Dairy Institute
Of California

June 12, 2006

Mr. David Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
560 J Street, Suite 150
Sacramento, CA 95814

RE: June 1-2, 2006 Class 2, 3, 4a, and 4b Hearing -- Post Hearing Brief

Mr. Hearing Officer and Members of the Panel:

Dairy Institute appreciates the opportunity to submit the following post-hearing brief to amplify portions of our testimony presented in Sacramento on June 1st and 2nd, 2006. The paragraphs that follow build on the propositions that we put forth in our testimony.

Assertions By The Center On Race, Poverty And The Environment Are Incorrect

We testified at the hearing that the assertions of the Center on Race Poverty and the Environment (CRPE), claiming that amendments to Stabilization and Marketing Plans fall under the definition of a "project" subject to review under the California Environmental Quality Act (CEQA), were unfounded. Any amendments to the Stabilization and Marketing plans as a result of this hearing will not mandate that milk producers or manufacturing plants (or any other entity) undertake activities that would impact environmental quality. If amendments to the Plans create an environment where investment in milk processing plants or dairy farms *might* occur, there is no guarantee that they *will* occur. Thus, while an appropriate milk price regulatory environment might be helpful creating economic conditions where California-based dairy manufacturing plants can be competitive in the national and international market, it is not a sufficient condition for industry expansion. Furthermore, nothing in the Plans or any proposed amendment to the Plans would weaken or undermine the existing environmental requirements facing the dairy industry. Any dairy industry activity undertaken that could potentially have an impact on environmental quality, such as building or expanding a processing plant or constructing or expanding a new dairy, is reviewed by various state, regional, and local agencies.

Amendments to the Stabilization and Marketing plans are an ongoing, continuing administrative activity that is characterized as "general policy and procedure making." As such, they are excluded from the definition of a "project" under CEQA guidelines. The extensive history of CDFA proceedings regarding milk pricing regulations, which have

never been held to be subject to CEQA review, is further testimony to the fact that Stabilization and Marketing plans, and any amendments thereto, are not CEQA projects.

A legal analysis of the assertions put forth by CRPE has been undertaken by David E. Cranston, Esq. of Greenberg Glusker Fields Claman & Machtinger, LLP. We have attached a letter from Mr. Cranston (Attachment 1), which was prepared at our direction, and which amplifies the points made in our testimony. The CRPE argument can thus be ignored by the Department as having no bearing on the hearing or any action taken as a result of the hearing.

Correlation Coefficient (r) or r-square

The witness for Milk Producers Council had indicated that the correlation coefficient was a more appropriate measure than was the r-square of the relationship between dry whey and 34% whey protein concentrate (WPC-34) prices. It should be obvious that both statistics are indicators of the linear relationship between the two price series. The Pearson correlation coefficient "r" is a measure of the linear relationship between two data series. It has a value between zero and one, where a value of one represents two series that are perfectly collinear, and a value of zero is representative of two series that evidence no linear relationship. The r-square is a statistic associated with an estimator. In this case, the r-square represents the proportion of the variation in WPC 34 prices that is explained by variation in the estimator, which here is a linear regression of dry whey prices on WPC 34 prices.

Since the policy-making context of this discussion is one where we are trying to ascertain whether or not we can use dry whey prices to estimate changes in the revenues (prices received) by manufacturers of WPC, the r-square is the more appropriate statistic. Of course, the interesting thing about the two statistics is that they are mathematically related in such as way that the correlation coefficient will always be larger than the r-square except when the value of r is zero or one. This mathematical relationship is such that the correlation coefficient will always appear to show a stronger relationship between the two series than will the r-square of a simple two-variable linear regression model. Therefore, it does not surprise us that MPC would regard the correlation coefficient as a "more appropriate" statistic, since it supports their position.

As a general comment, both the r-square and the correlation coefficient suggest that over certain periods, there is a positive linear relationship between the two data series. However, simple visual inspection of the plotted data shows that there are periods where the degree of linearity between dry whey and WPC 34 prices is weak, and others (as has been the case recently) where the relationship is negative (prices moving in opposite directions). To say that it is adequate to use dry whey to represent WPC revenues because over the long run there is some degree of linearity between the price series ignores the fact that plants are "caught" in periods when the prices are not positively linear. The essential point here is that plant margins will suffer greatly in these periods, and the recent changes in international demand for whey products suggest that diverging whey markets are more likely to occur in the future than they have in the past. The testimony by Sue Taylor of Leprino Foods supports this assertion.

Reinstating The Support Price Floor Will Be Relatively Ineffective At Increasing Producer Prices

We have argued that the support floor could hurt producers because it would create disincentives for California manufacturing plants to take milk at times when milk supplies are most plentiful, resulting in high costs to producers of shipping milk o ut of state, or dumping milk that cannot be marketed. Producer representatives have contended that the support price floor will provide price protection to producers. As evidence, they cite the increase in market prices for cheese that occurred after the California price floors were made effective in April 2003.

It is a misconception that the use of the support floor prevents the cheddar market from going below the support floor price. Many point to the market rising from $1.09 the end of March 2003 to above support price by the end of April 2003. They correlate the support floor price with pushing the market price up. This is a spurious correlation. Market prices increased in April 2003 due to tightening supply side market conditions. Numerous factors prove that this was the case.

Soybean prices were on the rise from early 2003 into the summer of 2003, rising over $0.60 per bushel during this timeframe. This resulted in an increase in the composite feed price per ton for dairy farmers. The increased cost squeezed margins for farmers, encouraging them to tighten rations and cull milking cows. Milk cow numbers fell substantially in April 2003.

Production growth, which had been humming along at 2.5% in 2002, was still greater than or equal to 1% each month of the January - March 2003 period. In April 2003, year-over-year growth in milk production came to a virtual standstill, up just 0.2%, and then was near zero or negative for the remainder of the year. The turnaround in milk production was due to an extended period of poor farm level milk prices that sent the signal to farmers nationally to decrease milk production by culling cows or exiting the business. In addition to this relative decrease in milk production, there were continued talks by major cooperatives during this time frame about a self-funded supply management program, which ultimately became known as CWT and was implemented July 1, 2003.

American cheese inventories (includes cheddar) in January 2003 were 12.0% above previous year and 10.1% above the previous five-year average. By April, the year-over-year increase had decreased to 4.1% above previous year and 5.2% above the previous five-year average. And, by May, the year over year increase had decreased to 0.5% above previous year and 3.0% above the previous five-year average. These year-over-year changes indicate that the supply of cheese as compared to previous periods was tightening from January through May 2003.

Ultimately, poor farm level economics resulted in less milk produced in April 2003. Less milk was then made into fewer dairy products, tightening the cheese supply available to the industry. This tightening of supplies, and not the implementation of the support floor

price snubber in the Class 4a and 4b formulas, led to the increase in cheddar market prices experienced in April 2003.

Although upward price movement in the CME price in April 2003 was due fundamentally to the tightening of milk and cheese supply factors that was occurring at the time, we are aware of a rumor that a large cheesemaker with plants in California went to the CME in April 2003 and bought cheese in attempt to raise the CME price so that its plants in California would not loose money on the cheese it manufactured and sold. Losses would have been incurred by selling for a price that was less than its raw product cost, a situation that would have been caused by the support price snubber in the 4b formula.

The price floor might have encouraged some CCC purchases which had the temporary effect of moving the cheese price higher, but such activity could have been effective in the longer term only because of the tightening supply of milk and cheese. Prices would likely have risen with a few weeks, regardless of such intervention at the CME by a large buyer. Attempts by cheesemakers to hold the price above a supply/demand determined price level have been routinely unsuccessful. The ability to influence the price in this manner is generally short-lived and only possible when supply conditions are tightening.

Even if it were possible for California cheese manufacturers to go to the CME and raise the market price by purchasing cheese, it is poor policy to put the burden of pushing the national market price for cheese back above the support level on California cheesemakers. This policy clearly puts a higher regulatory burden on California plants. The state should not be pursuing policies that discourage ongoing plant operations and job creation in California. The problems created by an ineffective national support price policy should be addressed by national-level changes in that policy, not by adjustments to California's pricing formulas.

Market-Oriented Principles And California's Class 4b Price In Relation To The Federal Class III Price

In our testimony we indicated that prices should be set based on market-oriented principles. There was some discussion at the hearing regarding the appropriate level for California manufacturing prices relative to federal order price levels. Some California producer associations and out-of-state manufacturing interests have insisted that California's Class 4b price be increased to avoid destructive competition between the California and federal order systems. They argue that reductions in California price for milk will automatically be reflected in lower prices for commodity cheese, which will ultimately reduce federal Class III prices and therefore, defeat any competitive advantage for California that was gained by reducing the 4b price.

By focusing exclusively on the relationship between California and federal order prices, these advocates of higher Class 4b prices are missing a crucial point. California plants must have a sufficient margin between what they receive for their product and what they pay for their milk with which to pay operating *and marketing costs* and provide for a suitable return on investment. If plants in California cannot be competitive with dairy

manufacturing plants in the rest of the country, there will be reduced incentives for California plants to maintain existing operations or invest in new ones. Because of the location value of cheese, manufacturing milk also has a location value. According to economic models developed at Cornell University, manufacturing milk values are lowest in the western part of the country and rise as product moves east. This pattern follows that of manufactured product values (butter, cheese, and nonfat dry milk), which are likewise lowest in the West and higher in the East. Therefore, it is entirely appropriate for Class 4a and Class 4b prices to be lower than their federal order counterparts (Class IV and Class III).

The underlying market value of manufacturing milk must be revealed through end product pricing, where manufactured product values, manufacturing costs for the products made from producer milk and associated product yields from producer milk, in concert with milk production costs and the overall milk supply/demand balance determine the value for manufacturing milk. This approach is exactly what Dairy Institute has put forth in its petition, and we urge the Department to adopt this market-oriented approach.

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

Sincerely,

William A. Schiek
Economist