

**TESTIMONY FOR LAND O' LAKES, WESTERN REGION
THE STABILIZATION AND MARKETING PLANS FOR MARKET
MILK FOR THE NORTHERN AND SOUTHERN CALIFORNIA
MARKETING AREAS**

Red Lion Hotel, 1401 Arden Way, Sacramento California

May 3, 2005

Mr. Hearing Officer and Members of the Panel.

My name is James W. Gruebele, dairy industry consultant. I am testifying on behalf of Land O' Lakes Inc which handles about 14 million pounds of milk per day and has a California membership of about 249 producers. The Land O' Lakes Board members from the Western Region endorsed the testimony. The main petitioner for today's hearing is the Dairy Institute and there were a number of alternative proposals.

Dairy Institute's Proposal

The proposal by Dairy Institute would reduce the Class 1 prices in California by 88 cents per cwt. The basis for their proposal is that the Class 1 usage has been declining in California. But, that decline is mainly due to overall increases in milk production. The time series data definitely support the hypothesis that California has a comparative advantage in milk production. As a result California has become the leading milk producing state in the nation. So the percent of milk used for Class 1 declined because of significant milk production increases in California. The class 1 utilization percentages declined in many federal order markets as well. Part of the reason is that the demand for some manufacturing products, especially cheese has increased over time and more of the milk is manufactured into cheese today than ever before in most markets around the United States. This does not mean that the Class 1 milk prices are out of line with other prices. Most of the milk produced around the country has been converted from Grade B to Grade A. As a result most of the milk used for lower class uses is Grade A rather than Grade B. This is still another reason why the percent of milk used for class 1 in the pool has declined over time. Finally, the Food and Agricultural Code specifies that the reasonableness and soundness of milk prices for all classes must give consideration to the combined income from all classes of milk in relationship to the cost of producing and marketing of milk to insure an adequate and continuous supply of milk for **all purposes**.

It is our opinion that based upon the code, there is little justification for the reduction of Class 1 prices in California.

Two extension economists at the University of Wisconsin co-authored an article entitled "Cost of Producing Milk: A Comparison by State which shows costs of producing milk in various regions of the country.^{1/} Their study showed that the costs of producing milk in West Texas were slightly lower than the cost of producing milk in California. This is the only closest "neighboring market" where there was information on mailbox prices as well as the cost of producing milk. The article by the two Wisconsin economists shows that producers in Texas have lower average total costs of production than producers in California. As shown in the California Dairy Information bulletin for April 2005, the mailbox price for December 2004 in Texas is slightly higher than it is for California. These data indicate that there is little reason to reduce the Class 1 prices in California.

Alternative proposal by the Alliance of Western Milk Producers.

One major problem with the alternative proposal by the Alliance of Western Milk Producers is that it calls for a reduction in the area differential and we are opposed to such a change. The markets are different in California. The Bay Area and Southern California markets are deficit while the Central Valley and the South Valley are areas of surplus. Economic theory definitely supports the concept that prices in areas of surplus should be lower than in deficit markets. Bressler a former economist at the University of California at Berkeley in an article entitled "Pricing Raw Product in Complex Milk Markets" provides a strong case that deficit markets are different from areas of surplus.^{2/} The deficit markets are characterized by the existence of fluid milk processing plants while areas of surplus are characterized by manufacturing operations processing butter, powder and cheese and, in part, serve as a reserve supply of milk for the deficit markets when needed for fluid milk purposes. He states "These market prices and the transportation costs, then, establish geographic structures of product prices throughout the region so that the price at any point is represented by the market price less transportation costs" (emphasis added).^{3/}

The principles discussed by Bressler apply to nearly all goods and services and except for government policies the principles apply on an international basis as well. Manchester a former economist, now retired, with the US Department of Agriculture states, "But costs vary from one area to another. Corn grows better in the Corn Belt than in most other places. So it is cheaper there. Cows produce better in cooler weather than in hot. Pastures grow better in some climates than in others...He states this is why supplies are large in the Upper Midwest and tight in Florida." He goes on to say "the geographic

1/ Jesse, Ed and Bruce Jones, "Cost of Producing Milk: A Comparison by State", Marketing and Policy Briefing Paper, Paper No. 84, November 2003, p. 9.

2/Bressler, R.G., Pricing Raw Product in Complex Milk Markets, Reprinted by the Agricultural Marketing Service from Agricultural Economics Research, Vol. X. No. 4, October 1958. pp. 114-130.

3/Ibid. pp. 114-130.

structure of Class 1 milk prices must be designed to deal with these facts.”^{4/}

The basic factor that supports the different Class 1 prices are predicated on the principle of comparative advantage and the economics of location. The markets are different in California. The Bay Area and the Southern California markets are deficit, while the Central Valley and the South Valley are areas of surplus. Under sound economic principles one would expect the Class 1 milk prices to be different in these markets. Prices would be the lowest in surplus markets and highest in deficit markets. Manchester stated “The geographic structure of Class 1 prices which one would anticipate in a competitive market basis of economic location theory has these characteristics. From the major surplus area (surplus with respect to fluid needs), prices would increase to more distant markets, reflecting transportation costs and local supply and demands”^{5/} He goes on to say “The principle of comparative advantage and economics of location indicated that, in a competitive system responding to economic forces, milk for fluid use (including a reserve to meet day to day and seasonal fluctuations) would be produced near consumption centers, if it can be produced at or below the cost of milk from the base zone”^{6/} And he further states, that prices in all other markets (other than areas of surplus) would be higher by the cost of transportation from the base markets except in those markets with surpluses above their own needs.^{7/} Fallert and Buxton, two former economists in the Economic Research Service, in a 1978 study of Class 1 milk stated that in the absence of Federal or State regulation that the milk prices would be at different levels to reflect the costs of moving the milk from areas of surplus to deficit markets. As transportation costs increase, Fallert and Buxton conclude that the Class 1 differentials would increase to reflect those cost increases.^{8/}

Federal order reform developed Class 1 differentials for every county in the United States, including California. The Class 1 differential for Los Angeles County and surrounding counties would be \$2.10 per cwt but it would only be \$1.60 for the South Valley counties of Fresno, Kings and Tulare Counties. So there would be a difference of \$.50 per cwt in the Class 1 price in the Los Angeles County area and the South Valley counties. Of course, the area differential between Southern and Northern California is only \$.27 per cwt.

4/Manchester, A.C., Issues in Milk Pricing and Marketing, Economic Research Service, U.S. Department of Agriculture, Agricultural Economic Report No. 393, Washington D.C., December 1977, p. 7.

5/Manchester, A.C., Dairy Price Policy, Setting, Problems, Alternatives, U.S. Department of Agriculture, Economic Statistics and Cooperative Service, Agricultural Economic Report No. 402, 1977, p. 56.

6/Ibid. pp. 56-57

7/Ibid. p. 57.

8/Fallert, R.F., Blayney, D.P., and Miller, J.J., Dairy Background for 1990 Farm Legislation, Economic Research Service, Commodity Economics Division, U.S. Department of Agriculture, Staff Report, AGES 9020. March 1990, pp. 30-32.

Absent government regulation, the Class 1 price difference between the South Valley and Southern California would significantly exceed the current area differential of \$.27 per hundredweight. Competition among processors in the deficit market would naturally result in a price difference to account for the cost of the haul from a major surplus producing area and a deficit market, like Southern California. The same principles apply in Northern California. Competition among deficit market processors in the Bay Area market would cause the Class 1 price difference to reflect the cost of the haul from the surplus producing areas in Northern California to the deficit market in Northern California.

In any case, Land O' Lakes recommends no change in the area differential in California as a result of this hearing.

California Dairy Campaign

The CDC proposal would base California Class 1 prices on the Federal order mover. And it would reduce the area differential by 2 to 3 cents. The Federal order mover would utilize NASS prices and the price announcement would be made later than currently is the case. For example, the May Federal order Class 1 prices were announced on April 22nd and in California the May Class 1 prices were announced around April 10th. In addition, the CME prices have always been used to move Class 1 prices in California. CME prices are also used to establish Class 2, Class 3, Class 4a and Class 4b prices. It is our opinion that we should maintain the California system to move the California Class 1 price and again that we should maintain the current area differential.

Western United Dairymen

The Western United Dairymen proposal would simply reduce the area differential in California. We object to such a change.

Conclusion;

Land O' Lakes opposes the petitioner's proposal as well as all of the alternative proposals. No change is needed in the Class 1 formula in California. We support the current program. There should be no reduction in the Class 1 price and there should be no reduction in the current area differential. However, if CDFA, as a result of this hearing, does reduce the area differential between Northern and Southern California then we would propose a penny for penny adjustment in the transportation credit. The transportation credits would be adjusted only for milk moving from the South Valley to Southern California markets. Even if the current area differential were reduced as a result of this hearing LOL proposes no change in the transportation credit for moving milk plant to plant from Los Angeles county to Riverside County and for moving milk plant to plant from some Northern California counties to the Bay area because a reduction in the area differential would not affect the economics of moving milk on plant to plant basis in these locations.

That concludes my testimony.