Hearing Panel Report

Based on a Public Hearing Held
October 30 and 31, 2008

Addressing the Class 1, 2, and 3 Pricing Formulas
Contained In the
Stabilization and Marketing Plans
For Market Milk for the
Northern and Southern California Marketing Areas

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Based Upon a Public Hearing Held on October 30 and 31, 2008

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plans for Northern California and Southern California (Plans) is based on evidence received into the Department of Food and Agriculture's hearing folder. The folder includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held October 30 and 31, 2008, and written post-hearing briefs.

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INTRODUCTION/WITNESSES

California Food and Agricultural Code Section 61801, *et sec*., provides the authority, procedures, and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of Stabilization and Marketing Plans for Market Milk (Plans).

A Petition was submitted by:
1. Alliance of Western Milk Producers (Alliance), Western United Dairymen (WUD), and California Dairy Women Association (CDWA)

Two alternative proposals were submitted:
1. Dairy Institute (Institute)
2. Milk Producers Council (MPC)

A total of 15 witnesses testified including the Department's witness:

Thomas Gossard, Department
*Alliance, William Van Dam
*WUD, Tiffany LaMendola
CDWA, Linda Lopes
*Institute, William Schiek
*MPC, Robert VandenHeuvel
Safeway Inc., Randall Dei
The Kroger Company (Kroger), John Hitchell
Super Store Industries, Dennis Brimhall
*California Dairies, Inc. (CDI), Eric Erba
HP Hood LLC, Michael Newell
*Dean Foods Company, Inc. (Dean), Evan Kinser
Nestle USA, Patricia Stroup
Land O'Lakes, Inc. (LOL), James W. Gruebele
*Kraft Foods (Kraft), Michael McCully

Also entered into the hearing record was additional written testimony received by:

Farmdale Creamery, Nicholas Sibilio
General Mills, Jeff Malbon
California Dairy Campaign

* Indicates submission of a Post Hearing Brief

Background: California's Dairy Landscape

The following economic data and statistics represent the current situation of California's dairy industry and were considered when examining and evaluating the proposals and testimony submitted at the hearing.

Cost of Producing Milk

- For 2007, the cost of producing milk increased in all four areas of the state when compared to the same period for the previous year, with statewide average costs at $13.96 per hundredweight (cwt.) (up $1.32/cwt. from 2006). When including return on investment and management, the cost of producing milk in 2007 was $15.77/cwt. (up $1.59/cwt. from 2006).
- For the first six months of 2008, compared to the first six months of 2007, the statewide average cost of producing milk was $15.74/cwt. (up $2.34/cwt. from 2007). When including return on investment and management, the cost of producing milk for January-June 2008 averaged $17.68/cwt. (up $2.62/cwt. from the same period in 2007).
- Looking at the last five years, comparing the second quarter of 2008 to the second quarter of 2003:
  - total feed costs in 2008 account for 59.4 percent of the total cost of production, compared to 51.7 percent in 2003;
  - California "milk cow" hay costs averaged $279 per ton in 2008, compared to $152 per ton in 2003;

Mailbox Milk Prices

- California: mailbox milk prices for July 2007 through June 2008 averaged $18.47/cwt., $5.25/cwt. higher than the average for the same time period ending in June 2007.
- Federal Orders: mailbox milk prices for the twelve months ending June 2008, averaged $20.18/cwt., $5.39/cwt. higher than the average for same time period ending June 2007.

California Milk Production

- Annual milk production has *increased* at an average rate of 4.2 percent over the last 20 years; 4.0 percent over the last 10 years; and 2.8 percent over the last 12 months.
- Trend of increasing milk production over the last 20 years:
  - Above 9 percent - 2 years
  - 5 to 8.9 percent - 4 years
  - 3 to 4.9 percent - 8 years
  - 1 to 2.9 percent - 4 years
  - Less than 1 percent - 2 years
  - No years recording decrease in milk production, compared to the previous year

Milk Cows

- Annual California cow numbers have *increased* at an average rate of 2.7 percent over the last 20 years; 2.7 percent over the last 10 years – while U.S. cow numbers have *decreased* -0.2 percent over the last 10 years.
- California has more dairy cows and produces more milk than any other state, yet ranks 5th in milk production per cow, and 8th in total number of licensed dairies.

Utilization

Class 1 Usage

- Class 1 usage in California accounted for 14.3 percent of total Pool fat and solids-not-fat usage in 2007, compared to 14.5 percent in 2006; and 23.5 percent in 1996.
- Class 1 usage in California increased 4.3 percent, comparing the 12-month period October 2007-September 2008 to October 2006-September 2007.

Cheese Production (Class 4b)

- In 2007, 47 percent of California's total milk production was used to produce cheese.
- California cheese production continued to grow and set an annual record at 2.29 billion pounds in 2007.
- The California and other western states share of total U.S. cheese production increased to 44 percent. For California production alone, the U.S. market share is 24 percent.
- Class 4b usage has decreased 4.7 percent, comparing the 12-month period October 2007-September 2008 to October 2006-September 2007.

Butter and Nonfat Dry Milk (NFDM) Production (Class 4a)

- In 2007, 30 percent of California's total milk production was used to produce butter and NFDM.
- California is ranked first in the U.S. for butter and NFDM production, and when combined with the other western states, the U.S. market shares are 48 percent and 77 percent, respectively. For California production alone, the U.S. market share is 33 percent and 56 percent respectively.
- Butter has shown a 37 percent growth in production over the last 5 years to 498.9 million pounds in 2007.
- Class 4a usage has increased 20.9 percent, comparing the 12-month period October 2007-September 2008 to October 2006-September 2007.

Cottage Cheese, Yogurt, Ice Cream, as well as other soft and frozen dairy products (Class 2 and 3)

- Frozen dairy product growth has been relatively flat over the last 5 years, recording a decrease of 3 percent over the five-year span.
- Total cottage cheese production has increased 22 percent over the last 5 years.
- Yogurt production has increased 17 percent over the last 5 years.
- Class 2 and 3 usage has increased 0.7 percent, comparing the 12-month period October 2007-September 2008 to October 2006-September 2007.

SUMMARY OF PROPOSALS

The following proposals were submitted (all proposed changes are in **BOLD** print):

ALLIANCE OF WESTERN MILK PRODUCERS, WESTERN UNITED DAIRYMEN, AND CALIFORNIA DAIRY WOMEN ASSOCIATION

Proposed Changes Effective January 1, 2009 through June 30, 2009

Class 1, 2, and 3 Fat = Current Formula Fat Price Calculation **+ $0.04**

Class 1, 2, and 3 SNF = Current Formula SNF Price Calculation **+ $0.10**

DAIRY INSTITUTE

Class 1 Pricing Formula Proposed Changes:

Class 1 Fat = ((CME Butter – **$0.1315**) x 1.2)

Class 1 SNF = (((CRP **– $1.203**) **–** (Class 1 Fat Price x 3.5)) x 0.76) / 8.7

Class 1 Fluid = (((CRP **– $1.203**) **–** (Class 1 Fat Price x 3.5)) x 0.24 / 87.8
(Same change for Northern and Southern California formulas)

(For Northern California, subtract $0.0031 from the per pound price of fluid carrier.)

Class 2 and 3 Pricing Formulas Proposed Changes:

Class 2 fat price = Average Class 4a fat price ~~+ Differential~~ { ~~$0.0370 Northern California~~ / ~~$0.0393 Southern California~~

Class 3 fat price = Average Class 4a fat price ~~+ Differential~~ { ~~$0.0370 Northern California~~ / ~~$0.0393 Southern California~~

Class 2 SNF price = Average Class 4a SNF price + Differential { ~~$0.0643~~ / **$0.0490** Northern California / **$0.0748** Southern California / ~~$0.0901~~

Class 3 SNF price = Average Class 4a SNF price + Differential (~~$0.0586~~ **$0.0433** per pound throughout California)

MILK PRODUCERS COUNCIL

Class 1 Fluid = (((CRP + $0.0147) **–** (Class 1 Fat Price x 3.5)) x 0.24 **+ Factor***) / 87.8

(For Northern California, subtract $0.0031 from the per pound price of fluid carrier.)

***Factor = $$\frac{\textbf{0.26 x Previous total monthly cost to the Pool of transportation allowances and credits}}{\textbf{Number of hundredweights of raw milk processed by Class 1 plants in such month}}$$**

Table 1: Estimated Impacts of Hearing Proposals on California Class 1, 2, 3 and Pool Prices

● The table below shows the impacts of the petition and alternative proposals on class and pool prices relative to current prices from October 2003 through September 2008.

● The analysis assumes that the petition, alternative proposals and current formulas were in effect throughout the entire period.

● When a change is a "plus," the proposal would have increased the price.
● When a change is a "minus," the proposal would have decreased the price.

Table 1

Estimated Impacts[1] on Class 1, 2, 3 and Pool Prices if the hearing proposals had been in effect for the 5-year period: October 2003 to September 2008
Annual and Five-Year Averages

	Class 1 ($/cwt.)	Class 2 Northern ($/cwt.)	Class 2 Southern ($/cwt.)	Class 3 Northern ($/cwt.)	Class 3 Southern ($/cwt.)	Pool[2] ($/cwt.)
Alliance et al. proposal						
2003-2004	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.26
2004-2005	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.24
2005-2006	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.23
2006-2007	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.23
2007-2008	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.23
5 year average	+$1.01	+$1.01	+$1.01	+$1.01	+$1.01	+$0.24
Institute Proposal						
2003-2004	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.27
2004-2005	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.25
2005-2006	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.24
2006-2007	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.24
2007-2008	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.24
5 year average	-$1.35	-$0.26	-$0.27	-$0.26	-$0.27	-$0.25
MPC Proposal						
2003-2004	+$0.08					+$0.01
2004-2005	+$0.10					+$0.02
2005-2006	+$0.12					+$0.02
2006-2007	+$0.14					+$0.02
2007-2008	+$0.13					+$0.02
5 year average	+$0.11					+$0.02

[1] Compares alternative California formulas with current California formula

[2] Quota and overbase price

PROPOSED TRANSPORTATION SURCHARGE TO THE NORTHERN AND SOUTHERN CALIFORNIA CLASS 1 FORMULA

Issue

The cost of the California milk movement system that helps ensure that California's Class 1 processors obtain sufficient milk supplies are borne by all producers via the monthly Pool prices. Every month, about $2 million dollars of Pool monies are allocated to milk movement incentives. Most of the $2 million is allocated within the Pool from all producers to those producers shipping milk to higher value usage (Classes 1, 2 and 3). Additionally, a small portion of the $2 million is allocated primarily to producer owned cooperatives for plant-to-plant shipments to Class 1 plants.

The policy issue is whether or not the recently increased cost of the milk movement system (transportation allowances and credits) that resulted from the most recent hearing on the issue (July 1, 2008) should be financed by increasing the Class 1 price. Adoption of the proposed change would shift the responsibility of financing any additional cost needed in the transportation system from dairy producers to consumers of fluid milk products.

Review of Proposal

Specifically, MPC proposed implementing a "transportation surcharge" in the Class 1 price formula. MPC calculated that the impact of the last milk movement hearing provided a 26 percent increase in the amount of Pool revenues needed to fund the milk movement incentives. MPC proposed a transportation surcharge that would offset this 26 percent increase. Specifically, the surcharge would equal:

$$\frac{\text{(26 percent) times (monthly milk movement incentive costs)}}{\text{(87.8) times (monthly pounds of Class 1 fat + SNF + fluid)}}$$

MPC has taken the position at a number of hearings that additional costs needed to supply the Class 1 market should be funded by consumers of fluid milk products rather than from Pool revenues.

Impact of Proposal

The proposed surcharge on Class 1 milk would result in an increase of $0.11/cwt. on Class 1 and an estimated combined Pool price increase of $0.02/cwt. for a five-year average of October 2003 through September 2008. The specific construct of the formula changes and price impact estimates can be found in the "Summary of Proposals" section and Table 1.

Discussion

The Milk Pooling Plan, which instituted statewide Pooling in 1969, fundamentally changed the means of distributing revenues from milk sales to dairy farmers. Prior to 1969 with individual plant Pools, producers competed for contracts with fluid milk plants. In contrast to current Pooling regulations, no mechanism existed to compel producers to share the higher revenues from these sales with other producers. The Milk Pooling Plan introduced the concept of equitable producer prices by sharing of Pooling revenues from milk sales among all

producers in the state. Because statewide pooling eliminated direct contractual arrangements between producers and plants, pooling also removed the incentive for producers to ship milk to fluid milk plants.

Under statewide pooling provisions, producers can minimize their hauling costs by shipping milk to local cheese or butter/powder plants rather than the fluid plants which are typically located in the major urban cities.

Fluid milk processors were opposed to the proposed pooling plan if it negatively affected their ability to obtain sufficient milk supplies or required them to pay added premiums over the minimum Class 1 price levels in order to attract adequate milk supplies.

In order to implement and adopt the statewide pooling of milk sales revenues, dairy producers gave concessions to processors ensuring them that sufficient milk supplies would be made available to them without the need for added premiums above the minimum prices.

As industry grew and economic conditions changed, the mechanism used by the Department to ensure sufficient milk was made available to fluid processors has changed. The milk movement incentives system that employs transportation allowances and credits is the current system put in place to ensure a predictable and sustainable flow of milk to fluid processing plants since 1969.

History has proven that in order to successfully implement fundamental changes to the pricing and pooling system, dairy stakeholders have collectively discussed, reviewed, analyzed, debated and developed a consensus for those changes. This type of review occurred when the pooling system was first implemented.

Adoption of this proposal would seemingly raise fundamental policy issues about some of the basic tenants of the current pooling system. Dairy processors have testified that they are strongly opposed and would challenge any modification of the basic foundation of the pooling system.

More importantly, there was very little support by other dairy stakeholders expressed at the hearing. Processor witnesses generally opposed the proposal and no other producer witness testified in favor of adoption of this proposal at the hearing. All other witnesses took a neutral position but did caution that this proposal involved a significant policy change and as such warranted the need for stakeholder study.

Panel Recommendation

The Panel recommends that the proposal of a surcharge on the Class 1 price be denied.

CURRENT ECONOMIC CONDITIONS FACING THE CALIFORNIA DAIRY INDUSTRY

Prior to the review of the various proposals for change in the individual Class 1, 2, and 3 pricing formulas, a general review of the current economic conditions facing the California dairy industry is warranted.

Milk Prices and Cost of Production

Department data show that 2006 was a difficult year for producers due to low milk prices and comparatively high cost of production. However, in early 2007, the milk prices received by producers increased dramatically as the international demand for dairy products increased at a time when a prolonged drought in Australia and New Zealand significantly reduced their milk production. These global conditions led to very favorable dairy prices, which continued until the end of 2007.

By the end of 2007 and the beginning of 2008, milk prices decreased in response to weakening international demand for dairy products and increasing international milk supplies from Australia and New Zealand. This decrease in milk prices will likely continue into the near future based on present conditions.

At the same time, the cost of production was rapidly increasing due primarily to the drastic increase in the cost of feed. Since 2007, the cost of hay, corn, feed mixes, and other feeds used in California have increased significantly, especially in 2008 according to Department data. As a result of lower milk prices and higher production costs, dairy farmers are once again facing difficult financial pressures.

Surplus Milk Supply

Despite a deteriorating financial situation, the milk supply in California is in a surplus condition due to continual milk production increases and lack of corresponding increases in processing capacity. In industry meetings and publications, both producer and processor groups have acknowledged the imbalance between the state's increasing milk supplies relative to the state's processing capacity. In order to find a home for all of its milk supply, the California dairy industry has been shipping milk supplies to out-of-state processors and to calf ranches. There have been periodic occasions when milk production could not be processed.

In response to the surplus milk conditions, many organizations have placed restrictions on the amount of milk they will receive from producers. The three major producer cooperatives have instituted production bases to restrict production growth. If a member increases their production beyond their base, then the member is responsible for paying the added costs of shipping the milk to an out-of-state processor and accepting the lower price that this milk shipment will receive. Major proprietary processors have also placed limits on the amount of milk they will receive from their contracted producers.

Two major cooperative organizations are in the process of building or remodeling/expanding their butter/powder plants in order to help alleviate their inability to handle all the milk production of their members. Unfortunately, the new plant capacity is already committed to the increased production that is already planned by the cooperatives' members.

In addition to production restrictions, two major California fluid milk processors have given termination notices to over 40 dairies producing approximately 26 loads of milk per day due to decreased milk procurement needs. While the first group of termination notices was first effective for about half the producers on July 1, 2008, and the termination notices for the second half of the producers was effective on November 1, 2008, neither group has had much success in securing a permanent buyer for their production.

Utilization of Pooled Milk

The constant and steady milk production expansion has enabled California to remain the largest milk producing state in the country. The production growth has made dramatic changes in the usage of the milk produced in the state.

In 1987, Class 1, 2, and 3 utilization of the state-wide Pool represented 35.7 percent, 6.1 percent, and 6.5 percent respectively or about 48 percent of the total Pool. However, as the cheese industry in the state grew and as more and more milk production was moved into the production of butter/powder, utilization of Pool milk changed. By 1997, the Class 1, 2, and 3 utilization of the Pool had decreased to 22.5 percent, 4.9 percent, and 5.8 percent respectively or about 33 percent of the Pool. Presently, the respective Pool utilizations of these classes are only about 14.2 percent, 4.4 percent, and 4.0 percent or about 23 percent of the total Pool.

This downward trend in Pool utilization of the highest valued milk classes translates into lower Pool prices over time. Another way to state this is that over time the Pool utilization of the manufacturing classes of 4a and 4b, which provide the lowest value to the Pool, has increased and is becoming a larger portion of the overall Pool. Furthermore, as more and more milk is produced, it appears that the increased production will continue to be used primarily in Class 4a (butter/powder). In essence, it appears likely that the current decline of Class 1, 2, 3, and possible 4b utilization coupled with increasing Class 4a utilization will continue to decrease the Pool price that producers receive, even if the prices remained at their current levels.

Additionally, if the utilization of the highest valued milk in the Pool decreases significantly, the California dairy producers would be more dependent upon the lowest class prices (i.e. for milk used in butter, powder and hard cheese). These prices are generally established at levels that are necessary to clear the California market of all California milk production. These prices are becoming more volatile and sensitive to global supply/demand conditions. Whenever the global supply/demand relationship results in excess supply, then the resulting Pool price will fall to levels much lower than they do with the current influence of Class 1, 2, and 3 values. If the vast majority of California's milk production is used in Class 4a and 4b usage during a period when there is a surplus of global milk supplies, there would be little opportunity for offsetting the seriously depressed Pool prices. It would mean that California dairy producers would be "stuck" receiving the lowest value possible for their milk production. If these conditions persisted over an extended period, it would pose significant challenges to the long term viability of California dairy farmers.

PROPOSED CALIFORNIA CLASS 1 PRICE ADJUSTMENTS

Issue

On the one hand, dairy farmers are facing an incredible milk price and production cost squeeze based on increases in the cost of production, primarily due to increasing feed costs, coupled with decreasing milk prices. California dairy farmers have had to cope with an approximate $2.00/cwt. increase in milk production cost during 2007 alone, raising the production cost from approximately $15.00/cwt. to $17.00/cwt. In the first six months of 2008, the cost of production has increased approximately another $1.00/cwt. from $17.00/cwt. to $18.00/cwt.

Meanwhile milk prices have been on a downward slide. In the first ten months of 2008, the overbase prices have dropped approximately $2.00/cwt. Since the beginning of 2008, the decreasing margin between the overbase price and the Department‘s published cost of production data has become negative. To help the dairy farmers address this increasing troublesome price/cost squeeze, producer representatives have proposed the temporary increase in the Class 1 price to provide producers with some relief as they adjust their operations in response to the lower milk prices and higher operating costs.

On the other hand, California milk supplies are in excess of what can be processed in California. Surplus California milk production is supplying a fluid processor in an out-of-state location at prices substantially below the California Class 1 minimum price, which enables the out-of-state processor to successfully compete in the California fluid market. California does not have the authority to regulate the price of either unprocessed milk from the farm or finished fluid products that are imported into the state. Increasing California’s Class 1 price provides added economic incentive for more milk to be imported as a replacement for California products. Both the federal government and the State of Nevada recently adopted pricing regulations that decrease the Class I prices in federal orders and Nevada. Both consumption and sales of Class 1 products are flat or declining in California.

Summary/Impact of Proposals

The Alliance, WUD, and CDWA proposed temporarily increasing the Class 1 price by $1.01/cwt. for a period of six months. This proposal, together with their proposed Class 2 and 3 price increases, would have an estimated combined Pool price increase of $0.24/cwt. The specific construct of the formula changes and price impact estimates can be found in this Panel Report in the “Summary of Proposals” section and Table 1.

The Institute proposed a permanent decrease in the Class 1 price of $1.35/cwt. This proposal, together with their proposed Class 2 and 3 price decreases, would have an estimated combined Pool price decrease of $0.25/cwt. The specific construct of the formula changes and price impact estimates can be found in the “Summary of Proposals” section and Table 1.

Discussion

Producer organizations testified that the financial strain upon producers has caused negative operating margins on some producers. Although feed costs have tempered slightly in the last

few months, the current levels are still above the long-term average trend of the last number of years. Producers also testified about the negative impact of the higher costs relating to waste management, environmental regulations, higher diesel and gas prices, and the increased costs associated with tighter credit conditions related to their operating loans.

Department data reflect that milk prices are decreasing, cost of production is increasing, and the cost of feed has been increasing over the past few years, especially since the beginning of 2008. Analysis shows there is financial pressure facing dairy producers and there is the distinct possibility that this situation may continue in the near future. The financial situation and outlook of all stakeholders in the industry is important because a healthy California dairy industry that promotes the needs of all stakeholders is ideal. Furthermore, processors also acknowledged in their testimony the challenging extent of the financial circumstances facing producers.

Many witnesses expressed concern about the state's surplus milk supplies. Data show that for year-to-date 2008, milk production has increased over 2007. Although one producer group testified that base production plans have brought the state's milk supply under control, the fact that additional milk supplies have been continually shipped out-of-state for processing, sent to calf ranches, and even left on the ranch indicates that the surplus situation continues to be problematic. Any price increase would send a signal for additional milk production that would not be effectively processed in California and would exacerbate current conditions further.

Producer groups recognized that some Class 1 sales could be lost as a result of their proposed temporary price increase, although no analysis or research on such lost sales was performed. Despite California's growing population, data show that California's per capita fluid milk consumption has been steadily decreasing, while the per capita consumption in the rest of the country has been constant. Any lost sales would further decline the state's fluid milk sales trend.

Processors testified that Class 1 sales have been lost already to out-of-state processors due to the competitive advantage in raw product prices that out-of-state processors enjoy relative to California processors. Processor witnesses stated that fluid sales are normally won or lost based on a few hundredths of a cent per gallon. Sales are difficult to regain once lost, as it is easier to maintain sales contracts once made. Because of lost sales, California processors testified they had idle processing capacity available that could be used if their sales were to increase. Further, multi-state processors, with plants both inside and outside of California, testified that their California operations are not as competitive as their out-of-state facilities. These conditions provide economic incentives to expand at the expense of their California operations.

At a time when fluid milk sales are flat and the state has a surplus milk supply, an increase in Class 1 prices, even on a temporary basis, would intensify this situation further and worsen the long-term economic prospects for producers. As sales are lost, additional milk supplies would need to find a processing "home" out-of-state or be processed in the lower valued classes. This shift in utilization would cause the blend price to decrease and result in a loss of future income. In essence, a temporary Class 1 price increase would be a trade off between temporary increased revenue now in exchange for a possible permanent reduction in future revenue.

Processors testified that California's competitive position has changed due to the price formula changes in surrounding states. All the class prices in federal orders were decreased effective October 1, 2008; with the Federal Order Class I price decrease varying between $0.27/cwt. (when driven by butter/powder) to $0.35/cwt. (when driven by cheese/whey). Recently, cheese/whey values have driven the fluid milk price formulas in both the California and federal orders systems, and are expected to continue to drive those fluid milk class prices. Based on the current commodity prices that determine class prices and the expectation that the NFDM price will likely remain at low levels, it appears that the cheese/whey values will likely continue to drive the fluid milk prices in the near future.

In addition, the Nevada Dairy Commission reduced their Northern Nevada Class I price effective August 2008 so that instead of being equal to the Northern California Class 1 price, it is now $1.00/cwt. lower. Based on these changes, the relative Federal Order Class I Price will be expected to be about $0.35/cwt. lower than the California Class 1 price and the relative Northern Nevada price will be $1.00/cwt. lower. Therefore, California's competitive advantage will deteriorate in the absence of any price changes in the current California formula.

The immediate effect of these lower milk prices in surrounding states is a decrease in competitiveness for California processors, which will likely lead to: further lost sales; additional idle processing capacity; and additional reductions in the California Class 1 utilization of the Pool. Coupled with the lower Class 4a price and increased Pool utilization of Class 4a, it is likely the blend price will continue to decline as well.

As a result of the December 2006 Class 1 hearing, the Class 1 formula was adjusted effective February 2007 to include a whey factor in order to track better with the Federal Order Class I formula. Therefore, in order to compare the California Class 1 price with those in surrounding states, the Panel compared the average of the historic announced prices between February 2007 and September 2008 (prior to the recent federal order change). The average federal order prices were then subtracted from the average California prices and the differences are as follows:

- The Northern California Class 1 price was $0.10/cwt. **lower** than Oregon
- The Northern California Class 1 price was $0.10/cwt. **higher** than Northern Nevada
- The Southern California Class 1 price was $0.28/cwt. **lower** than Arizona
- The Southern California Class 1 price was $0.67/cwt. **higher** than Southern Nevada

These differences show that on average when comparing the class prices prior to the federal order changes; the California price is slightly less than the Oregon and Arizona prices and more than the Northern Nevada and Southern Nevada prices. A $0.35/cwt. decrease in the California Class 1 price would mathematically restore California's previous Class 1 alignment with surrounding states. However, given the current economic conditions facing the California dairy industry, the Panel concurs with the testimony from processor witnesses that the previous price alignment would not be appropriate. A larger decrease in the Class 1 price is warranted and would result in a more appropriate price alignment with the neighboring states in today's economic climate.

Some producer representatives would argue that California's Class 1 price must be aligned so that they are roughly equal to the weighted average of the neighboring states to be in

accordance with Section 62062.1 of the Food and Agricultural Code (Code). This view is based on a rather narrow interpretation of Section 62062.1 and would require that no consideration be made of the other policy requirements that are mandated in the Code. A more inclusive and thorough review of all relevant Code sections at this time warrants establishing the California Class 1 price at price levels that are lower than the mathematical average of the surrounding states.

There was significant testimony regarding the competitive disadvantage California processors procuring California milk currently are experiencing. The testimony revolves around the manner in which processors can procure milk that circumvents minimum pricing. For example, there currently is an out-of-state fluid processor that is procuring California milk and selling their finished product in California. This processor enjoys a raw product cost advantage because California milk shipped out-of-state is not subject to minimum prices. There are also out-of-state milk supplies that are shipped into California fluid processing plants that enjoy a raw product cost advantage because these out-of-state milk shipments are not subject to minimum price regulations. Moreover, producer-distributors both in and outside of California continue to have cost advantages over the conventional dairy processors that have enabled them to capture greater market shares. Together with the concern of surplus milk in the state, processors argued that prices should be lowered in order to reduce these competitive inequities in the marketplace.

The Panel considered the economic incentive for an out-of-state producer to ship milk into California fluid milk plants. If the agreed upon price is greater than the price the producer would have received in his or her own state plus the cost of the haul, then an out-of-state producer would be financially better off to ship milk into California. The California processor would be better off if the agreed price was lower than the California minimum Class 1 price. Increasing the California Class 1 price, increases the incentive for more milk supplies outside California to take advantage of the opportunity. Data show that out-of-state milk is continually shipped into California Class 1 plants.

The need to find a home for one's milk in the face of a surplus milk situation, provides ample incentive for California milk to be shipped to a processing plant out-of-state. The incentive under this scenario is the difference between the California Class 1 and the overbase (blend) prices. In a Pool system, a fluid processor must pay the Class 1 price for procured milk, but many producers receive the overbase price for their milk, regardless of how the milk is utilized. When the difference between the Class 1 and the Pool overbase price is sufficiently large, it is advantageous for both the California producer and the out-of-state processor. If the agreed upon price under this scenario provides the producer with a price above the overbase price plus the cost of the haul and provides the processor with a price below the Class 1 price plus transportation cost of finished products, then the producer receives a better price while the processor raw product costs are lower. This lower cost for the out-of-state processor becomes a raw product cost advantage over California processors. As long as the spread in prices is larger than the cost of transportation, this incentive would exist and the situation would be mutually beneficial. This situation currently exists.

When milk is procured outside of minimum pricing, California processors experience a competitive disadvantage compared to out-of-state processors due to differing raw product costs, which results in lost Class 1 sales. The adverse effect of these scenarios for California producers is less procured milk going into California Class 1 plants, which then lowers the overbase price and California plant capacity becomes idle at a time of surplus milk

production. Ultimately, these scenarios will likely cause additional California production to move into Class 4a utilization, which is on average the lowest value of milk, exerting further downward pressure on the overbase price.

Analysis shows the price difference between the Class 4a and 4b prices is one factor that is strongly related to the Class 1 and overbase price spread. As the difference between the Class 4a and 4b price widens, the Class 1 and overbase price spread increases and vice versa. The Class 1 price is determined using the "higher of" value of either butter/powder or cheese/whey. When the Class 4b (cheese/whey) price is relatively high and "sets" the Class 1 price at a relatively high level and when the Class 4a price is relatively low and drives down the overbase price, then the spread between the Class 1 and overbase prices increases. Volatility of class prices will also influence the Class 1 and overbase price spread.

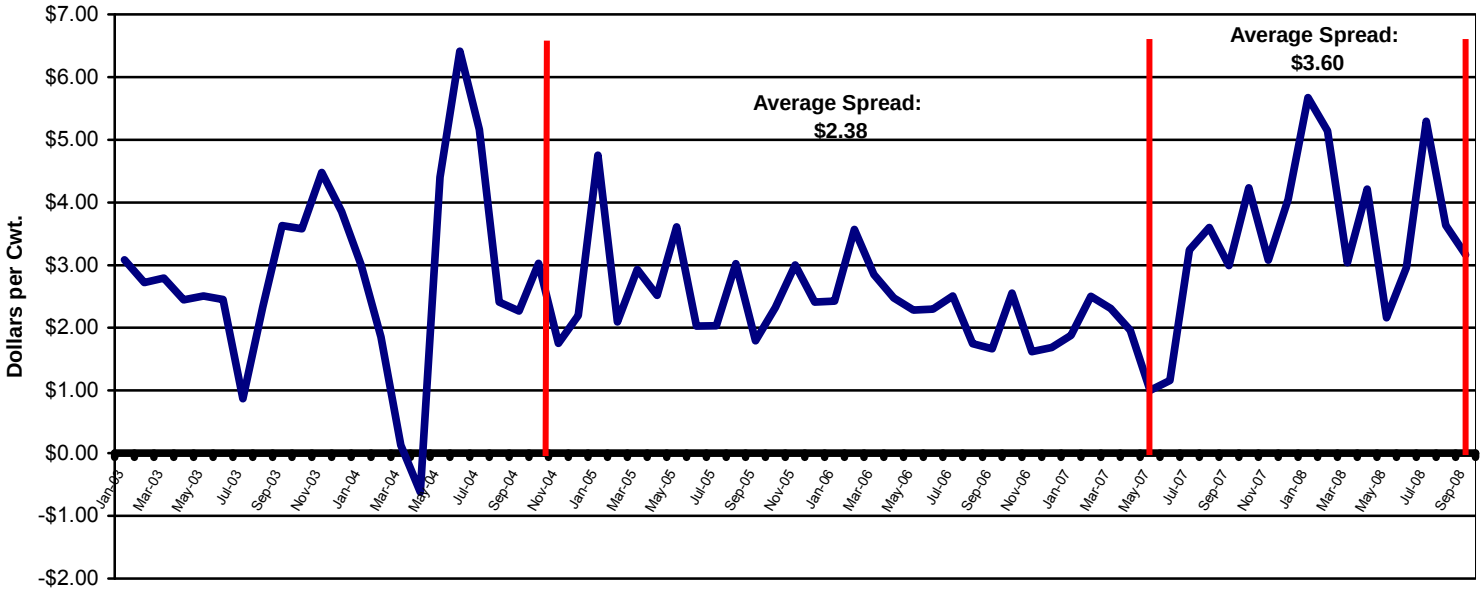
The Department examined the spread between the Class 1 price and the overbase price and found it has in fact been increasing. From the beginning of 2003 to the middle of 2007, the spread was in the mid-$2.00/cwt. range; however, in the middle of 2007 to the present, there has been a marked upward movement in the spread to the mid- to upper-$3.00/cwt. range. Since the spread has increased, it appears the competitive position of California processors compared to out-of-state processors, relative to raw product costs, has deteriorated.

In light of the state's surplus milk supply, the likelihood of lost Class 1 sales at a time of decreasing per capita consumption, and the adverse effects of probable decreased overbase prices in the future; it is not appropriate to increase the Class 1 price, even temporarily. Because of the deteriorating competitive situation California processors face against out-of-state processors and the out-of-state milk that is shipped into California fluid milk plants due to a relatively high Class 1 price, the Class 1 price should be decreased, which will also decrease the spread between the Class 1 price and overbase price.

In order to determine the adequate level of a Class 1 price decrease, the Department reviewed the monthly Class 1 and overbase price spread shown in Figure 1. Prior to fall 2004, the spread is quite variable and erratic. However, between November 2004 and May 2007, there appears to be a period of lesser variation and relative stability to use as a baseline for comparison to the period after May 2007. A visual review of Figure 1 shows that around May 2007 there appears to be structural change in the relationship that caused the spread to increase significantly.

According to Figure 1, the average values in the spread during the two time periods in question are $2.38/cwt. and $3.60/cwt. respectively. Since the current Class 4a price is relatively lower than the Class 4b price and this is expected to continue, the Panel anticipates that the Class 1 and overbase price spread will continue at its elevated level in the future barring any changes. Therefore, in order to regain the previous competitive level that California had prior to the increase in the Class 1 and overbase spread since May 2007, the spread must be decreased so that it returns to an average level of about $2.38. The Panel recognizes that the spread can not be entirely eliminated, but this recommended change will restore the competitive position that existed previously.

Figure 1 - Historic Price Spread
California Class 1 Price Less the Overbase Price
January 2003 - August 2008



Source of Data: CDFA

In order to validate the appropriateness of a decrease in the Class 1 and overbase price spread back to an average level of $2.38, the Department analyzed a few concerns that could possibly arise due to this recommended change. To achieve a decrease in the spread, the Department examined the appropriate Class 1 price decrease in coordination with the Panel's recommended decrease in the Class 2 and 3 prices in order to jointly achieve the desired level.

The Panel also examined the possibility of the Northern California Class 1 price dropping below the Southern California Class 2 price (these are the lowest Class 1 and highest Class 2 prices). The analysis shows that in only 1 month the estimated Class 1 price may drop below the estimated Class 2 price. If this were to occur for an extended period of time or regularly due to the lags associated with the Class 1 and 2 formulas, this would raise serious concerns. Since this is expected to happen on a rare basis, the "one-time" possibility is much more tolerable. Historically, the Class 1 price was less than the Class 2 price twice in early 2000 in California and twice in surrounding federal order states in 2004.

In addition, a review of the Class I and blend price spreads in surrounding states compared to the California Class 1 and overbase price spread shows the California price spread has always been greater in every year back to 2000. As a point of reference, the average spread over the last few years from January 2005 to August 2008 is $2.82, $1.95, $1.94, and $0.38 respectively for California, Oregon, Arizona, and Southern Nevada. In essence, this shows that the competitive disadvantage of milk crossing state lines in order to take advantage of the spread is greater in California than its surrounding states.

The Panel has concluded that after the above review, that it is necessary and appropriate to lower the Class 1 price. This action will help prevent, or at the very least, limit some of the

negative consequences impacting the California dairy industry. These issues include the frequency of surplus milk supplies in the state, the potential loss of Class 1 sales, the negative trend in per capita consumption, the deteriorating competitive advantage of California fluid plants, and the further increase in the Pool utilization of lower valued class milk.

Panel Recommendation

The Panel recommends the following:

- Deny the proposal to temporarily increase the Class 1 price.
- Change the Class 1 formula Butter Adjuster from $0.1180 to $0.1315.
- Change the Class 1 formula CRP Adjuster from $0.147 to -$0.870.

PROPOSED CALIFORNIA CLASS 2 AND 3 PRICE ADJUSTMENTS

Issue

Similar to Class 1, producers and processors sought adjustments to Class 2 and 3 prices. In response to high feed costs and reduced milk prices, the petitioners proposed a temporary price increase on Classes 2 and 3. On the other hand, processor witnesses sought decreases of these same class prices on the basis of the reduced competitiveness of California products relative to reduced federal order prices.

Summary/Impact of Proposals

More specifically, the Alliance, WUD and CDWA petitioned to temporarily increase the Class 2 and 3 prices by $1.01/cwt. This increase was requested for a period of 6 months, and combined with their proposed Class 1 increase would add $0.24/cwt. to the Pool price. The Institute proposed a permanent decrease of Class 2 and 3 prices of $0.26/cwt. and $0.27/cwt. for Northern and Southern California, respectively. This proposed change, along with their proposed Class 1 change, would result in a Pool price decrease to the order of $0.25/cwt. The proposed formula changes and impacts are detailed in the section “Summary of Proposals” and in Table 1.

Discussion

As mentioned in the “Class 1 Price Adjustment” section, producer organizations have been clear about the financial pressure currently affecting dairy producers. The Panel recognizes, based on Departmental data and analyses, that the overbase price is decreasing while the cost of production is increasing, thus reducing net income and possibly creating negative operating margins.

Processors argued, and producers recognized, that some Class 2 or 3 sales could be lost as a result of a price increase, even if temporary. Any lost sales could have serious negative long term impacts for the industry as a whole. Processors testified that in some cases there was plant capacity to process more milk into Class 2 and 3 products, but that the sales were not there because the prices were not competitive. Department data does reflect that although yogurt production has grown in California due mainly to increased demand, U.S. production has grown at twice the rate. Increasing prices would just exacerbate this situation and lessen the competitiveness of California plants.

Losing any sales in these higher valued classes of milk would contribute to lower Pool utilization percentages, thus lowering the Pool price producers receive. Utilization of Class 2 and 3 slowly keeps shrinking, from 6.1 percent and 6.5 percent 20 years ago to 4.4 percent and 4.0 percent currently. Even if the increased prices would provide producers with temporary relief, in the long run these lost sales could have a serious negative impact by further depressing blended Pool prices.

These potential Class 2 and 3 sales losses were documented by processors’ testimony. According to the Institute, not only would these losses occur if there is a price increase, they would also occur if no change in the Class 2 and 3 formulas are made. The Institute testified that a key issue is the competitive disadvantage facing California processors that existed

prior to the reductions in federal order Class II prices. The witnesses testified that this competitive disadvantage was further magnified by the recent decreases in federal order prices. By increasing manufacturing cost allowances in federal order pricing formulas, USDA lowered the raw product prices in contiguous neighboring states, leaving California processors with a further deteriorated competitive position. They testified that "failure to keep pace on pricing will lead to reduced sales of California Class 2 and 3 products as customers move to procure product from suppliers in nearby states."

The federal order formula changes resulted in a reduction of federal order Class II prices by approximately $0.27/cwt. (more specifically -$0.0484/lb. for fat and -$0.0107/lb. for solids not fat). This change alters the relationship between California and contiguous states as raw product costs in neighboring states decrease relative to California costs. For example, Department analysis shows that if the new federal order formula and the current California formula had been in effect for the last five years, Southern California processors would have lost a $0.3¢ advantage over Arizona processors for the raw product cost of a quart of yogurt. Table 2 below shows these differences in raw product cost for yogurt and ice cream.

Table 2: Estimated Difference in Raw Product Costs for Ice Cream and Yogurt,[1] California Costs less Costs in Contiguous States, October 2003 to September 2008

- When a price is a "minus," plants in California have a price advantage
- When a price is a "plus," plants in contiguous states have a price advantage

	Southern California less: *Phoenix, AZ*		**Northern California less:** *Medford, OR*	
	Yogurt (¢/quart)	**Ice cream** (¢/½-gallon)	**Yogurt** (¢/quart)	**Ice cream** (¢/½-gallon)
Current Formulas[2]				
2003-2004	-0.6¢	-3.7¢	-0.7¢	-2.9¢
2004-2005	-0.7¢	-1.7¢	-0.7¢	-0.8¢
2005-2006	-0.2¢	+0.7¢	-0.2¢	+1.6¢
2006-2007	-5.1¢	-6.8¢	-4.4¢	-4.7¢
2007-2008	+0.3¢	-1.1¢	+0.7¢	+0.5¢
5 year average	-1.2¢	-2.5¢	-1.0¢	-1.3¢
Historic prices				
2003-2004	-0.8¢	-4.3¢	-0.8¢	-3.4¢
2004-2005	-0.8¢	-2.5¢	-0.8¢	-1.5¢
2005-2006	-0.4¢	-0.5¢	-0.4¢	+0.4¢
2006-2007	-5.3¢	-7.8¢	-4.6¢	-5.7¢
2007-2008	+0.1¢	-2.3¢	+1.1¢	0.0¢
5 year average	-1.5¢	-3.5¢	-1.1¢	-2.1¢

[1] Assumes Yogurt is 1% fat, 10% SNF, 2.1625 lb/quart; Ice Cream is 10% fat, 10% SNF, 2.25 lb/½ gallon

[2] Uses current California and Federal Order pricing formulas, assuming they had been in place since October 2003.

Dean Foods testified that Class 2 and 3 products can move great distances and any price increase would force them to look at buying their raw milk in another state, or process and

package the products out of California and ship it to California, which would further decrease Class 2 and 3 Pool utilization. They added that decreasing prices could encourage increased production in these classes, thus helping current surplus milk supply issues in the state. On Class 3, Nestle testified that any increase in the cost of milk would encourage frozen product manufacturing to move out of California. Moreover, the Nestle witness argued that their company would not be able to pass the price increase on to consumers as an option to compensate for increased costs. Following a research project Nestle commissioned in 2005, they discovered that "increases in premium packaged ice cream prices of eight percent across the category result in up to a 9.8 percent decrease in sales volume." And "when consumers are not buying ice cream, 75 percent of the time they are spending those potential dairy dollars on non-dairy dessert items."

Kraft also testified to the competitiveness issue and its potential negative impacts. More specifically, their concern focused on the sales of cottage cheese and sour cream (Class 2). They testified that any price increase would give an advantage to out-of-state competitors, who already have growing market shares in sour cream and cottage cheese. These lost sales to out-of-state manufacturers would further erode Class 2 utilization and exacerbate the milk surplus issues.

Reconstitution is another important consideration when examining Class 2 and 3 pricing formulas. If the component prices for unprocessed milk are significantly higher than the prices for NFDM or butter, an incentive is created for processors to incorporate basic dairy commodities (NFDM, butter) and reconstitute them (in place of unprocessed milk) to manufacture Class 2 and 3 products. More specifically, a changed relationship between Class 2 and 3 component prices and Class 4a could encourage the use of finished Class 4a products instead of condensed milk and cream to make products like yogurt or ice cream. This, again, would increase Pool utilization of lower valued products, further depressing the overbase price.

The Panel analyzed the current potential for reconstitution and found that for September 2008, if the Class 2 SNF price had been increased by the same magnitude as proposed by Alliance *et al.*, there would have been an incentive to use nonfat dry milk in Class 2 products. Considering NFDM prices are currently approaching the support price, increasing Class 2 and 3 product prices creates the potential for reconstitution.

Dean Foods testified that there are options to make Class 2 and 3 products with little to no raw milk. Nestle explicitly argued that they have the ability to substitute NFDM for condensed milk and other sources of fat for cream. That choice depends on whichever price is more advantageous. More worrisome is the strategy of using non-dairy ingredients to make Class 2 or 3 products. Nestle testified that they currently replace butterfat with vegetable fats for their ice cream in many countries around the world. Thus, increasing the butterfat price would add to the risk of non-dairy substitution.

Finally, based on the current conditions of the dairy industry cited in the "Current Economic Conditions Facing the California Dairy Industry" section of this Report, it is not appropriate to increase any minimum Class prices at this time. California currently does not process all the milk it produces and raising prices would send the wrong signal in this surplus milk situation. Year-to-date 2008 milk production is above 2007 levels, showing that the oversupply condition still exists despite production caps put in place by some cooperatives and proprietary plants earlier this year.

Given the oversupply situation in the state, increasing the Class 2 and 3 prices is not appropriate. Before the federal order changes, Class 2 sales were declining and Class 3 was flat. With the lower Class II prices in federal orders, California's competitiveness has worsened relative to contiguous states. In order to address the federal order changes to maintain the previous price relationships with contiguous states and avoid further declines of Class 2 and 3 sales and utilization, it is necessary to decrease those class prices. Therefore, a reduction in California prices of the same magnitude as federal order changes would at least restore the competitive position of California products prior to the reduction in federal order prices. The Institute proposed differentials would achieve this goal. The Panel has modified those proposed differentials slightly as statutes only allow, in the case of Consolidated Hearings, the modifications of Class prices in different marketing areas in two ways: by changing them by the same amount, or by changing them to the same value.

Panel Recommendation

The Panel recommends the following:

- Deny the proposal to increase the Class 2 and 3 prices.
- Change the Southern California Class 2 and 3 fat differentials from $0.0393 to $0.00.
- Change the Northern California Class 2 and 3 fat differentials from $0.0370 to $0.00.
- Change the Southern California Class 2 SNF differential from $0.0901 to $0.0757.
- Change the Northern California Class 2 SNF differential from $0.0643 to $0.0490.
- Change the Southern and Northern California Class 3 SNF differential from $0.0586 to $0.0433.

This Hearing Panel Report has been prepared and submitted by:

_____	_____
David Ikari, Branch Chief	Candace Gates, Research Manager
_____	_____
Hyrum Eastman, Ag. Economist	Annie Pelletier, Ag. Economist

Appendix A

Summary and Price Effects of the Panel Recommendations

Panel Recommendations:

- Deny the proposed surcharge on the Class 1 price.
- Deny the proposal to temporarily increase the Class 1 price.
- Change the Class 1 formula Butter Adjuster from $0.1180 to $0.1315.
- Change the Class 1 formula CRP Adjuster from $0.147 to -$0.870.
- Deny the proposal to temporarily increase the Class 2 and 3 prices.
- Change the Southern California Class 2 and 3 fat differentials from $0.0393 to $0.00.
- Change the Northern California Class 2 and 3 fat differentials from $0.0370 to $0.00.
- Change the Southern California Class 2 SNF differential from $0.0901 to $0.0757.
- Change the Northern California Class 2 SNF differential from $0.0643 to $0.0490.
- Change the Southern and Northern California Class 3 SNF differential from $0.0586 to $0.0433.

Price Effects of Panel Recommendations

Had the Panel recommendations been in effect from October 2003 to September 2008, the five-year average impact would have been:

- A Class 1 price decrease of $1.017/cwt.;
- A Class 2 (Northern and Southern California) price decrease of $0.263/cwt.;
- A Class 3 (Northern California) price decrease of $0.263/cwt.;
- A Class 3 (Southern California) price decrease of $0.271/cwt.;
- A decrease of $0.192/cwt. for California Pool prices.

Had the Panel recommendations been in effect for the 12-month period October 2007-September 2008, the average annual impact would have been:

- A Class 1 price decrease of $1.017/cwt.;
- A Class 2 (Northern and Southern California) price decrease of $0.263/cwt.;
- A Class 3 (Northern California) price decrease of $0.263/cwt.;
- A Class 3 (Southern California) price decrease of $0.271/cwt.;
- A decrease of $0.184/cwt. for California Pool prices.

Appendix B

SUMMARY OF TESTIMONY AND POST-HEARING BRIEFS

ALLIANCE OF WESTERN MILK PRODUCERS, William Van Dam

Testimony

- "[We] live in interesting times":
  - Corn from $2/bushel to high of $5.20 to low of $3.80 now
  - Oil from high of $147/ barrel to $65 yesterday
  - Congress's ethanol mandate: 32 percent this year's corn crop; 40 percent 2015's corn crop
- Prices and cost up for very different and unrelated reasons
- World prices jumped:
  - weather in Oceania,
  - growing demand for dairy product (particularly Asia)
  - weak dollar
- Prices now falling:
  - NFDM high of $1.33 per pound to $0.91 and still dropping, Class 4a price down from $15.51/cwt. to $12.87
  - Cheese is only $0.0275 above yearly low, Class 4b price down from $16.63/cwt. to $14.97
  - Prices in Europe and Oceania have declined so no protection by European purchases
- Cost increase due to increasing feed costs, a by-product of ethanol mandate with displacement by corn of other feed crops, "the battle for acres"

Post-Hearing Brief

- President-Elect Obama supports congress's ethanol mandate
- Short-term price increases should not affect competitive position of California processors
- While it is unfortunate that some California producers do not have a home, the 98 percent that do need a price increase

WESTERN UNITED DAIRYMEN, Tiffany LaMendola

Testimony

- Neutral on MPC proposal, but consideration needs to be given both:
  - to the increasing cost of allowances and credits
  - to the fact that most costs are returned to producers serving market
- Oppose Institute proposal
- Need because of milk price / production cost squeeze
  - Transition to dramatically lower milk prices with sustained production costs at new, historically high levels
  - Expect cyclical nature of milk prices, not yet adjust to concurrent record high production costs
  - Earlier, cost increases were somewhat offset by higher milk prices, as global demand for U.S. dairy products soared
  - Both feed and costly environmental regulations

- Producer margins are shrinking with price less cost
  - o -$2.60/cwt. October,
  - o -$3.40/cwt. November,
  - o December worse
- Milk prices, which have already started a precipitous drop, may register further declines
  - -$5.40/cwt. from the high in November 2007
  - Current indicators suggest further price weakening throughout 2009.
- Feed costs have continued to soar:
  - Adjusting feed rations and contracting feed less effective in lowering costs, all primary feed prices are high
  - Even with declines, costs are well above previous years
  - Very few, if any, producers have contracted feed at desirable prices
  - Feed was 51 percent of total cost in 2003; increased to 60 percent in second quarter of 2008
  - Corn from $124/ton up to $310 down to $254, with current contacts at $240 to $250/ton
  - Alfalfa from $159/ton up to $253
- Other costs increasing:
  - Central Valley Waste Discharge Requirement, new monitoring and reporting costs
  - Production limits:
    - o Fees for excess milk
    - o Limits economies of scale

Post-Hearing Brief

- Short-term price increases should not affect competitive position of California processors
- Short-term price increases should help transition to dramatically lower milk prices with sustained production costs at new, historically high levels
- Permanent price decreases would make an orderly transition a potential disaster

CALIFORNIA DAIRY WOMEN ASSOCIATION, Linda Lopes

Testimony

- Oppose Institute proposal
- Need because of high production costs and falling milk prices:
  - Sky-high input costs
  - Milk brokers
  - Credit crunch making it challenging to obtaining capital
  - A 40 percent increase in costs with a $0.71/cwt. price decrease
- Costs are still high:
  - Feed costs up 40 percent
    - o Today, feed costs are dropping but some feeds were contracted earlier in the year
  - Fuel prices up 30 percent
  - Many vendors adding fuel surcharges
  - Cooperatives have mandatory production caps with assessments
  - Higher input costs require increases in credit lines, resulting in higher bank payments
  - Increased costs to address environmental issues
  - Paying more for water, fertilizers and seed
- Milk price is dropping daily

- Markets without oversight fail:
  - With housing market and melamine contaminated milk, the respective prices fell to the bottom and customers were lost
  - Without proper oversight, this could happen to California dairy industry if minimum prices do not cover costs

DAIRY INSTITUTE OF CALIFORNIA, William Schiek

Testimony

- Propose permanent decrease of Class 1 price $1.35/cwt., decrease Class 2 and 3 prices $0.26 to $0.27/cwt.
- Oppose MPC proposal
- Oppose Alliance *et al*. proposal
- Legislature requires Secretary to consider specific directives and to consider all relevant economic factors, including:
  - Prices in surrounding states
  - Relative prices among the five California classes, and
  - Current economic conditions
- Prices should not be determined by milk production costs alone, but by supply and demand in the marketplace
- Class 1, 2 and 3 prices must be reduced because they no longer conform to the specific directives and the relevant economic factors
- In California, milk production has been increasing faster than has dairy plant capacity:
  - Milk was dumped
  - Fed to calves
  - Shipped out-of-state to California plants' competitors at a discount
  - Some dairymen without a home
- Producers facing challenging times
  - Extreme volatility of milk prices and many input costs
  - Input costs fallen by over a third from peak, still higher than their historic norms
  - Rumors of processors not paying and producers not receiving minimum prices; if true, then it would undermine minimum pricing and result in unequal raw product cost
  - Increasing Class 4a utilization dragged down Pool prices
  - Both producers and manufacturers are experiencing the challenges of operating in this dynamic environment
- Pricing policy should not repeat past federal follies that resulted in low product prices and surplus production:
  - Milk price support program excesses of the early 1980s
  - Supplemental assistance programs for grain farmers in the middle to late 1990s
- Adequate demand for California-produced dairy products is unlikely to materialize unless the state's regulated milk prices are lowered
- Any loss [increase] of commercial sales, no matter how small in terms of the state's total, will worsen [lessen] the existing problem and put more [fewer] dairy families at risk
- Class 1 sales were down slightly in 2007 and flat in 2008 to date, per capita consumption continues to fall
- Class 2 and 3 product production is down.
- Class 4b production is down 8.8 percent, year-to-date

- There is a growing increase in the differences both between Class 1 prices and overbase prices (Class 1 less overbase) and between the Class 1 prices and quota prices (Class 1 less quota)
  - An increase in the level of the Class 1 less overbase price, increases the incentive for California overbase milk to be marketed out-of-state with a backhaul of out-of-state milk coming into California Class 1 plants
    - The California milk possessed out-of-state can then be brought back into California in packaged form at heavily discounted prices
  - An increase in the level of the Class 1 less quota price, increases the competitive advantage Type 70 exempt PDs have relative to other Class 1 processors
- Compared to all of 2006, the average level of the Class 1 less overbase price has increased
  - $1.35/cwt. for the 12 months ending December 2008 (estimates for both Class 1 and overbase prices)
    - The $1.35 was the basis for the Institute's proposed Class 1 change
  - $1.60/cwt. for the 12 months ending September 2008 (estimates for overbase prices only)
  - $1.65/cwt. for the 12 months ending October 2008 (estimates for overbase prices only)
- The widening spread between Class 1 and overbase prices is not a transitory problem:
  - Class 4a prices will continue to weaken and Class 4a market share will continue to increase
  - Class 4b prices will continue to weaken and Class 4b market share will continue to decrease
- Competitive position of California processors has deteriorated due to reductions in federal order and Nevada state prices; downward adjustments to California prices required to protect Class 1, 2, and 3 sales and keep more producers from losing homes for their milk:
  - Federal Class I down $0.33/cwt.
  - Nevada Class I down $1.00/cwt. in Reno
  - Federal Class II down $0.26/cwt.
- Institute proposed $0.26 to $0.27/cwt. decrease in Classes 2 and 3 will restore prior relationship with federal order Class II prices
- Possible approaches to Class 1 price reductions:
  - $0.48/cwt. reduction based on $0.33 federal reduction plus an additional $0.15 to restore historic relationship between federal Class I prices and California Class 1 prices
  - $1.14/cwt. reduction based on California Class 1 utilization compared to regression between federal Class I utilization and prices
  - $1.35 to $1.64/cwt. reduction based on historic relationships between Class 1 prices and overbase prices
- On consideration of above, Institute proposed $1.35/cwt. reduction

Post-Hearing Brief

- Class 1, 2, and 3 prices must be reduced because they no longer conform to the specific directives and the relevant economic factors
- Adequate demand for California-produced dairy products is unlikely to materialize unless the state's regulated milk prices are lowered
- Competitive position of California packaged products has deteriorated due to reductions in federal order and Nevada state prices; downward adjustments to California prices

required to protect Class 1, 2, and 3 sales and keep more producers from losing homes for their milk
- Any price increase, even temporary, would reduce processor competitive position
- The Class 1 less overbase price difference is increasing the incentive for California overbase milk to be marketed out-of-state with a backhaul of out-of-state milk coming into California Class 1 plants
- Production is surplus to total Class 4a/4b plant capacity plus **competitive** Class 1, 2, & 3 capacity, lower prices would create more **competitive** Class 1, 2, and 3 capacity
- Cooperative caps on milk production are a sign of market failure

MILK PRODUCERS COUNCIL, Robert VandenHeuvel

Testimony
- Increase the Class 1 price sufficiently to offset 26 percent of the cost of the transportation allowances and credits
- Originally made proposal at July 1, 2008 hearing on Transportation allowances and credits; told proposal needed to be made part of Class 1 hearing, such as this one
- Oppose Institute proposal
- Transportation allowances compensate producers for the cost to haul their milk to a Class 1 plant farther away less the cost to haul their milk to a local processing plant
- Transportation subsidy system: who should bear the responsibility for funding?
  - Dairy producers have fully funded these subsidies since 1969
  - Proponents: money comes from producers and is paid pack to producers, making the transaction a wash
  - However, producers pay all the costs of delivering their raw milk to any processing plant, therefore, individual producers may be equalized regarding haul, but all producers see a reduction in Pool prices
- Consumers need to step in and fund at least part of this system:
  - Want milk products on their shelves
  - Want dairies in the Central Valley
  - Costs more to haul milk longer distances to market
  - Cost offset by transportation subsidy system
- Consumers, who are receiving a fresh farm product without having the farm nearby, should be paying for the subsidy
- July 1, 2008 hearing resulted in a roughly 26 percent increase in subsidies; proposal based on this 26 percent increase
- Negative margins for dairy producers, now and for the foreseeable future
  - Input costs, especially for feed and fuel, are well above levels seen in prior years
  - The overall milk price is weakening by the day

Post-Hearing Brief
- The transportation subsidy system should be funded in part by consumers
- Cooperative production caps, increased production costs and tighter credit will bring supply and demand back into balance
- Class 1, 2, and 3 prices are in reasonable alignment with Class I and II prices
- The Class 1/overbase price difference is a dynamic one that will change on its own over time

- Movement of bulk milk into and out of California reflects long standing contractual agreements, not market conditions

SAFEWAY INC., Randall Dei

Testimony

- Member of Institute and support their proposal
- Oppose Alliance *et al*. proposal
- Oppose MPC proposal
- Milk production exceeds plant capacity:
  - Milk shipped out of state at a discount
  - Cooperatives have placed production quotas
  - Cooperatives are not willing to invest in additional balancing plants
- Raising milk prices will increase Class 4a utilization, not Classes 1, 2, and 3
- Important to look at other factors that could lead to more disorderly milk movement:
  - USDA decreased prices by increasing make allowances
  - Class I prices were recently lowered in the state of Nevada, this will lead to more packaged milk moving into California
- If prices were increased:
  - Lower utilization in higher classes reducing Pool prices
  - Sends wrong production signal to producers risking a further imbalance of supply and demand
  - Could result in an uncompetitive position and risk out-of-state sales of California packaged product that currently benefit Pool prices

THE KROGER COMPANY, John Hitchell

Testimony

- Member of Institute and support their proposal
- Oppose Alliance *et al*. proposal
- Oppose MPC proposal
- Milk in oversupply
  - Dumped on farm
  - Cooperatives instituted supply management programs
- Federal orders reduced prices, thus altering the relationship of the California Class 1, 2, and 3 prices to prices in contiguous states
- Reductions in California Class 1, 2, and 3 prices are necessary to restore historic relationship with contiguous states
- The Institute proposal:
  - Will reestablish the historical price relationship between California and contiguous states
  - Will aid in the sales and expand the market for dairy products packaged in California.

SUPER STORE INDUSTRIES, Dennis Brimhall

Testimony

- Proposals:
  - Member of Institute and support their proposal

- Producers should make a fair return, however, with an oversupply, prices will decrease
- Class 1 price exceeds cost of production
- If producers need $0.22/cwt., then increase all class prices $0.22, not just a $1.01 increase for Classes 1, 2, and 3
- Nevada producers accepted a $1.00/cwt. Class I decrease
- Alliance *et al*. willing to give up Class 1, 2, and 3 sales, someone else's sales, processors' sales
- Packaged Class 1, 2, and 3 products imported into California every day
- Competitive prices in contiguous states justifies price decrease
- Alternatively, processors will purchase more out-of-state milk to be competitive
- Rumors of milk illegally sold below state minimums

CALIFORNIA DAIRIES, INC., Eric Erba

Testimony

- Member of Alliance and support the proposal of the Alliance *et al*.
- Neutral on MPC proposal, but would be a tremendous change in the Department's policy
- Full recovery of cost increases problematic for both producers and processors:
  - Ethanol boom
  - Weak dollar
  - International demand for grains
- Feed/grain markets more volatile and unpredictable
- Uncharted waters with astronomical increases for farm input costs, particularly feed and energy:
  - Cost of production up 33 percent
  - Alfalfa hay up 32 percent
  - Grain, mineral, and supplement prices up 69 percent
  - Corn prices up 40 percent
  - Hauling costs up 16 percent
  - USDA's milk-feed ratio down
- Cost and feed price increases realized and documented by Departmental data
- Cheaper mix of rations decreases milk production leaving profitability unchanged
- Feedlot style dairying contributed to tremendous production gains, but vulnerable to feed price increases
- Alliance *et al*. proposal not induce increased milk production:
  - At $0.24/cwt. on Pool prices, is not large
  - Major cooperatives and some proprietary processors have successfully implemented supply management
    - Since March 2008, milk production up 1 percent compared to historic 4 to 5 percent
  - Unrest in financial markets
  - Short-term to see if prices become more stable
  - Takes time and resources to set business plans into motion
- That cost relief lies ahead based on current changes is betting on future events and expected outcomes that have not yet been realized

Post-Hearing Brief

- Uncharted waters regarding farm input costs

- USDA's milk-feed ratio is a valid measure
- Cost and price increases realized and documented by Department
- While it is unfortunate that some California producers do not have a home, the 1800 that do need a price increase
- That relief lies ahead with increased sales of Class 1, 2, and 3 products is betting on future events and expected outcomes that have not yet been realized

HP HOOD LLC, Michael Newell

Testimony

- Member of Institute and support their proposal
- Oppose Alliance *et al*. proposal
- The Alliance *et al*. proposal will place an even greater demand on what is an already inadequate Class 4 processing capacity
- Class prices need a reasonable economic relationship with contiguous states:
  - Recent changes in federal prices make California prices uncompetitive
  - The Alliance *et al*. proposal would make situation worse
- Higher value classes of milk continue to make up a smaller share of the California milk Pool, the Alliance *et al*. proposal would quicken the pace of this erosion
- Hood's move to California:
  - Innovator in ESL processing
  - Serve existing West Coast ESL customers (significant portion of its production to surrounding states)
  - Growth platform for branded and private label ESL products currently served by ESL plants located in Washington, Utah and Arizona
  - Competitively price crucial to justify the capital investment that ESL processing requires

DEAN FOODS COMPANY, INC., Evan Kinser

Testimony

- Member of Institute and support their proposal
- Oppose MPC proposal (in post-haring brief)
- Oppose Alliance *et al*. proposal (in post-haring brief)
- California Class 1, 2, and 3 prices are uncompetitive with contiguous states
  - Recently reduced federal Class I and II prices
  - Recently reduced Nevada Class I prices
  - Out-of-state packaged products entering California, some made from often-unregulated California bulk milk shipped out-of-state
  - Unregulated out-of-state bulk milk utilized by California plants
  - Problem of widening gap between Class 1 and overbase prices:
    - Production increases
    - Loss of California Class 1, 2, and 3 sales
    - Expansion of lowest price Class 4a
  - New Nevada plant purchases California overbase milk, hauls it to Nevada for processing, hauls packaged products back into California:
    - For Class 1 still have a price advantage of 9¢/gallon ($1.04/cwt.)

- Decreasing Class 1, 2 and 3 prices is the only option because California has no authority to control the flow of either raw or packaged out-of-state milk
- Lowering Class 1, 2 and 3 prices will invites California processors to produce more of these products, growing California capacity at the expense of capacity in other areas of the country and will limit out-of-state cannibalistic investment that cost California dairy farmers
- California milk production is surplus to its plant capacity:
  - In any market, when supply exceeds demand, prices decrease
  - Lowering of Class 1, 2 and 3 prices could expand available plant capacity
  - Lower Class 1, 2 and 3 prices signal dairy farmers to decrease milk production and invite consumers to increase dairy product purchases
- The uncompetitive and unsustainable Class 1 prices give processors four options:
  - Buy milk out-of-state in unregulated areas
  - Process and package milk out-of-state and ship it in
  - Rationalize plants
  - Inform the Department to change the regulations

Post-Hearing Brief

- California losing Class 1, 2 and 3 sales:
  - California Class 1, 2 and 3 prices are uncompetitive with contiguous states
  - Out-of-state packed products entering California some made from often-unregulated California bulk milk shipped out-of-state

NESTLE USA, Patricia Stroup

Testimony

- Member of Institute and support their proposal
- Oppose Alliance *et al*. proposal
- California prices intrinsically deal with cost of production because California uses commodity prices in an end-product pricing formula
- Fluctuations in commodity prices reflect underlying supply and demand with supply reflecting producer costs
- Regulated milk prices not intended to guarantee producer or processor profitability
- The use of a milk-feed price ratio as evidence of producer distress is fundamentally flawed
- Increases in Class prices will encourage processing and production to move out of California
  - Shift production out of California and into manufacturing lines that we own in our federal order plants
  - Majority of our consumers do not live in California
  - With recently lowered federal prices, distinct advantage in shifting processing to our non-California plants
- Processors not able to successfully pass price increases through to consumers:
  - Premium packaged ice cream **prices up 8.0 percent**
  - Premium packaged ice cream **sales down 9.8 percent**
- Delinking Class 3 prices from Class 4a prices will encourage substituting Class 4a finished products (butter and NFDM) for Class 3 liquid milk inputs
  - Position ourselves for arbitrage opportunities

  - Butter and NFDM can be forward purchased and stored
  - Purchase lower cost ingredients from a greater distance, including imported
- Dairy products and ingredients must be competitively priced
- Consumer price matters, especially with consumer confidence at a historic low
- With insufficient plant capacity for more than a year, it would be unfortunate if even more capacity left the state because of more advantageous dairy pricing elsewhere

LAND O'LAKES, INC., James W. Gruebele

Testimony

- Oppose Alliance *et al*. proposal
- Oppose MPC proposal
- Oppose Institute proposal
- Supply and demand conditions determine dairy commodity prices
- The difference between contiguous state blend prices and California Class 1 prices provides the incentive to move out-of-state bulk milk into California
- Supply and demand conditions in California argue against class price increases
  - Lack of manufacturing capacity
  - Producers about to lose their market
  - Some milk not being picked up or shipped out of state or both
  - Rumors that some California Grade A producers are paid less than the minimum prices
- Cost of production has increased significantly, concerned about any class price reductions
- California is not an island onto itself
- Economics determine when milk will flow across state lines
- Current market environment reflects those relationships

KRAFT FOODS, Michael McCully

Testimony

- Member of Institute and support their proposal
- Oppose Alliance *et al*. proposal
- Oppose MPC proposal
- Signs of regulator failures:
  - Milk regularly transported out of the state
  - Milk dumped on the farm
  - Production grows, but processing capacity does not keep up
  - Major cooperatives institute production caps
- Input costs have risen dramatically for farmers, **and** processors, **and** consumers:
  - West producers purchase feed, while Midwest and East producers grow feed
  - Production and profitability in Midwest and East increased relative to West
- Feed (corn & soybean meal) and energy prices have declined:
  - Future uncertain but project feed prices to stabilize near current levels
  - Energy prices greater unknown, but with a global economic slowdown, likely energy prices will stay below this year's peaks
- Thus, main issue for the call of hearing has largely been mitigated

- Caution that elevated price levels have made milk-feed ratio irrelevant as a guide to farm margins
- Importance of producers hedging input costs as well as milk prices, as well as use of other risk management tools
- Rising input costs common to all livestock industry, but beef, pork, turkey, and chicken:
  - Cutting back on production
  - Taking other steps to cut costs
  - Solutions are market based and not reliant on action by the government
- In oversupplied market, sometimes lower and even negative margins are necessary to bring supply and demand into balance
- Once supply reduced, prices increase
- Class 2 (cottage cheese and sour cream):
  - Significant presence in California
  - Also distributed throughout the West and Southwest where competitor costs determined by federal Class II prices
  - Federal order prices have declined, to reestablish the prior price relationship, California needs a comparable price decrease
  - Increasing California prices creates a competitive disadvantage relative to plants in federal orders
- Not benefit California producers to decrease demand for California milk and increase demand for out-of-state milk

Post-Hearing Brief

- Daisy's market share of sour cream in California went from 14 percent in 2006 to 19 percent in 2008
- It probably costs Daisy 6¢ to 9¢ to move a 12-ounce sized dairy product from Texas to California