports the inclusion of DEIP in NASS reporting, DEIP inclusion cannot be said to be any more current or more indicative of supply and demand transactions than a commercial transaction subject to a long-term contract with a fixed price term. Consistency demands that both transactions be reportable and reported. The same is true of CCC transactions (the price having been set in such transactions for many years and far longer than any export transaction for NFDM).

The testimony of California Dairies, Inc. (a DairyAmerica owner member) at the August 28 CDFA hearing on CWAP reporting is especially instructive and helpful. The entire testimony is attached as Attachment C. An excerpt that goes directly to the issue at hand is incorporated here:

> Export markets take time to develop and the competitive nature of these markets requires long term price commitments. For example, California's largest milk powder export market, Mexico, is mostly contracted through the Mexican government Agency, Liconsa. Liconsa contractually requires long term fixed price contracts for its own budgetary purposes. These fixed price contracts are currently at a minimum of six months in duration. Attached is a letter from DairyAmerica that presents in more detail these contracting requirements with Liconsa and other export customers.
>
> We believe that California regulations should not restrict California's ability to serve these important export markets, but rather should encourage development of these markets. Regulations excluding sales from the reported price would place tremendous price risk on the contracting manufacturer. Manufacturers would be more reluctant to commit to the export volumes that will be necessary to balance the growing milk production in California. This in turn would place more volumes

> on the domestic market and one could predict that this would have the effect of lowering domestic prices.

Attachment C, p. 3. The Liconsa contracting requirements letter referenced by California Dairies is attached as Attachment C, Schedule A.

Since DairyAmerica cannot presently (and sees no immediate future for) hedge and since DairyAmerica faces immediate price risk for engaging in long-term, fixed price contracts, the alternative should AMS fail to recognize economic reality and legitimate economic transactions, is for DairyAmerica to give up on a significant element of the export market and instead reintroduce product to the domestic market, DEIP and the CCC. DairyAmerica makes decisions based upon what is best for its entire membership and will not ultimately engage in contracts only reportable to CWAP and not to NASS because different reporting rules and results would give rise to different incentives to serve the domestic market (e.g. if CWAP pricing is less than NASS pricing on sustained basis, unintended incentive will arise to ship NFDM from California east within the U.S.). Moreover, it is unlikely that CWAP will retain indefinitely a policy so different from NASS. Indeed, as discussed below, NASS and CWAP should be properly aligned.

The operators of the NFDM operations cannot be both the destination of last resort and forced to shoulder all the price risk of entering into transactions beneficial to all industry participants. For all of the reasons recognized by AMS when it first adopted Class III-A and for these economic considerations, the domestic market can and will expect to have increased supply at the expense of what could be lucrative export markets. This is not a easy decision for DairyAmerica to make. Nor is it one that it makes lightly, but the economic reality under present regulatory conditions is that transactions that DairyAmerica has sought to enter into either are not entirely reportable (e.g. a medium term contract of four to six months with a price term varying with a floor and a ceiling – NASS informed DairyAmerica that shipments outside 30 days would not be reportable if either the floor or the ceiling was reached) or are not acceptable to customers who are still able to obtain long-term commitments elsewhere (e.g. long-term price varying contracts) or are not acceptable to DairyAmerica (e.g. low-ball contracts). Critics assume that the fixed price contracts (at 30 days or 90 days out) will be a lower price than what the prevailing spot price is. This is false as the NASS revisions to data in the early weeks of the 52-week review show. The irony is that U.S. dairy farmers generally are poised to reap the benefits of a developed export market at a time when U.S. currency exchange rates are favorable, and now critics of long-term, fixed price contracts want NFDM manufacturers to abandon that market precisely when market conditions are most favorable.

Recent export opportunities with potential long-term favorable price conditions have not been executed precisely because of the inherent risk created by NASS rules of non-reporting. DairyAmerica operates as a marketing agent on behalf of all of its members; it owes a duty to its members to maximize overall profit and not engage in transactions that might benefit one member at the expense of others or DairyAmerica as a whole. Thus, the members of DairyAmerica that are subject to Federal Order pricing rules cannot live with price risk associated with NASS reporting even if the transactions entered into are entered into in California and are presently reportable to CWAP. Critics who do not produce, sell and report NFDM products simply cannot second guess this economic risk. It is vital and it is real. Again a careful reading of the Class III-A decision reveals why this price risk is so important to DairyAmerica on behalf of all its members.

E. AMS should permit NASS reporting of medium-term, fixed price NFDM export contracts.

In conclusion as to this portion of the comments, to date AMS has adopted what appears to be a one size fits all category of reporting rules with respect to the inclusion or exclusion of long-term, fixed price contracts. Government supported transactions are reportable regardless, but commercial contracts in the domestic market and the international market for butter, cheese, whey and NFDM are treated as if there is no market differentiation. The reality is far from this one size fits all approach. AMS in reviewing the Interim Rule can and should consider how the markets for each product and in domestic and international arenas actually behave in ways that are independent of each other.

An investigation of these various markets, DairyAmerica genuinely knows, should reveal a true market difference between the international market for NFDM and all other dairy markets. If AMS concludes, as DairyAmerica submits it must, that the international market for NFDM behaves differently, then DairyAmerica submits that, consistent with the rationale for Class III-A and now Class IV, AMS should recognize an additional set of longer-term export contract transactions that can and should be reported to NASS.

VI. CWAP REPORTING

A. History of CWAP.

CDFA for the August 2007 hearing on CWAP procedures issued CDFA's background of CWAP reporting reproduced below in the text, but with citation to internet (page 5 of document) (http://www.cdfa.ca.gov/dairy/pdf/hearings/2007/Aug14HearingWorkshopMaterials.pdf):

> Since 1973, the California Department of Food and Agriculture (Department) has utilized sales reports to collect data from California processing plants producing nonfat dry milk NFDM).

> On both a weekly and monthly basis, the Department receives and audits sales of NFDM. Using the sales data from all reporting processing plants, the Department then computes a weighted average price of NFDM called the California Weighted Average Price (CWAP). The CWAP is one of the commodity prices that are used directly in the Class 1 and Class 4a pricing formulas.

Separately on the same website, CDFA also summarized the present reporting CWAP program in a Summary of Proposals):

> Currently, on both a weekly and monthly basis, the Department receives and audits survey information through sales reports of nonfat dry milk (NFDM) from California processing plants. Presently, the sales reports include all types of Extra Grade and Grade A NFDM sold to wholesale customers for human consumption, regardless of length of storage, container size or sales volume. The reported types of NFDM include low-, medium-, and high-heat, organic, and rBST free powders; however, the reports do exclude sales of other powdered milks, such as instant NFDM, whole milk powder, skim milk powder and skim milk power blends. In addition, all types of sales are included in the reports such as spot market sales, long-term and short-term contract sales consisting of fixed or indexed prices, and government sales to the Commodity Credit Corporation (CCC). There are some sales that are excluded from the reports, specifically inter-company sales to other plants that belong to the same organization or coop as the reporting plant.

B. <u>Importance of harmonizing the systems.</u>

DairyAmerica knows that CDFA's CWAP procedures are presently working well and should be maintained. DairyAmerica strongly supports reporting of NFDM export transactions recognizing the international market's demand for fixed price contracts. As a company with members operating both within California and within federal milk marketing orders, DairyAmerica recognizes that AMS cannot simply agree to operate its system based upon California. However, in this instance, the long history of successful CWAP reporting that includes long-term, fixed price contracts is both instructive and the right solution. In addition, important testimony at the CDFA hearing August 28 by William Van Dam on behalf of the

Alliance of Western Milk Producers (Attachment D) is critical to NASS reporting rules. In response to a question posed by the CDFA panel, Dr. Van Dam testified that CWAP reporting rules become contract terms. For NASS, this means that a 30-day reporting rule becomes a 30-day contract limitation. These regulations should not affect market conditions in this way.

AMS has recognized that it is difficult, if not impossible, to maintain artificial product price disparities between and among federal milk orders. Therefore, DairyAmerica encourages alignment of NASS and CWAP reporting rules. Similarly, when Class III-A was first adopted, it was adopted in only three federal milk marketing orders (New England (Order 1), Middle Atlantic (Order 4) and Pacific-Northwest (Order 124) initially. Much litigation surrounded the adoption of Class III-A brought by opponents of a separate product classification and also by those who believe that the separate classification should apply across all federal milk orders with NFDM production. After a federal court injunction, a reopened proceeding considered all issues, including the adoption of Class III-A in just the three marketing orders because manufacturers of NFDM in other markets argued that limited adoption created market disruption. AMS ultimately agreed:

> Additional testimony at the reopened hearing also suggested that the initial decision should have considered the extent to which the application of Class III-A pricing in any one market has a tendency to set a price for excess milk over a broader area than in just the order in which it is adopted. Witnesses representing the Order 2 market testified to the marketing problems that developed as a result of the adoption of Class III-A pricing in the adjacent Orders 1 and 4. According to the testimony, the lower price in the adjacent orders basically set the same value for surplus milk used in NFDM under Order 2 even though Order 2 handlers were required to account for such milk at the higher Class III price. This resulted in placing Order 2 handlers at a disadvantage relative to other order handlers in selling NFDM in a national market. In addition, it had the effect of inhibiting the processing of excess Order 2 milk in neighboring order manufacturing plants that serve as outlets for excess milk supplies originating from common procurement areas.

58 Fed. Reg. at 58116.

The same problems identified in that 1993 proceeding are writ large in 2007. NFDM markets are such that pricing in California affects federal orders and vice versa. DairyAmerica for its part cannot and will not make decisions that are adverse to members in one region over another. As such, given these market conditions and given the economic logic behind long-term, fixed price contracts for NFDM in the international market, DairyAmerica urges AMS to move towards the CDFA model and to accept reporting of transactions in the international market that recognize longer fixed price contracts.

C. NASS 30-day rule should be rejected.

With respect to the international market for NFDM, CWAP provides better insight for reporting of transactions. Another reason why this is so is the fact that a 30-day fixed price rule provides an unnecessary and undesirable mechanism for manufacturers of NFDM to create reportable or non-reportable transactions virtually at will and for the benefit of those engaging in the transactions. AMS, unintentionally we are certain, has created the ability for NFDM manufacturers, if they are willing to forecast a falling market for NFDM, to seek contracts with delivery in excess of 30 days with willing buyers in the international market at prices that will benefit NFDM manufacturers at the expense of all dairy farmers in federal (or if California changes its rules, then California) milk marketing orders. But when prices are low and potentially rising, NFDM manufacturers will have the opposite incentive to maintain, if possible, contracts with delivery at less than 30 days.

To understand the real world impact of the NASS rule tied together with Dr. Van Dam's testimony that the CDFA (NASS in this case) rule will become the contract rule, DairyAmerica prepared (initially at the request of CDFA at the August 28 hearing) a chart showing a sample of its contracts and volumes subject to that volume:

Table 1. Percent of Export Contract Volume by Length of Contract.					
	0 - 59 days	60 -89 days	90-119 days	120-149 days	150+ days
Percent	10.4%	11.6%	16.6%	18.2%	43.2%

Data are taken from a sample of the contracts that cover 362 million pounds or 60% of the export volume handled by DairyAmerica from January 2006 to July 2007. For those contracts that are ongoing, the length of the contract represents the expected time needed to fulfill the contract.

As Table 1 shows, a full 90 percent of the sampled contracts (60% of DairyAmerica's export volume) is found in contracts exceeding 60 days. Continuation of the 30-day rule will thus by necessity require the modification of more than 90 percent of the contract volume for all the reasons stated above. Approximately 78 percent of these sampled contracts exceed 90 days and 43.2 percent of these contracts are fulfilled in over 150 days. The 30-day rule is about to have a profound adverse effect on the U.S. dairy industry. And it is not reflecting the market conditions.

As discussed above, this incentive may cost the U.S. dairy industry the ability to compete in the international market. If it doesn't, NFDM manufacturers will effectively elect the mechanism (e.g. deliveries of either less or more than 30 days after the price is set) for reporting and thus pricing that provides economic benefit to the manufacturer. This practice would in effect look a lot like recent experiences in federal milk marketing orders in which handlers have elected to pool or not pool milk normally associated with a federal order because of economic incentives in rapidly rising and falling markets. California has dealt with this issue by requiring handlers to make pooling decisions on an annual basis, and the federal order system has responded to decrease the economic incentive to "depool" and increase the cost of such depooling. The reasons for the series of decisions to limit the incentive to depool are that depooling can create disorderly marketing. Similarly a fixed 30-day rule at least as to NFDM sold in exports creates an incentive to manage the risk of pooling manufactured milk that ought not to exist – by telling NFDM contracting parties that deliveries within 30 days will be reportable, but deliveries 31 days and beyond will not be reportable. DairyAmerica submits that a real world rule should be a sufficient length of time to inhibit such economic moves.

This point also addresses the concern of some dairy farmers who claim that federal order prices should have been higher sooner in late 2006 and early 2007 because the flip side of reporting these long-term contracts would be to maintain higher prices longer than can now occur with the mandatory 30-day rule in place. If and when the spot and short-term markets turn around to head in a downward direction, long or medium-term contracts with a fixed price term at or near the present spot rate will now do nothing to slow that eventual price drop. As California Dairies testified before CDFA on August 28: "a change [to CWAP] to exclude sales may have the exact reverse effect if sales prices decline." Those who oppose reporting medium-term, fixed price contracts should be careful what they ask for. If they get what they want from AMS (e.g. Final Rule with 30-day rule as now exists in mandatory reporting), they certainly should not be heard to complain in any forum about future downward price movements that could have been slowed or alleviated by permitting reporting of any advantageous contracts that DairyAmerica or others are nonetheless, in the face of economic incentives to eliminate fixed price contracts entirely, able and willing to obtain.

VII. MEETING THE OBJECTIONS

From industry and agency reactions, DairyAmerica is aware of some potential objections to the proposal of DairyAmerica contained in these comments. DairyAmerica has made no secret of its position and has sought and welcomes industry discussion. DairyAmerica respectfully suggests that non-NFDM manufacturers do not fully comprehend the special market faced by reporting NFDM sellers and trusts that discussions with USDEC and Fonterra and others engaged in the international market will alleviate some of those concerns. Nonetheless, in no particular order, DairyAmerica attempts below to answer the known objections.

A. The "non-current pricing" objection.

Some have suggested that federal order minimum prices must be "current" prices and by extension long-term, fixed price contracts do not provide "current" prices. DairyAmerica respectfully disagrees with both the factual and policy predicates. First, fixed price contracts where delivery occurs significantly after 30 days after the price is set is in economic reality a current price when one fully comprehends the workings of the international market. CDFA in its Background for the August 2007 hearing on CWAP included material regarding the various uncertainties and difficulties in completing transactions once an international border and another country's (or countries' if product must travel through another country or countries to its final destination) rules and regulations are introduced. *See* CDFA website, *supra*, pp. 1-2. Given the practical reality of these transactions, it is difficult to get the pricing more current. Moreover, as discussed above, a full quarter of the transactions in late 2006 and early 2007 for NFDM were subject to these kinds of agreements. Current data must also be statistically valid data, otherwise it is no more valid.

But more importantly, the legal framework for what AMS is attempting to establish is important – the setting of regulated minimum prices – is based upon legitimate supply and demand for all milk. The supply and demand functions for NFDM sold in export are largely dominated by transactions that by necessity occur outside the 30 day window and are thus not reportable under present rules. But as AMS succinctly stated during Federal Order reform, the issue of market values must reflect supply and demand. The word "current" as opposed to "market" was not used in that framework:

> This pricing plan will allow the market-clearing price level of each of these manufactured products to be achieved independent of other products. As a result, dairy farmers will be paid a price which is more representative of the level at which the market values their milk in its different uses.
>
> The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk **cannot be overstated**. The prices for milk used in these products must reflect supply and demand, and must not exceed a level that would require handlers to pay more for milk then needed to clear the market and make a profit.

64 Fed. Reg. at 16095, c.3 (emphasis supplied). Note that AMS recognized that each product price needs to be achieved independent of others. So should AMS consider the 30-day rule independent for each product category and even between the domestic and international markets. Note, too, that the phrase that is used is "market" price, not "current" price. Finally, note that the handler must NOT be required to pay more for the milk then needed to clear the market and make a profit. DairyAmerica asserts that depriving NFDM manufacturers of a valid tool both to clear the market and still make a profit by insisting on an inflexible 30-day rule for export contracts in the face of market reality directly and clearly contradicts AMS' decisions rendered after both formal and informal rulemaking with respect to the importance of maintaining profitability for NFDM facilities.

B. The "price-signal" or "transparency" objection.

Similarly some buyers may tell AMS that they prefer to limit contracts to less than 30-days because it gives them a benchmark of price predictability. But the purpose of Class III and Class IV prices is to reflect supply and demand, not to provide a benchmark price to secondary buyers. AMS has or can have a data collection for this purpose (e.g. Dairy Market News' valuable service of "mostly" prices), but instead NASS reporting is solely about setting appropriate regulated minimum prices a process that as discussed above is infused with policy and historical precedent regarding minimum price decisions that runs counter to the exclusion of the export market for NFDM. If transparency is important to some in the industry, AMS could seek other non-market disruptive ways to achieve that result through non-minimum price setting mechanisms.

C. The "buyer-broker" objection.

Some may object by claiming that NFDM manufacturers can and should and have in the past sold to the export market through market brokers. These persons, with a vested interest in retaining the brokerage value, may claim that NFDM manufacturers can and should sell to them with "current" monthly prices and they will in turn supply the export market. Of course, this "offer" if such is made, is made at the expense of the dairy farmers supplying both the raw milk and the production facilities to make the product. Indeed, NFDM manufacturers like DairyAmerica have worked hard to develop the export market and now, for all dairy farmers, was beginning to reap the benefit through higher milk prices resulting from serving the export market. If brokers in turn take that added value, dairy farmers will never see any of it. Limiting reporting to 30-day contracts does not help dairy farmers, only middlemen and secondary buyers.

D. The "why not hedge" objection.

This objection has been countered earlier in these comments, e.g., pp. 6-7, *supra*. International commodity markets do not exist and international players are not going to be "forced" to participate in the U.S. commodity markets if they have alternatives such as competitors of the U.S. dairy industry who are not hamstrung by regulatory rules that make long-term, fixed price contracts more difficult or even economically infeasible. The fact remains that any existing NFDM market is too thin for DairyAmerica to be able to trade effectively and risk free. AMS should not by regulatory rule impose requirements to use theoretical future "futures" market, when AMS has been provided ample evidence of how the international NFDM market actually functions today.

VIII. OTHER ISSUES

In addition to the issue of what transactions should be reported based upon the length of the contract and a fixed price term, DairyAmerica has the following comments:

A. Suggested inclusion of additional NFDM products to enhance CDFA alignment.

In order to achieve better alignment with CDFA's CWAP reporting, DairyAmerica also respectfully suggests including additional products in NASS reporting. This will further reduce statistical bias and should increase validity of data. Thus NASS should expand the specifications for nonfat dry milk prices to include nonfat dry milk manufactured using a high heat process as well as fortified product. The costs and pricing arrangements of nonfat dry milk manufactured using a high heat process as well as fortified NFDM closely resemble the costs and pricing arrangements of nonfat dry milk manufactured using a low or medium heat process. Moreover, DairyAmerica encourages every effort to align the nonfat dry milk product specifications with the nonfat dry milk specifications of the California Weighted Average Prices series for nonfat dry milk that currently includes high heat powder and fortified NFDM.

B. Definition of intra-company sales.

Intra-company sales are excluded as reportable transactions. The logic behind such a rule is that an intra-company sale may not be an arms length transaction and thus may not represent a "true" market price. So much is clear. The problem arises in how the rule is applied by NASS to a marketing agent such as DairyAmerica. DairyAmerica does not and indeed cannot favor one member over another or provide benefits to one member at the expense of DairyAmerica as a whole. This is an important distinction with respect to alleged intra-company sales. NASS has advised DairyAmerica to exclude from its reporting all sales of product from one member of DairyAmerica to that member's wholly owned subsidiary. In a normal corporate sense this rule may make sense. However, DairyAmerica's cooperative structure requires it to maximize its revenue for its members. Unlike a for-profit corporation with subsidiaries, there is no incentive (indeed the rule is the opposite) for DairyAmerica to sell product from a member of DairyAmerica to that member's subsidiary at anything other than an arm's length transaction price. DairyAmerica respectfully requests that AMS reconsider the implementation of the intra-company sale rule to account for transactions that actually are made at arm's length.

C. Need for common understanding of the rules.

DairyAmerica urges AMS to issue promptly a generally available list of questions and answers. It is important that everyone in industry have a common understanding of how the rules are applied so that different entities do not interpret the rules differently. At the August 28 CDFA hearing, a witness commented negatively on a proposal to exclude organic NFDM from the CWAP based upon that witness' understanding that organic NFDM was included in NASS reports. DairyAmerica has been told otherwise by NASS – to exclude organic NFDM from NASS reporting. This is one example supporting immediate issuance of public guidance on NASS reporting.

D. Expedite final agency action.

The issuance of the mandatory rules with the 30-day rule is adversely affecting the international market for U.S. sellers such as DairyAmerica. DairyAmerica urges AMS to reconsider promptly and revise the limitation to permit the export market to function fully for the benefit of the U.S. dairy industry. While DairyAmerica believes its position is correct, nonetheless, if the Agency, after due consideration, nonetheless and contradicting these comments disagrees, DairyAmerica still urges expedited action. Manufacturers of NFDM need certainty as to the rules. Even though the industry may not like the result, finality will provide guidance as to where DairyAmerica needs to go with respect to this issue.

IX. CONCLUSION

The precise problem that AMS faces is whether in the face of Congressional and administration policies supporting exports and the international trade market, will this agency adopt as permanent policy a reporting rule that fails simply to reflect the real economic market and instead dramatically affects the U.S. export marketing of NFDM adversely. DairyAmerica urges AMS promptly to permit additional fixed price contracts in the international market for NFDM to be reported under NASS.

Respectfully submitted,

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Background on Exports and Contracts[1]

As companies try to expand their customer base, they often pursue global markets. Indeed, selling overseas can be an advantageous activity, however, sales outside the country also involve many steps that lengthen the marketing process. This process can vary greatly depending on the product exported and the country of destination, as government requirements can differ.

First, for any given agricultural product, companies need to research, plan and make critical decisions as they face many competitors from around the world and they need to make sure they can be competitive. As outlined by the Foreign Agricultural Service (FAS) of the USDA, the following steps are the most common:

- Identify Available Resources
- Identify Target Markets
- Develop and Commit to an Export Plan
- Identify Market Entry Requirements
- Visit the Market
- Find Buyers for Your Product
- Identify Funding Programs

Companies in the dairy industry who want to export are no exception to this process. Once they have targeted a specific country and product, they can find the information about the precise requirements of the destination country on the U.S. Dairy Export Council (USDEC) website. Those will include:

- Tariff rate and quotas
- Health Certification & Inspection Requirements
    - License permits, sanitation certificates, pre-inspection requirements, animal health certificates
- Labeling & Product Standards
    - Composition (ingredients, fat content, etc), additive, microbial and packaging requirements
- Codex Alimentarius Standards
    - Internationally endorsed standards for milk and milk products used by WTO to resolve international trade dispute

Among dairy exports, milk powder is a product that is highly traded around the world. The biggest markets for U.S. powder are Mexico, Indonesia and the Philippines. The following table shows a summary of the most important U.S. export markets.

Top 10 U.S. export markets, Skim milk powder (MT)

Country	2002	2003	2004	2005	2006
Mexico	49,500	57,427	90,178	106,166	65,873
Indonesia	3,515	7,040	19,023	23,430	36,265
Philippines	3,725	13,825	22,803	22,522	33,332
Malaysia	3,665	640	11,456	14,179	19,034
Vietnam	801	780	10,383	16,591	16,014
Egypt	107	0	3,474	3,393	15,409
China	2,240	1,688	5,222	4,979	13,960
Algeria	0	559	2,768	9,460	13,042
Singapore	1,195	603	4,757	5,495	6,977
EC 15	521	566	9,231	1,594	6,435

Source: USDEC export trade data, 2007

[1] Information gathered from July 12 to July 26, 2007.

To give a more specific example of the requirements for companies exporting products, the case of exports to Mexico, the biggest U.S. market for skim milk powder, is observed. Below is a (non-exhaustive) list of what is required.

- Register in the Importers Rosters at the Tax Administration Service
- Fill out a "Pedimento de importacion." This document indicates the customs procedure under which the merchandise will be imported and must be accompanied by:
  - Commercial invoice. The invoice should be in Spanish. If it is not, a translation must be attached. The invoice should include the shippers and sellers addresses, along with the delivery and buyers addresses, the description of the goods and numbering and marking.
  - Packaging list (when more than one package). Includes weights and volumes of each package.
  - Bill of Lading or Airway Bill of Lading, endorsed by the transport company. This states the quantity, marking, volume and description of the goods.
  - Documents required in order to comply with specific regulations (e.g sanitary requirements, product composition regulations, etc), applicable to that particular product.
  - Certificate of Origin
  - Import permits (required for agricultural products vital to Mexico's economy)
  - If applicable, the document demonstrating guarantee of payment of additional amounts that may arise if the declared value is less than the estimated price established by the Mexican government for merchandise which has been undervalued.
- Meet product labeling requirements
- For 2007, Tariff Rate Quota (TRQ) = 58,742 (MT) ; Over quote tariff = 11.8%.

The above information can be found on the Secretaria de Economia at *http://www.nafta-mexico.org/ls23al.php?s=200&p=3&l=2* . Tariff information is from FAS, *Mexico; Dairy and Products*, Gain Report 2005.

As mentioned above, requirements can vary depending on the country of destination and the product. However, some broad conclusions[2] can be made about dairy exports. Regarding the time frames and required certifications:

- The average time to process exports would be from two weeks to one month.
- Any time a country asks for a specific certification, it adds time to the process.
- All required documents need to be ready when the products are loaded. If they are not, the products will have to wait and the shipper faces losses.
- In order to stay competitive, U.S. dairy exporters need competitive prices and quality. But they also should honor their agreements with the importers, hence the need to have all the required documents ready when it is time to ship.

The above information is valid for commodity as well as higher value products (i.e organic, rBST-free, high heat, etc.). Unfortunately, export data does not disaggregate the two categories so numbers are not available separately. However, some differences can still be observed:

- To market a product for its higher value, companies need to be able to prove the high value of the product. This process usually adds time to the certification as more documentation is required. This needs to be done efficiently in order to stay competitive.

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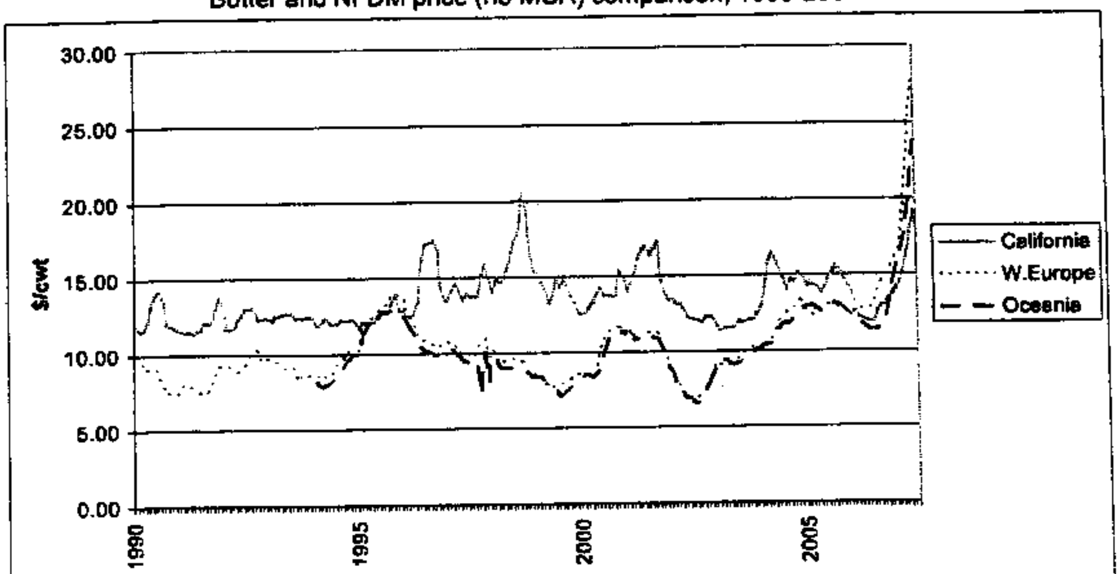
[2] Information from Matt McKnight, Vice President of Export Ingredients, Marketing and Industry Affairs, USDEC.

- Some countries will not accept certain products (i.e. rBST) so that is another reason why the high value products and commodities are not separated in export data.

Finally, exports can be a great opportunity for dairy companies as long as they stay competitive. The following figure shows how California prices compare with Western Europe and Oceania, 1990 to the present.

Butter and NFDM price (no MCA) comparison, 1990-2007



Sources: NASS, CME, International Dairy Market News, 1990-2007.

Another dimension of interest in dairy sales is contracts. More specifically, when it comes to exports, is it usually long-term contracts? And if so, are they useful? As Matt McKnight (USDEC) explains, the data regarding the length of the contracts is not available. The only way to find out some average would be to gather the information from every supplier individually. However, some trends can be observed:

- Buyers prefer long-term contracts, usually from 6-9 months. Some even prefer a year.
- The lower price producer is the Oceania region and they are seasonal. Buyers can believe they will get a better price at the beginning of the season so the typical contracts are 9 months to assure a constant price.
- The U.S. has the Commodity Credit Corporation (CCC); the European Union has stock intervention (stopped at the moment), but Oceania has no program, so they have to sell, leading them to do fixed price contracts. The U.S. also does fixed price contracts because large buyers prefer that.

Contracts have also drawn researchers' attention. Below is a list of sample publications related to the topic, including a short summary of the authors' findings.

- *Introduction to cheese and nonfat dry milk futures*. Cropp, Robert and Mark Stephenson. Dairy Market and Policy, Issues and Options. February, 1995.
  - Futures contract → commitment to either accept or make delivery of a specified quantity and quality of a commodity at a specified time.
  - Futures markets exist to provide a means for shifting the risk of price change on the cash market.

- Main characteristic of a commodity successfully traded on the futures market is one characterized by variable market prices.

- *Long Term Contracts in International Trade*. Amann, Erwin and Dalia Marin. Center for Economic Policy Research Discussion papers. April 1990.
  - Countertrade agreement → exporter agrees to buy in the future from the importer, commodities proportional to his original sale.
  - Allows the forward selling of commodities where no organized futures market exists.
- *Contracts as a Barrier to Entry*. Aghion, Philippe and Patrick Bolton. American Economic Review. June 1987.
  - "An incumbent seller who faces a threat to entry into his or her market will sign long-term contracts that prevent the entry of some lower-cost producers even though they do not preclude entry completely."
- *World Market Prices*. From: *World Agriculture, Toward 2010: An FAO Study*. FAO Corporate Document Repository. 1995.
  - "There has been the development in trading techniques that offer exporting countries new ways to counter the fluctuations in their commodity prices. These include long-term contracts with fixed prices, forward contracts, the use of options or hedge prices through commodity exchanges, over-the-counter markets and the use of swaps and commodity-linked bonds. As noted before, however, despite the usefulness of these various instruments to lessen the risk deriving from price fluctuations, they are unlikely to address the more fundamental factors underlying the long-term decline of prices of some agricultural commodities."
- *Forecasting Class III and Class IV Milk Prices*. Jesse, Ed and Jacob Schuelke. U.W-M Staff paper no.453. September 2002.
  - "Soft manufactured dairy products and Mozzarella cheese are more likely to be manufactured under contract than cheddar cheese, butter, or nonfat dry milk. In general, Class III dairy products (hard cheeses) and Class IV products (butter and nonfat dry milk) have the lowest call on the milk supply – that is, these storable products tend to buffer milk supply and demand. More of these products are produced when milk supplies are large relative to demand and less when supplies are relatively short. Consequently, seasonal variation in production is relatively large."

Additional resources on exports and milk powder

→ Dairy Management Inc.
- NFDM Compositions and Varieties
- www.innovatewithdairy.com

→ USDEC
- Industry overview, US standards, Powder categories and their definitions
- www.usdec.org

→ *Testimony on Cost of Processing in Cheese, Whey, Butter and Nonfat Dry Milk Plants*. Mark Stephenson, July 9, 2007.
- Breakdown of Nonfat Dry Milk processing costs in the U.S. (outside of California).

→ Dairy Export Incentive Program (DEIP)
- "USDA pays cash to exporters as bonuses, allowing them to sell certain U.S. dairy products at prices lower than the exporter's costs of acquiring them. The major objective of the program is to develop export markets for dairy products where U.S. products are not competitive because of the presence of subsidized products from other countries."

- DEIP allocations of 68,201 metric tons of nonfat dry milk, 21,097 tons of butterfat and 3,030 tons of various cheeses may be made available through Invitations for Offers. These allocations correspond to the total World Trade Organization (WTO) limits for this year's DEIP.
- Latest NFDM allocation: Nonfat Dry Milk : – Invitation No. GSM-511A-55 (effective August 15, 2003) – Amendment 1 Invitation No. GSM 511A-55 (effective January 5, 2004).
- http://www.fas.usda.gov/excredits/deip/deip-new.asp

→ Cooperatives working together (CWT)
- CWT accepts bids from member organizations to export various cheese and butter products, and awards export bonuses based on the lowest bid prices. Whole milk powder is also eligible.
- Sales of eligible products may be in retail-type packaging; however, the amount of assistance CWT provides will be based on product volume (bulk rate) not on the value of the product.
- http://www.cwt.coop/action/action_exports.html

→ World Trade Organization (WTO)
- World Tariff Profiles (Summary of every countries major tariff and imports by product groups and major export partners and duties faced).
- World Trade Profiles (Summary of countries' exports and imports, average tariffs and main categories)
- www.wto.org

→ Foreign Agricultural Service (FAS)
- Information available on commodity trends.
- "Forecast 2007: NDM markets in 2007 are expected to remain tight as exports from major exporting countries, i.e., New Zealand, Australia, EU-25, and the United States, are forecast to drop by 1 percent while imports in selected countries are expected to rise. U.S. exports are forecast to continue expanding –up 2 percent in 2007 – ensuring the United States remains as the major supplier of NDM to world markets. Key import markets in Asia, such as China, Indonesia, and Philippines are likely to continue growing due to strong economic growth promoting increased consumption. In contrast, Mexican imports of NDM are expected to decline. Trade figures in 2006 indicate that Mexican imports of NDM through September, 2006 are down one third over the previous year. For 2007, imports are projected to decline due to an increased domestic supply of milk and pressure on the Mexican Government by domestic producers to reduce imports".(Dairy: World Markets and Trade, 2006).
- http://www.fas.usda.gov/psdonline/

Week	Change	Original	Percentage
1	3,524,562	20,230,567	17.42%
2	6,366,743	20,052,855	31.75%
3	4,775,142	22,047,665	21.66%
4	7,734,346	26,232,673	29.48%
5	7,890,875	27,095,229	29.12%
6	6,509,756	24,998,906	26.04%
7	6,230,501	20,131,233	30.95%
8	8,087,698	27,831,021	29.06%
9	8,335,054	28,249,327	29.51%
10	13,418,531	35,057,559	38.28%
11	4,856,376	22,588,833	21.50%
12	7,069,810	24,273,987	29.13%
13	4,337,753	21,622,634	20.06%
14	5,304,770	26,030,634	20.38%
15	2,729,927	21,032,148	12.98%
16	1,579,929	12,963,857	12.19%
17	4,920,787	19,483,089	25.26%
18	5,756,414	18,772,434	30.66%
19	5,054,997	16,281,477	31.05%
20	4,953,642	14,503,897	34.15%
21	4,345,421	15,010,790	28.95%
22	4,020,973	11,957,015	33.63%
23	1,450,330	10,033,052	14.46%
24	4,304,393	13,859,578	31.06%
25	2,850,017	13,105,698	21.75%
26	1,764,804	11,306,860	15.61%
27	1,673,269	10,783,526	15.52%
28	849,149	9,166,077	9.26%
29	1,309,310	9,662,348	13.55%
30	1,390,770	10,081,480	13.80%
31	1,333,233	7,676,253	17.37%
32	2,107,323	12,646,202	16.66%
33	1,778,510	12,546,735	14.18%
34	2,033,766	10,042,487	20.25%
35	1,644,366	9,856,952	16.68%
36	1,682,402	7,509,796	22.40%
37	4,044,206	12,367,906	32.70%
38	9,240,689	24,966,183	37.01%
39	4,402,645	19,956,100	22.06%
40	3,988,777	18,339,583	21.75%
41	9,982,175	22,960,702	43.48%
42	5,992,635	18,424,632	32.53%
43	7,691,416	20,621,106	37.30%
44	5,331,242	18,995,088	28.07%
45	3,020,465	15,592,070	19.37%
46	4,979,911	17,557,997	28.36%
	212,649,810	814,506,241	26.11% Weighted Average

Attachment B

2000 North Plaza Drive
Visalia, CA 93291
Telephone: (559) 625-2200
FAX: (559) 625-5433

Testimony

NFDM Sales Reporting

August 28, 2007
California Department of Food and Agriculture
Sacramento, California

By

Joe Heffington
Senior Vice President & CFO
California Dairies, Inc.

Consolidated Public Hearing to Consider Amendments to the Stabilization Plans and NFDM Sales Reports

August 28, 2007

Mr. Hearing Officer and Members of the Panel:

My name is Joe Heffington and I am Senior Vice President and Chief Financial Officer of California Dairies, Inc. ("California Dairies"), whom I am representing here today.

California Dairies is a full service milk processing cooperative owned by approximately 600 Dairy Farmer Members located throughout the State of California and collectively producing over 17 billion pounds of milk per year, or 42% of the milk produced in California. California Dairies supplies nearly 50% of the milk our Member/Owners produce directly to customers located in California. Additionally, our Producer/Owners have invested over $300 million in 5 large milk processing plants which produce butter, powdered milk products, cheese and bulk processed fluid products and before the end of this year will have invested an additional $130 million in a sixth processing plant located in Visalia.

California Dairies currently produces over 500 million pounds of milk powders annually and is the largest producer of powdered milk products in the United States. California Dairies is a Member/Owner of DairyAmerica, a federated cooperative formed for the single purpose of marketing the powdered milk products produced by its Member/Owners.

California Dairies is also a Member of the Alliance of Western Milk Producers and supports their testimony given today.

Our Board of Directors, which is comprised of 20 Producer/Owner representatives, elected from our Dairy Farmer Members, unanimously approved our testimony regarding CWAP reporting issues presented today at their August 27th Board meeting.

First, I would like to point out that the reporting system under review here today has served the California Dairy industry for many years. The CWAP reporting instructions are fairly broad and therefore, easy to interpret and for the industry to understand. Basically all sales of Grade A and Extra Grade Nonfat Dry Milk are reported and, as a result, Producers receive the sales value received by plants for these products, less the make allowance, in their milk checks.

We understand the frustration Producers have had regarding the difference between the CWAP and NASS reported prices. California's CWAP price is reflecting what California manufacturers received for the Grade A and Extra Grade Nonfat Dry Milk made from California Producers' milk. Significant modifications to the CWAP reporting system at this time can not change what has happened. In fact, a change to exclude sales may have the exact reverse effect if sales prices decline. Excluding long-term fixed price contract sales may decrease the CWAP; the assumption that all long-term fixed price contracts end up being recorded at a lower price than the prevailing market price is false.

We believe that future markets for California's growing milk supply lie to the West, with export markets, not to the East where we will compete with other milk producers who are closer to those markets and we will have to absorb an ever increasing freight cost.

Export markets take time to develop and the competitive nature of these markets requires long term price commitments. Long-term contracts are more the norm in export markets. For example, California's largest milk powder export market, Mexico, is mostly contracted through the Mexican government Agency, Liconsa. Liconsa contractually requires long term fixed price contracts for its own budgetary purposes. We have been advised that Liconsa will be requesting bids in October 2007 for shipments during the first half of 2008 and will finalize this bidding process in November or early December 2007. This process places these fixed price contracts at a minimum of seven months in duration. Attached (Schedule A) is a letter from DairyAmerica that presents in more detail these contracting requirements with Liconsa and other export customers.

We believe that California regulations should not restrict California's ability to serve these important export markets, but rather should encourage development of these markets. Adopting rules that exclude sales from the reported price would place tremendous price risk on the contracting manufacturer. Manufacturers would be more reluctant to commit to the export volumes that will be necessary to balance the growing milk production in California. This in turn would back up tremendous volumes of product on the domestic market and it should be clear that this would have the effect of lowering domestic prices.

Regulation should be flexible enough to allow California Nonfat Dry Milk processors to engage in business transactions that will enhance California's position as a reliable major exporter of Nonfat Dry Milk. We believe that the current reporting rules for California do just that.

The CWAP reporting rules were reviewed at industry meetings during the 1990's, and results of those meetings centered around the timeliness and accuracy of the weekly and monthly reports and improving the Department's audit procedures to insure the accuracy of the data. As a result of those meetings and after many hours of industry input, reporting procedures and audit procedures were set in place by the Department to assure the accuracy of the reports. There truly is not another system like this in the entire U. S.

The interim rule offered by NASS contains a more complex set of reporting rules than CWAP. Also, the concept of auditing submitted reports is foreign to NASS. Even after NASS announces its Final Rules they will have much work to do. NASS must develop auditing procedures and administrative interpretations that will be necessary as a result of the more complex rules that may be adopted. It is fair to say that they are behind on those efforts that should have been completed long ago and now they are playing "catch up".

Modification of California's system to match or incorporate portions of a system currently under pressure to adopt rules and institute procedures just does not make good sense. We also disagree with the thought that alignment with NASS reporting is necessarily in California Producers long-term best interest. The California dairy industry needs to do what is right for California.

In summary, export markets are very encouraging and have great potential for the future if we maintain our commitment. Regulations that support and encourage development of these markets is what is needed.

California's current reporting procedures do just that.

Thank you for your attention to my testimony today. I respectfully request the opportunity to file a post hearing brief.

Schedule A

DairyAmerica™

DairyAmerica, Inc. 4974 E. Clinton Way, #C-221 Fresno, CA 93727-1520

August 27, 2007

Mr. Joe Heffington,Senior Vice President and Chief Financial Officer
California Dairies, Inc.
11709 E. Artesia
Artesia, CA 90701

Dear Joe:

The following information is in regards to the export market and the effects of changes to reporting sales to CDFA.

Background:
DairyAmerica has been supplying Member powder production to various international markets since 1995, either through brokers (traders), direct from DairyAmerica and over the last five years through Fonterra under our export marketing agreement.

The international market has been serviced for years, with the majority of powder supplied by Oceania and Europe. Over the last few years U.S. supply has become more competitive due to changes from cap reform in Europe, drought in Australia, changes in the value of the USD versus other currencies, as well as export bans put on by the governments from Argentina and India.

Contracting:
International contracting has, for years, been done on a medium term to long term (6 to 12 months) fixed price basis. This is mainly done because customers want to lock up their costs, know they have a secured supply and some customers, being government agencies, need to secure financing from their government. There are short term contracts (2 to 3 month) but these are the exceptions and not the rule.

Markets:
DairyAmerica's largest market is Mexico. One of the largest buyers in Mexico is Liconsa, a government agency that provides milk to undernourished children and adults. This agency commits to purchases based on a minimum of 6 months contracting. For instance, we will begin negotiations to supply Liconsa in Mid October 2007 for shipments January to June 2008. Liconsa will be making their decision to commit to a supplier by late November to the first of December 2007 for that contract. In addition, we will see the same conditions for a number of large multi-national companies looking to lock up supply and price from the first quarter to the first half of 2008. Those producers providing the requirements of a fixed price and supply for customer contracts will be the preferred providers and will receive a contract.

Mexico is NOT the only country that purchases through government agencies - we also have supplied, in the past, Algeria and Cuba through their government agency purchasing departments. These contract opportunities would also be subject to any changes being reviewed by the Department on Tuesday August 28, 2007. Algeria will be looking to bid their supply for the first quarter of 2008 in September 2007. They will be followed by Cuba in late September/early October for their first quarter 2008 requirements. Both of these markets have been supplied at one time or another by DairyAmerica Members from California.

As mentioned above, multi-national customers also require fixed price contracts on a 6 to 9 month basis for their supply needs and will look to others to supply, if DairyAmerica cannot meet the terms they require.

Summary:
International dairy markets work differently from the U.S. markets. International markets use long term fixed price contracts versus weekly pricing for U.S. markets. DairyAmerica, and its' Members, have invested huge sums of time and money to develop both domestic and international customer relations. To have something other than market conditions affect those relationships would be a major step backwards and will have detrimental effects to the contribution powder provides to producer milk prices.

Sincerely,

Rich Lewis, Chief Executive Officer
DairyAmerica, Inc.

Schedule B

10/10: *10 states, a decade of dairy exports*

($ million)

State	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1) California	153.8	162.1	171.5	192.3	225.2	212.7	214.2	282.9	372.1	390.7
2) Wisconsin	124.7	134.1	130.0	138.7	150.5	133.9	134.6	171.3	224.3	232.9
3) New York	64.3	69.0	68.1	71.1	79.9	74.1	72.3	90.4	119.4	121.0
4) Idaho	29.0	33.8	36.4	43.1	52.6	49.5	53.0	70.5	100.4	109.4
5) Pennsylvania	59.4	63.7	61.6	66.5	73.6	65.3	62.5	78.1	104.1	107.7
6) Minnesota	51.3	54.4	53.4	56.6	59.7	51.3	49.9	62.9	80.3	83.2
7) New Mexico	22.4	25.6	26.6	31.2	37.7	38.3	40.3	52.1	68.1	75.9
8) Texas	32.2	32.9	31.7	34.3	34.6	32.1	34.0	46.6	63.6	71.8
9) Michigan	30.2	31.5	30.7	34.0	39.8	37.1	38.5	49.0	66.3	70.9
10) Washington	29.6	31.3	31.2	33.4	37.4	34.1	33.7	42.0	55.4	54.9
U.S. total	870.2	923.1	916.1	998.5	1,120.9	1,031.4	1,030.2	1,325.0	1,744.5	1,819.6

Source: USDA Economic Research Service

State ranking based on 2006 export total

EXHIBIT 49

Testimony of

William C. Van Dam
Alliance of Western Milk Producers

August 28, 2007

Consolidated Public Hearing
To Consider Amendments to the Stabilization and Marketing Plans

Introduction

Mr. Hearing Officer and Members of the Hearing Panel, my name is Bill Van Dam and I am here today representing the Alliance of Western Milk Producers of which I am the Chief Executive Officer. The Alliance is an association of Cooperatives and has as its members California Dairies, Inc (CDI); Dairy Farmers of America – Western Council (DFA) and Humboldt Cooperative Creamery (HCC). The California members of these three organizations produce a bit more than 63% of the milk produced in this state. In the context of this hearing it is useful to note that our members also process at least two thirds of the non fat dry milk (NFDM) produced in this state. For the record it is also useful to note that one of our members, CDI, is nearing the completion of a new NFDM drying plant in Visalia which will have a capacity of five million pounds of milk per day.

The concepts presented in the testimony being presented today were approved by the Board of Directors of the Alliance at the July 23, 2007 meeting. We are grateful for the opportunity to testify on the reporting procedures used to establish the NFDM portion of base price to be used in the 4a formula.

Changing world

In the past few years major changes have been occurring in world dairy trade. Foremost among those changes is the gradually increasing relative wealth of the citizens of the developing nations in many parts of the world, particularly in Asia. With this has come increasing demand for dairy proteins. At the same time the European Union (EU) has trimmed what had been a very generous dairy program and they are no longer participating in world markets with large volumes of subsidized product. It does not appear they will ever reinstitute a similar program. The drought in Australia has been going on for years and it will be a long time before they can recover. In spite of high prices Australia projects decreases of milk production in the coming year.

These factors plus others create an opportunity for California dairymen to produce and market NFDM world wide. We have the strong belief that the future of California's dairy industry lies in export sales to the West. This state will continue to be important suppliers of product (most notably cheese) to the Eastern part of this country but there is little potential growth in that direction because that growth can be served economically by the growing milk supplies in Idaho, Texas and New Mexico.

The demand for NFDM is high and the prices are attractive. All indications are that this demand will continue for quite some time, mostly because there are few other places in the world that can respond. The current high milk prices enjoyed by our producers are driven almost exclusively by the world wide demand for milk proteins. .

But being a large scale and long term marketer of dairy products to the world market is new to our state and our country. Accordingly great care must be taken to insure that our regulations are flexible enough to allow California NFDM processors to engage in business transactions the will enhance California's position as a reliable major provider of NFDM (and other dairy proteins). Regulations to the contrary can only inhibit this evolution and injure dairy producer and NFDM processors. The world - with these high prices - is asking us to supply it with product, our producers are responding and our state needs to maintain a regulatory system that allows a sensible economic response.

CWAP

It just so happens that the procedures put together in 1973 – 34 years ago – are still a better option for California than any of the new proposals before us today. The basic idea behind the California Weighted Average Price (CWAP) was to use the **actual** values received by California plants for standard NFDM as the basis for determining what those plants paid for their milk. Looking back over the past one third of a century, one has to be impressed by how well this approach has worked for both producers and processors.

A review of the CWAP reporting instructions reveals that the instructions are broad and not overly specific. Discretion was left to the Department to determine which products should be included, what constituted a sale, etc. These decisions were made with the active informal support and input from industry. Changes to the rules were made, not by the hearing process, but with the same informal participation of the industry. The required changes were few and far between and the flexibility served the industry well. The proposals put forth by others at this hearing would create a regulatory environment that moves away from a system that has worked well for over three decades based on the very unusual price and market circumstances that occurred during a short period in 2007.

NASS

Unlike CWAP, NASS is a rather young series, beginning in 1997. Its guidelines were developed by NASS without much, if any, input from the industry and never went through the formal rulemaking process, and consequently, they did not review comments from the persons or companies directly impacted by their decision. There are many differences between NASS and CWAP pricing. Some of these are: types of products excluded, age of product, process used to make the product, as well as the now well known exclusion of long term contracts. All of these dissimilarities will contribute to disparities in reported prices. At the moment the procedures used by NASS are under a formal review. As part of this process an Interim Final Rule has been put in place but it is the same as the old rules. AMS states that there is 'good cause' to not change the rules now because they have been in place for several years – and to wait for comments on the Interim Final Rule to determine if changes should be made. There is no indication that the Interim Final Rule will, in fact, be the final rule.

Alliance Position

We are suggesting that there be only one change to the current methods for collecting and reporting NFDM sales information. Organic NFDM should not be included as reportable. Until recently, Organic NFDM was not included on the CWAP report. That, we believe, was the obvious and correct procedure. Organic products have distinct and higher pricing mechanisms as well as higher underlying cost structures than does the undifferentiated NFDM. Organic volumes are not large and the product is only made at a limited number of plants but the principle is important. It is not appropriate to add value that cannot be recovered by the processor making the basic NFDM product. It isn't that organic milk costs more money to process but it is that it sells for much more than commodity NFDM. Even at small volumes, the much higher selling price of Organic NFDM may force the other processors to pay more for their milk than they can recover from the market place.

Opposed to other proposals

We are opposed to the proposals of Western United Dairymen, Milk Producers Council and Dairy Institute. All of these proposals would severely limit the ability of California to participate in export trade.

Western United Dairymen has proposed that all sales based on fixed contracts that are not delivered within the first 90 days of the contract signing shall not be included in the CWAP prices. The use of 90 days is arbitrary and is difficult to justify. Is it the intent to limit all future contracts to 90 days or less? There are many complexities in preparing and delivering product to international accounts and we believe that limits of this sort would curtail the potential markets to which processors could deliver product. This approach assumes that long term contracts are always inferior to the prevailing market price and that the price received after 90 days will always be less. That supposition is not and cannot be true. Additionally, this proposal has the unintended effect (which we think is a fatal flaw) of leaving the processor in the enviable position of being able to choose, by manipulating the delivery date, whether or not a particular contact will be included in pricing calculations. Our view is that all sales of the properly defined commodity products should be included whether sold on long term contracts or as spot sales.

The proposal of Milk Producers Council would trade CWAP prices which are carefully gathered weighted data from plants actually producing NFDM for the Dairy Market News report data that is loosely gathered and is "designed to assist in the orderly marketing and distribution of farm commodities". The use of this price series to set prices for producers would be devastating to operating plants and would have a chilling effect on any new investment in NFDM plants. The DMN survey is: regional, voluntary, conducted by phone, not audited, includes buyers, sellers, brokers, resellers and are ranges (not weighted averages). If the goal of today's process is to position California to take advantage of export markets, then you simply cannot use the MPC proposal.

Dairy Institute's proposal to use NASS prices (or to change CWAP to include the same rules) is driven by their long term objective of having the cost of milk for the products made by their members here in California stay in a steady and competitive relationship with the same products produced in surrounding states. It is a valid concern but there are better more specific ways to address this specific issue. Additionally their way of approaching this issue would, like the other proposals, severely hamper the ability to market California NFDM internationally.

Consequences of Improper Regulations

There are two readily apparent consequences of creating regulations that are out of touch with the business environment in which export transactions are made:
First, potential sales to export trade will not proliferate but will instead fail to materialize and more product will have to be marketed domestically, and
Second, the resulting overabundance of domestic supply will negatively impact prices.

Closing

We believe that our proposal to remove Organic powder from the CWAP calculations will yield a more accurate price upon which to base Class 4a prices. In addition we strongly believe that long term contracts for commodity NFDM should continue to be included in CWAP reporting.

There is before us today a chance to foster the marketing of products of California to the world. The demand for milk protein has made 2007 a very unusual year that has presented novel circumstances, price levels and price relationships. So far this set of events is working out well for this state and this industry is poised to seize that opportunity. A rush by the California dairy industry to make far reaching changes in response to the unusual circumstances of the past 12 months could very well be detrimental to dairy producers and NFDM processors alike.

Thank you for the opportunity to present this testimony. We respectfully request the right to submit a post hearing brief.