Hearing Panel Report

Addressing the Class 1 Pricing Formula
Based On a Public Hearing Held On
May 3, 2005

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plan for Northern California (Plan) 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 Tuesday, May 3, 2005, and written post-hearing briefs.

Table of Contents

Note: During the hearing process, testimony and evidence was presented that referenced issues relating to (1) the ongoing litigation involving the 1997 amendments to the Pooling Plan and (2) interstate commerce issues. The Panel has purposely avoided consideration of and basing its decisions on these issues. Any mention of these issues is to give the reader a sense of the discussion and not to indicate that it influenced the Panel's recommendations.

Executive Summary

The Department held a Class 1 hearing during May of 2005. The Dairy Institute of California (Institute) proposed to uniformly lower Class 1 prices throughout the state, thereby decreasing producer pool prices by $0.18 per hundredweight (cwt.). The Alliance of Western Milk Producers' (Alliance) alternative proposal would raise the Northern California price by $0.42 per cwt. and the Southern California price by $0.28 per cwt.

The California Dairy Campaign (CDC) proposed changes to the California Class 1 pricing formula structure, namely changing the formula to mirror the structure of the Federal Order Class I pricing formula. With the current formulas, California Class 1 prices are released on or before the 10th of the prior month. Under a federal order Class I pricing structure Class 1 prices would be announced up to two weeks later. This delay raised a number of concerns by some witnesses. Looking at price data over five years, the current California Class 1 pricing formula is less *volatile* than pricing formulas used in the federal orders.

Western United Dairymen (WUD) argued that Northern California's $0.27 lower Class 1 price costs dairy farmers revenues that far exceed the total cost to the pool for partially financing the plant-to-plant haul of milk from Northern California to Southern California via the transportation credit system. Fluid processors testified that the current Class 1 prices made California fluid products uncompetitive in the market, strongly opposing any increase in the Class 1 price.

California's state legislature recognized that in order to accomplish its purposes and to promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that promote the intelligent and orderly marketing of market milk (Section 61802). It authorized the Secretary to determine minimum prices which are necessary due to varying factors of cost of production, health regulations, transportation, and other factors in the state (Section 61805b). While Section 62062.1 provides an important criterion, neither this Section nor any other Section should be viewed as having greater consideration or emphasis than any other statutory provision. The Panel believes that the public interests can be best served when the competing interests of producers, processors, wholesalers, distributors, retailers, and consumers are considered and reasonably balanced.

Dairy processors testified that the supply standard set forth by the legislature is that the combined revenue from all classes be sufficient to result in an adequate supply of milk for all uses. In its post hearing brief, the Alliance indicated that a more accurate measure of the adequacy of the milk supply is the national dairy commodity prices. It is the opinion of the Panel that national commodity prices are a reflection of supply/demand forces in the national dairy market. What is more relevant to the consideration is that during both the low and high commodity price periods, California's milk production has consistently increased.

While the Institute's proposed reduction of $0.88 per cwt. would improve the competitive position of California fluid milk products, it would take a larger decrease to completely restore the competitiveness of California's fluid milk products and to ensure uniform prices to handlers.

Much attention was focused upon statistical estimates that reflected a declining per capita consumption of fluid milk. After examining the issue more closely, the Panel believes that the

per capita consumption calculations submitted into the hearing record were based on incomplete or partial data.

Processor testimony and evidence presented at the hearing on the round-tripping issue raised concerns for the Panel. Round-tripping can be best described as the hauling of milk produced on a California dairy farm to a California fluid processing plant via a route that crosses the state border and then returns back into California. The Panel's analysis confirms that the existing Class 1 price level relative to the overbase price provides ample incentive to undermine California's minimum Class 1 price. The Panel determined that significant quantities of California milk supplies could benefit from round-tripping to supply the state's entire Class 1 needs. While making precise projections is difficult, the Panel believes that the $0.88 per cwt. decrease will not totally eliminate the incentive to round-trip. It does however, remove a substantial attraction to engage in round-tripping.

The Panel recommends:

- That the proposed changes in the Class 1 pricing formula to mirror the structure and operation of the federal Class I pricing structure be denied.

- That the proposal to reduce the current $0.27 per cwt. Class 1 price differential between the Northern and Southern California Marketing areas be denied.

- Decreasing the Commodity Reference Price adjuster of the Class 1 pricing formula from +0.464 to -0.416, thereby lowering the California Class 1 price by $0.88 per cwt. (equivalent to 7.6¢ per gallon of whole milk).

Introduction, Summary of Proposals and 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 Milk Stabilization and Marketing Plans for Market Milk (Plans).

The petition:

1. Dairy Institute of California

Three alternative proposals were submitted by the April 6, 2005 deadline:

2. Alliance of Western Milk Producers
3. Western United Dairymen
4. California Dairy Campaign

Table 1 outlines the effects of the proposed changes in the Class 1 pricing formula in contrast to the current pricing formula.

Table 1: Proposals Less Class and Pool Prices
Based on Current Formulas, January 2000 -- December 2004
(Prices per hundredweight)

	2000	2001	2002	2003	2004	Average
Northern California Class 1						
Institute	-0.88	-0.88	-0.88	-0.88	-0.88	-0.88
Alliance	0.42	0.42	0.42	0.42	0.42	0.42
WUD	0.18	0.18	0.18	0.18	0.18	0.18
CDC*	-0.22	0.22	-0.04	-0.25	0.42	0.03
Southern California Class 1**						
Institute	-0.88	-0.88	-0.88	-0.88	-0.88	-0.88
Alliance	0.28	0.28	0.28	0.28	0.28	0.28
WUD	0.00	0.00	0.00	0.00	0.00	0.00
CDC*	-0.24	0.20	-0.06	-0.27	0.40	0.00
Pool Prices						
Institute	-0.19	-0.18	-0.18	-0.17	-0.16	-0.18
Alliance	0.08	0.07	0.07	0.07	0.06	0.07
WUD	0.02	0.02	0.02	0.02	0.01	0.02
CDC*	-0.04	0.05	-0.01	-0.05	0.06	0.01

*The analysis reflects modifications made by CDC after the Pre-Hearing Workshop, but prior to the May 3, 2005 hearing.

**The proposals for Southern California made at the May 6th hearing are included to show the cumulative effects on the pool prices.

A total of 11 witnesses testified including the Department's witness:

*Cheryl Gilbertson — CDFA
*Dr. William Schiek – Institute
*James Tillison – Alliance
*Michael Marsh and Tiffany LaMendola - WUD

Andy Zylstra and Scott Magneson – CDC
*Ernest Yates – Dean Foods
Craig Fullmer – Safeway, Inc.
Geoffrey Vanden Heuvel – MPC
*Dr. Jim Gruebele – Land O'Lakes (LOL)
Dennis Brimhall – Super Store Industries
Sharon Hale – Crystal Cream and Butter

"*" indicates witness/organization who submitted 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.

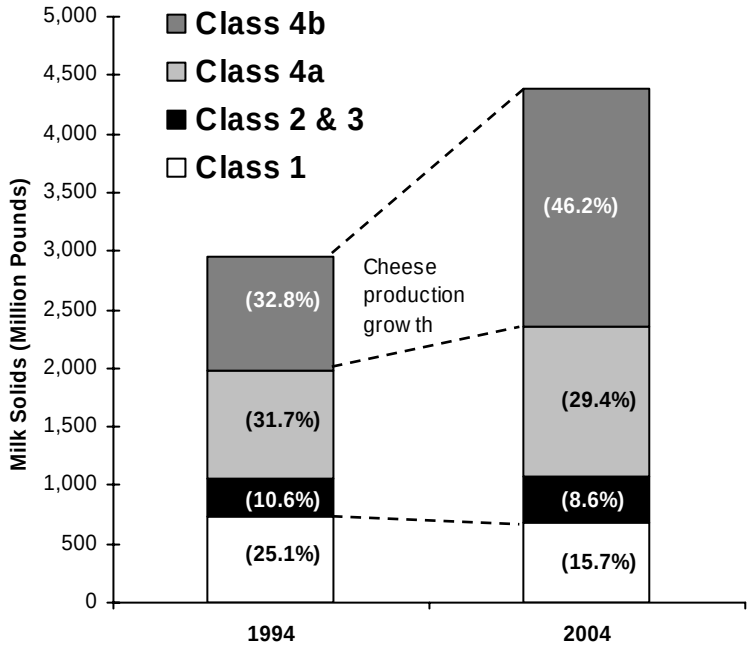
Cost of Producing Milk

- For 2004, the cost of producing milk increased in all four areas of the state when compared to the same period in 2003, with statewide average costs at $12.75 per cwt. (up $0.31 from 2003, or an average increase of 2.5%).
- Comparing costs to the same period in 2003, the North Coast and South Valley areas in 2004 had the largest increase in the average cost of producing milk, at $14.10 per cwt. (up 3.7%) and $12.53 per cwt. (up 3.4%) respectively.

Mailbox Milk Prices

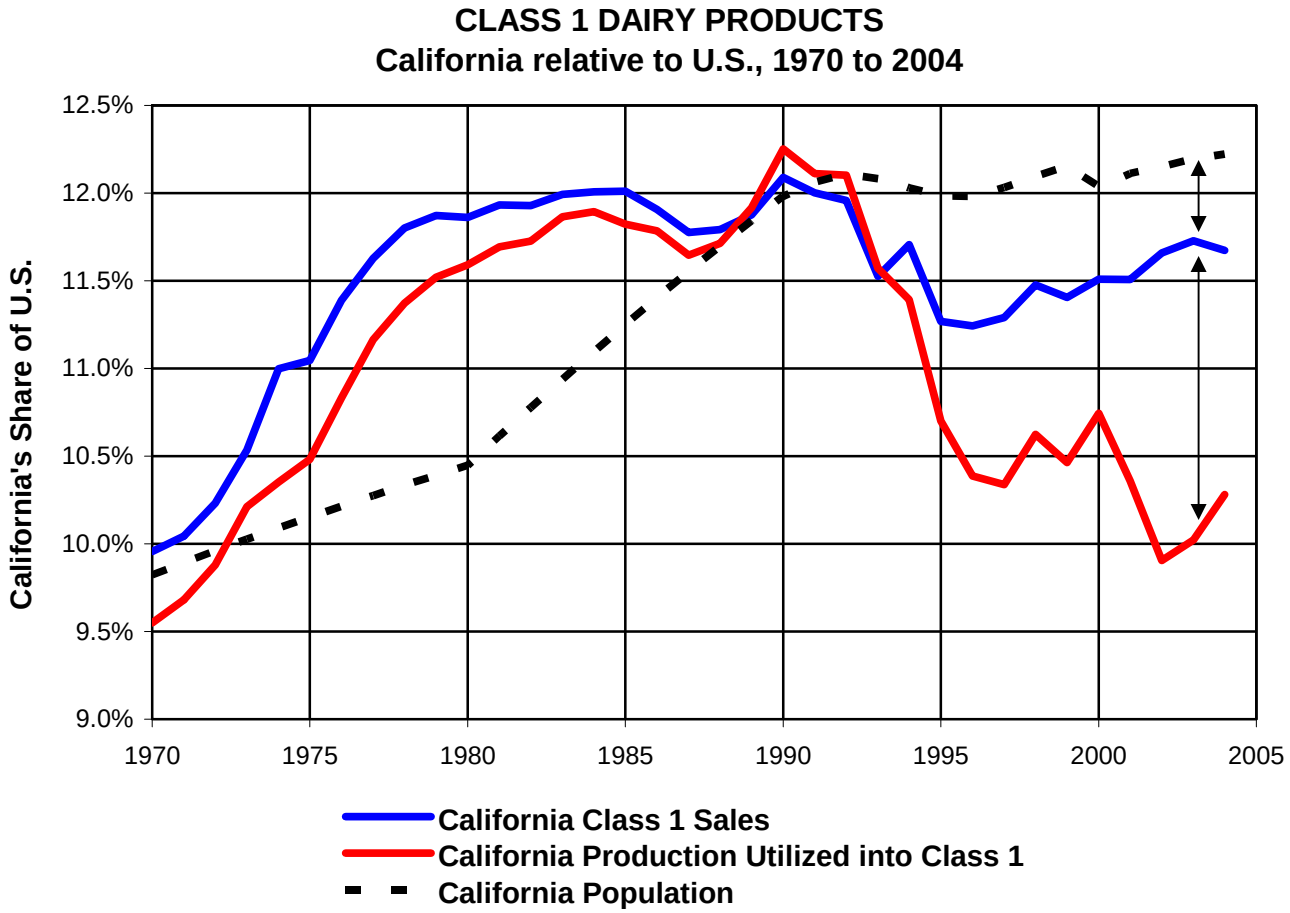
- For 2004, mailbox milk prices for all federal milk orders averaged $15.90 per cwt., $3.56 higher than the all-area average for 2003. For California, mailbox milk prices averaged $14.76 per cwt. during 2004, up $3.28 compared to 2003. For the U.S. in 2004, mailbox milk prices increased from January ($13.12) to record high levels in May ($19.01), then decreased slightly, ending the year at $16.38.

Use of Total Pool Milk Solids in California by Class, 1994 vs. 2004



Class 1 Sales

- Class 1 accounted for **15.7%** of total pool fat and solids-not-fat usage in 2004 and **16.1%** of total pool revenues. Class 1 accounted for **18.0%** of total milk usage in 2004 when including Grade B production, exempt milk, and milk coming in from other sources.
- California's share of U.S. population is approximately 12%, California's share of U.S. milk production is 21.3%. As shown in the chart below, California's Class 1 sales fall short of meeting California's share of the U.S. population. It should be noted that Class 1 sales data only include processed/packaged Class 1 products being sold in California plants that were either processed and sold in California plants or processed elsewhere and delivered and sold in as Class 1 productions in California plants. Class 1 sales data does not include packaged Class 1 products being sold in California that were processed in other than California plants, which, if it were included in Class 1 sales, might lessen the shortfall in meeting California's U.S. population share.
- Class 1 sales were down 1.2% comparing 2004 to 2003.
- As shown in the chart below the gap continues to grow between California Class 1 sales and California production utilized into Class 1 products. California Class 1 sales are made up of bulk milk shipped to plants and processed into Class 1 products and packaged Class 1 products sent to plants and recorded into Class 1 sales. What is not captured in California Class 1 sales figures is packaged Class 1 products sent directly to wholesale and retail customers in California, coming from sources other than California plants.



California Milk Production

- Annual milk production has increased at an average rate of 4.5% over the last 20 years; 3.8% over the last 10 years.
- For 2004, milk production reached an all-time high of 36.4 billion pounds, with eight of the 12 months in 2004 exceeding 3 billion pounds in milk production.
- The last four months of 2004 showed an overall average increase of 5.1% in milk production, compared to the same period in 2003.
- Trend of increasing milk production over the last 20 years:
  - Above 9% - 3 years
  - 5 to 8.9% - 4 years
  - 3 to 4.9% - 7 years
  - 1 to 2.9% - 5 years
  - Less than 1% - 2 years
  - No years recording decrease in milk production
- The last two rounds of the Cooperatives Working Together (CWT.) herd retirement program in California eliminated 38 dairies, 21,516 cows, and 429.3 million pounds of milk.
- Despite the impact in California of the CWT. program and the 2002-2003 low farm milk prices, since 2002, milk production in the State has increased by 1.6 billion pounds.
- Following the trend of the last 20 years, milk production could grow between 3.7% and 4.6% per year over the next 5 years. This means that by the year 2010, annual milk production in California could be between 45 and 47 billion pounds.

Milk Cows

- Annual California cow numbers have *increased* at an average rate of 3% over the last 20 years; 3.5% over the last 10 years – while U.S. cow numbers have *decreased* 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 licensed dairies.
- Over the last 5 years, the number of dairy cows increased by 293,000 cows.
- Despite the CWT. herd retirement program and low farm milk prices in 2002 and 2003, the number of dairy cows have increased 43,000 since 2002.

Cheese Production (Class 4b)

- In 2004, 46% of California's total milk production was used to produce cheese
- California cheese production set a record in 2004, at 1.95 billion pounds
- California share of U.S. cheese production increased to 22.5% (up from 14% in 1994)
- California cheese production has more than doubled in the last 10 years

Butter and Nonfat Dry Milk Production (Class 4a)

- In 2004, 30% of California's total milk production was used to produce butter and nonfat dry milk
- California is ranked first in the U.S. for butter and nonfat dry milk production, with U.S. market shares of 32.3% and 53%, respectively
- Butter has shown an 11% growth in production over the last 10 years to 383 million pounds in 2004
- Nonfat dry milk has shown a 75% growth in production over the last 10 years to 751 million pounds in 2004

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

- Frozen dairy product growth has been flat over the last 10 years, actually decreasing 6% from 2003 to 2004; with an overall decrease of 3% over the last 5 years
- Dry curd cottage cheese production has decreased 31% over the last 10 years; 25% over the last 5 years
- Yogurt production decreased 5.7% from 2003 to 2004

Should California's Pricing Formula Reflect Same Monthly Adjustments that are Made in Federal Order Class I Pricing Formulas?

Proposal

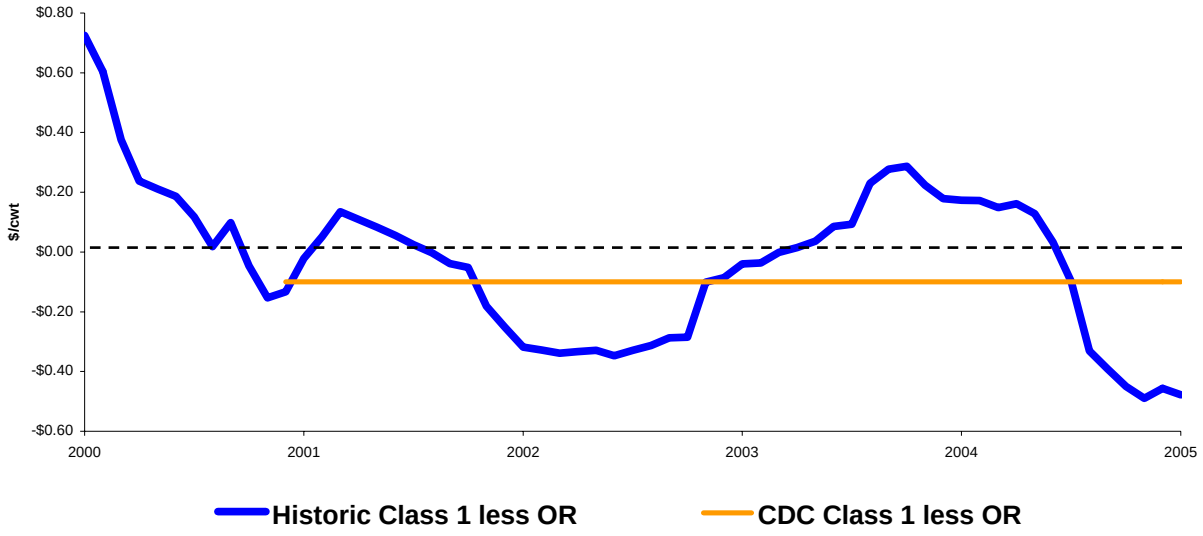
The California Dairy Campaign (CDC) proposed changes in the California Class 1 pricing formula structure, namely changing the formula to mirror the structure of the Federal Order Class I pricing formula. As proposed, these changes on average would have relatively little monetary impact to the California Class 1 price, but the proposed formula changes do address the price alignment issue by making the price difference between the California Class 1 price and the Federal Order Class I price constant.

Impact of the Proposal

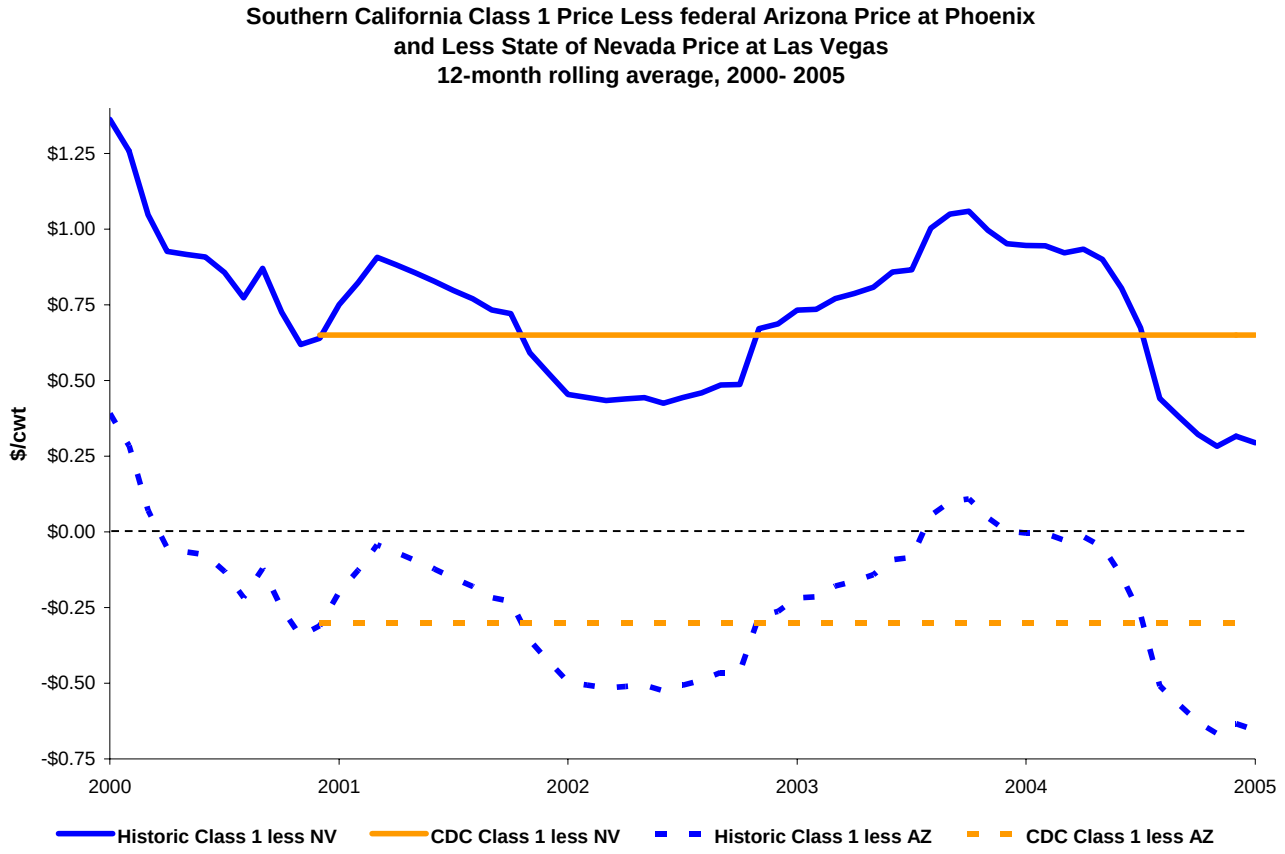
From 2000-2004, the CDC proposed changes to the Class 1 formula would have averaged a $0.03 per cwt. increase in the Northern California Class 1 hundredweight price and no difference to the Southern California Class 1 hundredweight price. Over that same period, the pool price would have been relatively unaffected, averaging an increase of less than $0.01 per cwt.

Looking at price data over 5 years, the current California Class 1 pricing formula is less *volatile* than pricing formulas used in the federal orders. The high and low peaks of the California prices are not as dramatic as those of the federal order prices. The following graph displays the difference in dollars per hundredweight between the Northern California Class 1 price and the federal order Oregon Class I price from 2000-2005. As the graph illustrates, California's Class 1 price has been higher and lower than the Oregon Class I price, but the CDC proposed Class 1 price adjustment would consistently be $0.10 per cwt. lower than the Oregon price.

Northern California Class 1 Price Less Federal Order Oregon Price (at Portland)
12-month rolling average, 2000 - 2005



Looking at Southern California, the graph below displays the difference in dollars per hundredweight between the Southern California Class 1 price and the federal Arizona price at Phoenix and the State of Nevada at Las Vegas Class 1 price from 2000-2005. As the graph illustrates, California's Class 1 price has been higher (ranging from $0.50-$1.35 higher) than the Nevada Class 1 price, with the CDC proposed Class 1 price adjustment consistently $0.70 per cwt. higher than the Nevada price. It also shows that California's Class 1 price has been higher and lower (ranging from $0.35 higher to $0.70 lower) than the Arizona Class I price, with the CDC proposed Class 1 price adjustment consistently $0.25 per cwt. lower than the Arizona price.



Discussion

The CDC proposal would restructure the California Class 1 formula to be based on the Federal Order Class I price mover, calculated with the most recent National Agricultural Statistical Service (NASS) data available by the 23rd of the prior month. The federal order price mover can be released as early as the 17th of the prior month, or as late as the 23rd of the prior month. Over the last three years, federal order prices were released after the 19th of the month 75% of the time, and after the 20th of the month 58% of the time.

Using NASS data rather than the current Chicago Mercantile Exchange commodity prices raised a number of concerns by some witnesses. With the current formulas, California Class 1 prices are released on or before the 10th of the prior month. The Institute testified that the NASS data lags the Chicago Mercantile Exchange (CME) markets, using the federal price mover slows any market pricing signals and their affects on the formula. In addition, they state that by using the federal price mover in the formula, California Class 1 prices would relate to

federal order manufacturing class prices, rather than to the California manufacturing class prices. The Crystal Cream and Butter witness testified on timing issues associated with using the NASS data. In particular, stating that it would severely compromise Crystal's ability to calculate monthly price changes and communicate those changes to customers prior to the first of the month. Crystal's pricing is complex due to the shear number of products, sizes and labels carried, combined with a wide variety of customer types, locations and levels of business sophistication for which they tailor their service – communicating price changes within the current formula release timeframe is critical.

Other Timing Issues of the Proposal

The following concerns have been outlined in prior hearing testimony regarding the use of the federal order commodity prices:

WIC (Supplemental Nutrition Program for Women, Infants, and Children)
WIC serves low-income pregnant, postpartum and breastfeeding women, and infants and children up to age 5 who are at nutritional risk (children are by far the largest category of participants). WIC participants receive checks or vouchers to purchase specific foods each month, specifically those high in protein, calcium, iron, vitamin A, and vitamin C. The dairy products of milk and cheese are two of the primary foods offered in this program. WIC state agencies receive funding from the federal Food and Nutrition Services Agency. These funds must cover all WIC foods, nutrition counseling and education, and administrative costs. With a fixed federally allocated annual budget, WIC officials must be able to predict or forecast future dairy product prices in order to allocate funds to other spending categories – milk and cheese account for a large percentage of their expenditures.

- The California WIC Program relies heavily on the current schedule of knowing what the Class 1 price will be 2-3 weeks before the next month pricing is in effect.
- Changing the pricing schedule to issue the Class 1 price only 7-10 days before the beginning of that month would have a detrimental effect on WIC's current dairy product price-setting and budget allocation.

Fluid Bottlers/Distributors, Schools, Grocers, and other Institutions
In most instances, school districts and other institutions across the State contract in advance for their milk purchases. The current Class 1 price announcement schedule of on or before the 10th of the month gives:

- purchasing agents ample time to adjust their budgets to reflect the next month's prices;
- purchasing agents ample time to negotiate with their milk distributors prior to the beginning of the next month – knowing if the price will be up or down, etc.;
- fluid product processors ample time to give notice of price changes to their customers/distributors;
- grocers and retailers time to adjust prices for advertising deadlines; and
- grocers and retailers ample time to change their accounting pricing systems (scanners, etc.) and adjust their store prices up or down, etc.

Summary

MPC supported the CDC proposal, stating it wants a price relationship closer to the federal order prices. The Alliance suggested that the CDC proposal would maintain a reasonable price relationship with contiguous states. WUD, the other California producer organization, testified as opposed to the proposal. All other testimony relating to the CDC proposal was not in favor of adopting this Class 1 pricing formula structural change. The CDC proposal makes very little

monetary impact to the current Class 1 prices and fails to address the issue of the need to lower the Class 1 price to enable California processors to have a more competitive position.

Panel Recommendation

The proposed changes in the Class 1 pricing formula to mirror the structure and operation of the federal Class I pricing structure be denied.

The Class 1 Price Relationship Between Northern and Southern California

Proposal

Currently, the Southern California Class 1 price is $0.27 per cwt. higher than the Northern California Class 1 price. There where three proposals to reduce this $0.27 difference: to $0.10 by WUD, to $0.12 by the Alliance, and to $0.25 by CDC.

Impact of the Proposal

Relative to Southern California prices, the WUD proposal would raise the cost of fluid milk in Northern California by 1.5 cents per gallon on whole milk, 1.5 cents per gallon on reduced fat 2% milk, 1.5 cents per gallon on low fat 1% milk, and 1.6 cents per gallon on skim milk. The proposals of CDC and the Alliance would have proportionally smaller changes, respectively 0.2 cents and 1.3 cents per gallon on whole milk. Since it was the largest proposed change, the analysis and discussion will focus on the WUD proposal.

Increasing Northern California's Class 1 prices benefits dairy farmers; it also decreases the competitiveness of Northern California produced fluid milk products. All things being equal, it will decrease Class 1 sales in Northern California. In the short term, the increased price will, when combined with the slight decrease in Northern California Class 1 sales, result in higher revenues for dairy farmers.

Since the price differential between Northern California and Southern California is reflected in establishing the transportation credit, the current transportation credit would need to be adjusted to reflect the proposed change.

Discussion

WUD argued that Northern California's $0.27 per cwt. lower Class 1 price costs dairy farmers revenues that far exceed the total cost to the pool for partially financing the plant-to-plant haul of milk from Northern California to Southern California via the transportation credit system. They testified that producers are financially better off if the Northern California price was closer to the Southern California level and producers were obligated to finance the hauling costs of only the amount of milk that must be transported into Southern California. They also argued that the current market conditions require processors in both marketing areas to compete for the same milk supply. They did not believe that there was any justification to reduce the Southern California price to the Northern California level.

WUD cited the large variations in milk production cost within one area is often greater than the variation between the Northern and Southern California area is another reason for a decrease in the $0.27 per cwt. differential between the two areas.

The Institute and the fluid milk processors argued at length that a decrease in the Class 1 price is warranted. Since WUD's proposal would increase the Northern California price, the processor representatives were all opposed to the WUD proposal.

LOL supported the processors in opposing any reduction in the current $0.27 per cwt. differential between Northern and Southern California Class 1 prices. They argued that the difference should be maintained because of the funding mechanism for plant-to-plant milk movements between the two areas. They argued that since the Southern California milk production was declining over the past few years, while transportation costs were increasing, the $0.27 per cwt. differential should be increased.

LOL indicated that a 1978 Economic Research Service, USDA study indicated that absent government regulations, milk prices would be at different levels to reflect the cost of moving milk from areas of surplus production (South Valley) to deficit area (Los Angeles area). More over, it indicated that the federal order reform had established a $0.50 per cwt. differential between Los Angeles County and South Valley.

Despite the above discussion, the Panel believes that while most witnesses took a position on this proposal, it was not the focus of the attention and consideration of most hearing witnesses.

The Panel is very cognizant of the fact that fluid milk processors proposed a statewide uniform Class in price in 1993. While WUD's proposal would appear to be a step in the same direction, there is one significant difference between the processor and producer vision of a more uniform Class 1 price, the method that would be employed to achieve a more uniform price. The fluid milk processors' proposal was revenue neutral in that it would lower the Southern California Class 1 price and raise the Northern California price. While at this May 3, 2005 hearing, WUD's proposal would raise the Northern California Class 1 price to a level closer to the Southern California level.

The Panel recognized that the testimony in both hearings indicated that there is increased competition between the two areas. There was insufficient data or analysis incorporated into either hearing record that more fully supported this statement. In the Panel's opinion the Department's cost of production and hauling rate data still suggests that there should be a sizeable differential between Northern and Southern California. The Panel believes that a more thorough economic evaluation of all the factors relating to supply and marketing within and between the Southern California and Northern California areas is necessary before major changes are made in the Class 1 differential.

Panel Recommendation

The Panel recommends that the proposal to reduce the current $0.27 per cwt. Class 1 price differential between the Northern and Southern California Marketing areas be denied.

Appropriate Class 1 Price Level

Proposals

1. The Institute proposed a permanent reduction in the Class 1 price by $0.88 per cwt. in an effort to enhance the competitiveness of California fluid products. The Institute testified that Class 1 prices are too high relative to the manufacturing classes of milk in the state.
2. The Alliance proposed a permanent increase in the statewide Class 1 prices to bring the prices into a more reasonable relationship with Class I prices in contiguous states:
    a. By $0.42 per cwt. for the Northern California Marketing Area.
    b. By $0.28 per cwt. for the Southern California Marketing Area.
3. WUD proposed a permanent increase in the Class 1 price by $0.18 per cwt. in order to bring the Northern and Southern California Class 1 price to a closer alignment. The proposal reduces the differential between the two marketing areas from $0.27 per cwt. to approximately $0.10 per cwt.
4. As discussed in the prior section the objective of the CDC was not to adjust the level of California's Class 1 price. While the changes would result in some slight adjustment in the Class 1 price level, the changes are relatively minor in nature. Since the CDC proposal was reviewed previously, it will not be discussed again in this section.

Impact of the Proposals

On a hundredweight basis, the Institute proposal would uniformly lower Class 1 prices throughout the state thereby decreasing producer pool prices by $0.18 per cwt. (see Table 1 on page 3). The Institute's proposal would lower the cost of fluid milk by 7.6 cents per gallon on whole milk, 8.5 cents per gallon on reduced fat 2% milk, 9.2 cents per gallon on low fat 1% milk, 7.9 cents per gallon on skim milk.

On a hundredweight basis, the Alliance would raise the Northern California price by $0.42 per cwt. and the Southern California price by $0.28 per cwt. The combined increase would result in a $0.07 per cwt. increase in the pool prices. The Alliance would increase the cost of fluid milk in Northern California and Southern California by 3.6 cents / 2.4 cents per gallon on whole milk, 3.9 cents / 2.7 cents per gallon on reduced fat 2% milk, 4.2 cents / 2.9 cents per gallon on low fat 1% milk, 3.8 cents / 2.5 cents per gallon on skim milk, respectively.

In the short term, lowering California's Class 1 prices benefits California consumers; it also increases the competitiveness of California-produced fluid milk products. All things being equal it would tend to encourage additional Class 1 sales. The increased sales would probably not offset the adverse impact of the lowered prices resulting in lower revenues for California dairy farmers. In the longer term, if the sales increase more than the price decrease, total pool revenues will be higher.

In the short term, increasing California Class 1 prices benefits California dairy farmers; it also decreases the competitiveness of California produced fluid milk products. All things being equal, it would tend to decrease Class 1 sales. The decreased sales would probably not offset the impact of the price increase resulting in higher revenues for California dairy farmers.

Discussion

Governing Legislative Authority

A fundamental issue of the May 3, 2005 hearing relates to interpretation of the California Food and Agricultural Code.

Producer witnesses argued that the single Code Section 62062.1 provides the governing policy for establishing minimum Class 1 price levels. This position was best demonstrated by the following Alliance testimony:

"Of All the Food & Agriculture Code that the Department referenced in the call of this hearing, only one, Section 62062.1 requires the Department to take action. It states:

> *"Any designation of a Class 1 price by any method or formula that is used to develop Class 1 prices paid to producers in the various marketing areas shall provide an a calendar-year basis a statewide weighted average minimum price level for a hundredweight of milk testing 3.5 fat and 8.7 solids not fat that is in reasonable relationship with the minimum Class 1 prices paid to producers in contiguous states. If the statewide weighted average Class 1 prices paid to producers are not in a reasonable relationship with the Class 1 prices paid to producers in contiguous states, the Secretary shall immediately hold a hearing to consider adjustments to the Class 1 prices."*

The Alliance goes on to indicate in their May 3, 2005 post hearing brief that producer organizations do not interpret the words "reasonable relationship" in Section 62062.1 to mean equal. The Alliance however, does further state in its hearing brief that "reasonable relationship" does not mean "the California Class 1 prices are significantly lower than those in contiguous states."

Fluid processor witnesses, as led by the testimony of the Institute, however, indicated that in the establishment of Class 1 prices and Class 1 pricing formulas, the Secretary must consider all the declared intentions of the legislature. In so doing, the Department must look beyond the confines of a single section of the Code.

In granting the authority to establish minimum prices to the Department, the legislature made a number of declarations. In Section 61801 of the Code, the legislature declared that milk production and marketing is a business affected with a public interest. In Section 61802 (e), it declared that it is the public policy of the state to promote, foster, and encourage the intelligent production and orderly marketing of market milk and to eliminate economic waste, destructive trade practices, and improper accounting of market milk purchases. In Section 61802 (g) it declared that it is necessary to conform the pricing standards governing minimum prices for market milk established under these provisions to current economic conditions.

The legislature recognized that in order to accomplish its purposes and to promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that promote the intelligent and orderly marketing of market milk (Section 61802). It authorized the Secretary to determine minimum prices which are necessary due to varying factors of cost of production, health regulations, transportation, and other factors in the state (Section 61805 b). In determining minimum

prices, Section 61805 (b) also directs the secretary to endeavor to achieve uniformity of cost to handlers within a marketing area.
Section 62062 establishes the governing framework. It states that:

> *"In establishing the prices, the secretary shall take into consideration any relevant economic factors,"*

Among statutory criteria the legislature included, but did not limit consideration to:

a) The reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those class prices, in relation to the cost of producing and marketing market milk for all purposes;
b) That the established prices shall insure an adequate and continuous supply, in relation to demand for milk for all purposes, at prices to consumer which when considered with relevant economic criteria, are fair and reasonable;
c) That prices, including the price components of milk, bear a reasonable and sound economic relationship to each other;
d) That the purposes, policies, and standards contained in Sections 61801, 61802, 61805, 61806, 61807, 62076, and 62077 shall be considered.

There is nothing in the statutes which implies that Section 62062.1 or any other section is the overriding criteria for establishing California Class 1 prices. In context to the relevant Code Sections which were outlined above, there is every reason to interpret Section 62062.1 as simply another criteria for consideration by the Department in establishing appropriate Class 1 prices in California.

Section 61806 reflects the intent of the legislature that the powers conferred in this chapter shall be liberally construed. More importantly, Section 61805 (b) authorizes and enables the Secretary to determine minimum prices to be paid to producers by handlers for market milk which are necessary due to varying factors of costs of production, health regulations, transportation, and other factors in the marketing areas of this state.

Given the context of the numerous enabling statutory provisions relating to establishment of minimum prices, it is the Panel's opinion that a broader interpretation of Section 62062.1 is more accurate and appropriate. While Section 62062.1 provides an important criterion, neither this Section nor any other Section should be viewed as having greater consideration or emphasis than any other statutory provision. The Panel believes that the public interests can be best served when the competing interests of producers, processors, wholesalers, distributors, retailers, and consumers are considered and reasonably balanced.

In accordance with this interpretation, the Panel believes that the Department has the authority to establish California minimum milk prices at levels that may be: below; equal to; or above, the minimum Class I prices paid to producers in contiguous states. In establishing the price alignment with contiguous states, it is incumbent upon the Department to consider and weigh all the relevant economic factors, including those prescribed by the statutory mandates. In establishing whether California's Class 1 price level is in a "reasonable relationship" appropriately aligned at a higher, equal, or lower value than any of the minimum prices in contiguous states, the Department must articulate the relevant economic factors and conditions that justify why the specified price level is reasonable.

Whenever the Secretary determines the Class 1 price level is in "reasonable relationship" to those in contiguous states, the Secretary is not limited to basing the determination on the

prior year's data. While Section 62062.1 does mandate the Secretary to annually review the relationship between California Class 1 prices and those in contiguous states, the Secretary must consider all economic data and relevant factors in determining an appropriate Class 1 price level.

Nature of the Class 1 Price Situation

Prior to the 1990s, California's Class 1 prices were among the lowest in the nation. Over subsequent years, changes in the California and federal order pricing structures, as well as dynamic changes in market conditions, created price alignment issues.

During the last 14 years (from 1990 to current), the Department has considered and addressed a number of specific Class 1 alignment issues through the public hearing process. Whenever the Class 1 pricing formula was reviewed during the last 14 years, fluid milk processors have generally argued that price alignment issues create competitive disadvantages for California fluid products. Dairy farmer representatives generally discount the competitive advantage arguments and maintain that California Class 1 prices are reasonably related to the minimum prices in neighboring states.

While the theme of the Class 1 price formula debate has been consistent, the focus has shifted over time. In the early 1990 hearings, the central issue focused on the ability of California fluid processors to compete in Southern Nevada and in the Northern Sacramento Valley. In more recent hearings, the issue has focused on whether or not California fluid products are at a competitive disadvantage in the Southern California market (California's major population center and site of the majority of California's fluid milk sales).

During the period from 1992 to current, California fluid processors have continued to argue that California Class 1 prices are misaligned with the basic framework of the federal order Class I pricing structure, and the economic conditions of the California dairy industry. They believe that this results in consistently higher Class 1 prices than appropriate. The processor representatives have testified that the misalignment creates a competitive disadvantage which adversely impacts California fluid product sales and Class 1 usage of California milk production. They argue that lower minimum farm prices will benefit consumers in the form of lower retail milk prices.

Dairy farmers strongly disagree, arguing that decreasing California fluid milk sales are no different than the national per capita fluid sales. They testified that California's larger decreases in per capita fluid milk sales may be a result of the changing demographics of California's population. They argued that the competitiveness issues are in part attributable to an unregulated plant operating in a federal order area and that the appropriate resolution is via federal legislation. Moreover, dairy farmers contend that lower Class 1 prices will not be passed through in the form of lower retail milk prices.

At the May 3 and 6 hearings, the nation's largest fluid milk processor, a national retail grocery chain, and a fluid milk processor for two regional retail grocery chains in the Sacramento and San Joaquin valleys, testified that the competitive disadvantage issue is serious enough for them to consider implementing a variety of options that would undermine the effectiveness of California's Class 1 price and adversely impact pool revenues.

Review of Relevant Facts

Current Market Conditions

At the time of the hearing, the Class 1 market can be characterized by the following:

- During the period 1994 to 2004, California's total milk production increased by 45%.
- California's 2004 annual Class 1 pool utilization of California's production was below the level attained in the calendar year 2000.
- Meanwhile California's population continues to increase, rising from 34 million people in the year 2000 to 35.9 million people in 2004.
- The higher the Class 1 price level relative to the Class 4 prices, the greater the raw product advantage that exempt producer/distributors have on the milk that is exempted from pool obligations.
- Prior to 1993, on average the Northern California Class 1 prices were almost always below Oregon's federal order Class I price.
- After 1993, on average the Northern California Class 1 price was almost always above Oregon's federal order Class I price.
- Prior to 1993, Southern California Class 1 prices were almost always below prices in Phoenix, Arizona. Likewise, Southern California prices averaged about the same as prices in Las Vegas, Nevada.
- After 1993, Southern California Class 1 prices were almost always above prices in Las Vegas, Nevada and about the same as prices in Phoenix, Arizona.
- The California milk pricing program does not have the authority, and does not regulate or govern the minimum price or any other economic aspect of interstate commerce of either raw or packaged milk that is being supplied from sources outside California.
- California processors have testified that California's Class 1 prices are not competitive.
- California processors have testified in this and prior hearings that they have sustained economic losses in the form of lost volume and price concessions.

Class 1 Price in Relationship to Cost Of Production

The Institute argues that California's cost of milk production is among the lowest in the nation. The Institute maintains that California's low production costs combined with California's low Class 1 utilization warrants establishing lower Class 1 prices. In comparing California's cost of production, fluid utilization, and the Class 1 differential with various federal order markets, no other market has the combination of low utilization and low cost of production and yet is characterized by a high Class 1 differential. (see Appendix D)

A producer group argued that the Institute analysis contained flawed information:

- The Class I utilization in federal orders is overstated because of the frequency of depooling in federal milk orders.
- Institute testimony ignores the substantial Class I premiums that exist in the rest of the nation, even in lower Class I utilizations. Historically, Class 1 premiums in California have been very modest in comparison.
- The Institute use of a $2.36 Class 1 differential for California is inappropriate and distorts the comparison. If the $1.57 that CDFA cited in the hearing background paper were used, the analysis falls apart.

The Panel determined that the $1.57 Class 1 differential cited in the pre-hearing background paper was based only on 2004 data and was calculated by subtracting California's Class 1

price from the federal order base price. The $2.36 Class 1 differential cited by the Institute was based on the last 5 years of data and was calculated by taking the difference between the Class 1 price and the higher of California's Class 4a or 4b price. The hearing Panel believes that the Institute analysis is appropriate as their $2.36 differential, like the federal order differential, is the difference between the fluid price and the price for manufactured products.

The Panel agrees that depooling of milk in federal milk orders will increase the Class I utilization in federal milk marketing orders. However, the differences in the operation of the federal versus California pool involve a number of complexities that prevent simple inferences. Currently, in the upper Midwest federal order for example, distant milk supplies within the market area only have to supply the Class I plants once, and a large amount of this supply never actually serves the Class I market on a practical basis. Yet this milk is a part of the federal order data that comprise its Class I usage. California's pooling program does require at least one shipment per month to fluid usage in order to qualify to participate in the pool. More importantly, in the Panel's judgment, even when depooling is factored into some of the critical federal orders (the upper Midwest); it does not substantially detract from the ordinal ranking comparison nor substantially modify the validity of the comparative analysis in Appendix D.

The Panel recognizes that Institute testimony did not address the impact of the Class 1 premiums. However, Class 1 premiums are based on a number of factors relating to the services the supplier provides the milk buyers, the available and alternative milk supplies in the market, and the relative market power of the milk suppliers versus milk buyers. The Panel believes that relative difference in premiums between markets is far too complex to form objective determinations that appropriate policy decisions can be based upon.

The Alliance argued that on average the overbase price for the period 2000-2004 has not covered the average 2000-2004 cost of producing milk. For the five-year period, the overbase price averaged $11.74, while the cost of production averaged approximately $12.79. The Alliance indicated that in only two of the past five years has the overbase price covered production costs.

During the period 1991 to 1997, the overbase price averaged -$1.73 per cwt. below the cost of production. During the period 1998 to 2004, the average difference that the overbase price fell below the cost of production was reduced to -$0.69 per cwt. This improvement occurred during a period that the quantity of overbase milk steadily increased. During the period 1998 to 2004 the quota price averaged +$1.01 per cwt. above the cost of production.

Finally, the Alliance testified that the lowest cost of production states (California, Idaho, and New Mexico) also reflect the lowest mail box prices. The data offered by the Alliance indicated that Idaho's mail box prices are generally lower than California. In the year 2004, Idaho's mailbox prices were significantly lower than California's. It is the opinion of the Panel that the average mailbox price in a given area is reflective of numerous factors that make the comparison of the level of Class 1 price difficult. The Panel believes that a more direct comparison is an examination of the Class I pricing structure that forms the foundation of the federal milk marketing orders. The Panel also was aware that the calculated federal order Class I price levels in New Mexico and Utah are higher than California Class 1 prices.

The Panel believes that the adequacy of the overbase price to cover the cost of production is more influenced by the national supply/demand situation than the Class 1 pricing formula.

Basically the same pricing formulas that were in effect during the 2000- 2004 period will result in remarkably different price levels. All milk prices were relatively high during much of 2004 and may in part be reflective of the voluntary effort by Cooperative Working Together (CWT) to remove excess milk production capacity from the market.

The Panel recognizes that no matter how accurate the cost of production data is, the use of weighted average costs often masks the hidden details of what's really happening. Roughly one third of the dairy producers only receive the overbase price. There are also huge differences between the low cost and high cost dairy farms. During periods that reflect significant economic losses for the "weighted average" dairy, there may be a large number of low cost producers that are making sufficient profits in the dairy operations to motivate production expansion. Additionally, the cost of production data typically reflects opportunity costs, non-cash costs of depreciation, a calculated return on investment and return on management.

More importantly, milk producer representatives in other regions of the country (including many in California) have historically voiced concern about California's low Class 4a and 4b prices relative to the federal order prices (rest of the nation). Over the last five years (2000-2004), California's Class 4a price has averaged $0.25 per cwt. below corresponding federal order prices while the Class 4b price has averaged $0.33 per cwt. lower. Since California's Class 4a and 4b production account for almost 80% of California's total usage, it raises the logical question, how is it that California dairy producers were able to consistently increase the total milk production by an average of about 4% per year over the last 20 years? Economic principals dictate that the California dairy industry did not do so at an economic loss. It is reasonable to conclude that milk revenues derived from the established minimum prices were sufficiently high enough to drive further production expansion.

Class 1 Prices That Are Fair and Reasonable In Relationship to An Adequate and Continuous Supply

Dairy processors testified that the Class 1 price is supposed to be sufficient to cover the cost of converting from Grade B milk to Grade A milk and maintaining a Grade A milk supply. However, the overwhelming amount of total commercial production, both in California and nationally, is reflected in Grade A milk production. For 2004, California's total Grade A milk production of 35.9 billion pounds dwarfed California's total Grade B production of about a half a billion pounds. Stated in percentages, Grade A milk production represented slightly more than 98% of the state's total while Grade B represented slightly less than 2%. Clearly the California's Class 1 price was sufficient to cover the cost of converting Grade B to Grade A milk.

Dairy processors testified that the supply standard set forth by the legislature is that the combined revenue from all classes be sufficient to result in an adequate supply of milk for all uses. The Institute testified that this standard has been exceeded because the per capita milk production is 434 pounds per person greater per year than what is needed to meet the state's dairy fluid product demand.

In its post hearing brief, the Alliance indicated that a more accurate measure of the adequacy of the milk supply is the national dairy commodity prices. In 2004, dairy commodity prices, and therefore milk prices, reached record levels. The Alliance argued that if the supply of milk nationally was adequate then this wouldn't have happened.

It is the opinion of the Panel that national commodity prices reflect the supply/demand forces in the national dairy market. In the several years that preceded 2004, national dairy commodity prices were very depressed. The whole is often not the same as the sum of its parts. The debate over national dairy policy often is contentious because of the differences in economic prosperity between the different milk producing regions of the country. In addition, the voluntary supply management CWT program has been in place for several years and is given some credit in helping reduce the nation's oversupply of milk and helped increase the level of milk prices mentioned by the Alliance. If California's milk supply was inadequate, then it doesn't make sense that the CWT program takes credit for removing surplus production from every region of the country, including California, and for the current level of higher milk prices.

What is more relevant to the consideration is that during both the low and high commodity price periods, California milk production consistently increased. Even the Alliance admitted in its post hearing brief that if the milk California produced versus the milk California consumed in the various forms is the criteria, then they believe the California milk supply is adequate.

Dairy processors argued that milk output growth of the magnitude we have seen in recent years has surpassed what is needed to "insure an adequate and continuous supply as required by Code. If milk production continues to grow at current rates, the supply of milk will exceed the capacity of the state's dairy product plants in the near future, possibly as early as 2006."

The Panel recognizes that California milk production did experience periods when its total production could not be processed in the State. Such surplus production was shipped out-of-state to find a home. In addition, at various times, cooperative producer organizations closed their membership or placed limits on the annual production increase of their members. During the just concluded hearing on Class 2, 3, 4a and 4b pricing formulas, witnesses testified that the state is nearing another period when its milk supplies will be in surplus of its current processing capacities. Whether or not the state's production will exceed the state's dairy product plant capacity is a question, like many hearing issues, that cannot be predicted with certainty. The Panel members are aware that currently at least one major California cooperative is not open to new membership, which may be a warning sign of the adequacy of the state's processing capacity.

Class 1 Price in Relationship to Other Classified Prices

A Departmental comparison of the statewide weighted average California Class 1 prices for 2004 to the minimum Class I prices paid to producers in contiguous states, does reflect that:

- the statewide weighted average California Class 1 price was $0.30 per cwt. lower than the average price of the neighboring states (Western Oregon, Southern Nevada, and Arizona)
- the Northern California Class 1 average price was $0.45 per cwt. lower than the Western Oregon Class I prices
- the Southern California Class 1 average price was $0.15 per cwt. lower than the average Class I price in Southern Nevada and Arizona.

This comparison was based on the announced hundredweight prices.

The Alliance, using a different method, estimated an annual difference between the California weighted statewide average and the average price of the neighboring states (Oregon, Nevada, and Arizona) to be $0.59 per cwt. lower.

Federal milk marketing orders establish different prices for Class I milk across the entire nation. These prices are established for each county in the 48 contiguous states. The prices are based on a 1998 study performed by Cornell University, "Estimation of Regional Differences in Class I Milk Values Across U.S. Milk Markets." The Cornell study based the prices on the different regional milk supply and fluid demand conditions in regional areas across the nation. The prices basically reflect the local population size relative to the regional milk supply. Prices are lowest in the regions with high milk and manufactured product production, relative to the region's population levels.

The result (with some congressional input) was the map entitled "Class I Price Differentials" (see Appendix E), which depicts the relative Class I prices (referred to as Class I differentials) for each county in the contiguous 48 states. The lowest differential (lowest price) is $1.60 per cwt. This low price is applicable to a group of counties on a line running southwest from the border of Montana and North Dakota to the California central coast. South and east of this line the Class I prices steadily increase to a maximum in Miami, Florida at $4.30 per cwt. Prices also increase more modestly north and west of this line to a maximum in Portland and Seattle at $1.90 per cwt.

Over the last ten years since the map was compiled, California's milk production has (1) grown faster than the nation as a whole and (2) has grown faster than the State's population. Thus, if the Cornell model were rerun with the current supply/demand conditions, then it is reasonable to assume that California's differential would reflect a relatively lower price than that depicted in the map.

Basing the alignment of California's Class 1 prices on the weighted average of the contiguous states is inconsistent with the federal Class I structure. California, which leads the nation in milk production, represents over 21% of the nation's total. For the year 2004, California's milk production in surplus of its Class 1 usage was so large that it could supply the combined Class I usage (3.3 billion pounds) of Oregon, Washington, Nevada, and Arizona for 2004 and still have a production balance that would exceed the combined total annual production of Oregon, Washington, Nevada, and Arizona. In fact, California's surplus production in excess of its Class 1 usage could supply the combined usage for those four states (9.6 billion pounds) and still have a production balance that would entitle it to be the nation's leading dairy producer.

In 2004, California produced enough milk to satisfy all the fluid (Class 1) needs of every state west of the Appalachian Mountains. California's Class 1 usage represents only 16% of its total production while the contiguous states of Nevada, Arizona, and Oregon have significantly higher Class I utilizations of approximately 88%, 30%, 33% respectively. If the Cornell model were rerun, Nevada, Arizona, and Oregon would, relative to the California region, have higher Class I differentials.

Obviously, a critical policy question that must be addressed relative to this criterion, is whether or not the California Class 1 price should be more closely aligned with those of the neighboring states or better aligned with the economic factors/analysis described above.

Uniform Class 1 Prices to Handlers

The Institute argued that the current plans fail to foster uniform prices to processors competing in a marketing area. They also testified that the exempt producer/distributors have an advantage in the marketplace because they incur no pool obligation on their exempt quota holdings. The Institute calculated the difference between the Class 1 Price and the quota price as the measure of the exempt producer/distributor advantage. The higher the Class 1 price level relative to the Class 4a and 4b price level, the greater the producer/distributor advantage on their exempt milk. The Institute indicated that the advantage has averaged 11.2 cents per gallon in Southern California and 8.8 cents per gallon in Northern California since the year 2000.

The producer/distributor advantage has been a frequent issue raised by conventional dairy processors. It is true that the higher the Class 1 price level, the greater the associated advantage.

While the Institute's proposed reduction of $0.88 per cwt. would improve the competitive position of California fluid milk products, it would take a larger decrease to completely restore the competitiveness of California's fluid milk products and to ensure uniform prices to handlers.

Fair & Reasonable Prices To Consumers

The Institute testified that the California Class 1 prices do not result in fair and reasonable prices to consumers for California fluid milk products. The Institute argued that the artificially high Class 1 price level, relative to manufacturing usages, causes erosion of per capita fluid milk consumption. They maintained that California's per capita fluid consumption has declined faster in California than the rest of the United States. The Institute indicated that Class 1 consumers are bearing too heavy a burden for supporting producer income.

Producer witnesses testified that other factors like the demographics of California's population and light-oxidized flavor defects because of the opaque plastic containers have more impact on the per capita consumption than Class 1 price levels. They cited a study covering the period 1996 to 2004 by Harry Kaiser at Cornell University, which determined that the most important factors included in order of importance: (1) per capita food expenditure away from home; (2) higher retail milk prices; (3) increase in bottled water advertising; and (4) the percent of population younger than 6 years old.

Although the statistical estimates that reflected declining per capita consumption of fluid milk focused much hearing attention, after examining the issue more closely, the Panel believes that the per capita consumption calculations were based on incomplete or partial data. By basing the calculations solely on the pool utilization data, the per capita consumption calculations did not reflect: (1) the exempt producer/distributor usage; (2) the Class 1 usage from non-California sources of raw milk; and (3) the known packaged fluid milk sales from non-California sources. The Panel believes that these combined elements would raise the total fluid milk consumption in California by slightly more than 2% (15.7% to 18.0%). More importantly, there never has been creditable data available regarding the packaged milk processed in out-of-state facilities and sold in the California market.

Since the per capita consumption estimates for federal orders were also based on the total Class I usage utilized in the federal order, these calculations may or may not include the

sales of the federally exempt producer/distributors. Prior to any comparison between California and the federal order, these calculations should be completed.

The Institute cited the milk marketing studies by professor Hoy Carmen at U.C. California, Davis whose study "California Milk Marketing Margins," reflected "that there is a strong direct relationship between retail and farm level milk prices- retailers increase and decrease their prices equally in response to f.o.b. price increases and to f.o.b. price decreases."

Producer witnesses argued that California consumers do not benefit from lower farm prices. They cited the increasing spread between the farm price and retail price as ample evidence. WUD cited the 2001 CDFA report entitled "Consumer Milk Price Survey, Report to the Legislature," which indicated that the presence of a retail price survey seemed to have some impact on the retail pricing practices of fluid milk. WUD argued that with the absence of current retail surveys, it is hard to imagine that retailers will decrease the retail price the full amount of a lower farm price.

At first blush, it seems inconsistent that the spreading farm-to-retail margins can be accurate while at the same time Professor Carmen's study reflects the fact that there is a strong relationship between the retail and farm level milk prices. Upon closer review of data for December 1999 to November 2004, Departmental analysis indicates that changes in raw product cost explains 98% of the changes in retail prices at wholesale club stores. While changes in the raw product costs only explain 61% of the change in retail price in the conventional retail grocery chain store. However, this figure increases to 94% when lagged data is incorporated into the analysis. The apparent contradiction between Dr. Carmen's study and the farm-to-retail price spread relates more to the time differences. The farm-to-retail price spread is more reflective of a long term trend, principally inflation, while Dr. Carmen's study represents the price transmission through the wholesale and retail based on a monthly change in the retail price.

The Panel recognizes that what appears to be a long term trend in the competitive price relationship between large discount retailers (e.g. club stores, and "superstores") and supermarkets, can rapidly change. Over the past few years conventional supermarkets have established prices on fluid milk products that for the most part, are higher than those of the large discount retailers. Thus far, supermarkets have been able to successfully compete with the lower prices of the large discount retailers by offering greater service, a wider array of grocery items, smaller more convenient product sizes, convenient store locations, and featuring one stop shopping. However, as the Club Stores, nontraditional retailers (drugs stores, general merchandisers) continue to gain grocery sales at the supermarket expense, and as the establishment of "Superstores" becomes a real possibility, supermarket chains are starting to change their pricing policies. Over the last few years, the supermarket chains have sought major wage and salary concessions in order to enable them to be more price competitive. Hearing testimony reflected that a supermarket chain had established a retail price lower than the club stores in the Reno market. The Sacramento based Raley's/Bel Air supermarket chain recently began promoting/featuring lower prices on a large number of common grocery items including fluid milk.

Round-Tripping

Round-tripping can be best described as the hauling of milk produced on a California dairy farm to a California fluid processing plant via a route that crosses the state border and then returns back into California. Round-tripping at its most basic level is the procurement of

California milk by California fluid processors, at prices less than the state established minimums, through a normally uneconomic shipment of milk to distant state border crossings locations for subsequent return to California plants. Round-tripping is made possible whenever a California dairy farmer that receives the overbase price, can receive a higher price by round-tripping their milk to a California Class 1 plant.

The Panel's analysis confirms that the existing Class 1 price level relative to the overbase price provides ample incentive to undermine California's minimum Class 1 price. The difference between the Class 1 price and overbase price is sufficiently large, that round-tripping can be a positive benefit to both dairy farmer and California processor.

Moreover, roughly a third of the state's milk supply receives only the overbase price. In reviewing the number of dairy farms in locations suitable to take advantage of the round-tripping, the Panel determined that significant quantities of California milk supplies could benefit from round-tripping to supply the state's entire Class 1 needs.

Clearly, round-tripping potential is a factor that must be considered as a basis for reducing California's Class 1 price level. If the Class 1 price level was reduced, the economic benefits for round-tripping would be diminished.

The Panel believes that round-tripping would not be consistent with a number of statutory mandates:

- Intelligent and orderly marketing of milk and to eliminate economic waste, destructive trade practices, and improper accounting of milk purchases
- Uniformity of costs to handlers
- Minimum prices which are necessary due to the varying factors of cost of production, health regulations, transportation, and other factors as outlined in the Code.

While making precise projections is difficult, the Panel believes that the $0.88 per cwt. decrease will not totally eliminate the incentive to round trip. It does however, remove a substantial attraction to engage in round-tripping. It seems to provide the level of adjustment that California fluid milk processors feel necessary to make California‘s fluid milk products competitive. Absent the adjustment, several major fluid milk processors indicated a willingness to examine the options available to them which will result in a more competitive milk supply.

While the Panel believes that the potential for round-tripping is justification for reducing the minimum Class 1 price, the Panel must also acknowledge that there is a certain degree of uncertainty that the potential will be realized and if so, how quickly it would happen. More importantly, the Panel recognizes that dropping the Class 1 price by $0.88 per cwt. does not guarantee that round-tripping will not occur.

Panel Recommendation

In developing the recommendation on the appropriate price level, the task would have been far more straightforward and less subjective if there were more conclusive certainty on the following hearing issues:

- How much of the decline in Class 1 sales is attributable to the level of Class 1 price versus other factors?

- How much of a role should the Class 1 price play in covering the cost of milk production?
- Should California's milk production supply be viewed more as being adequate for all class usages or surplus to its Class 1 needs?
- Should California's Class 1 price be properly aligned with: (1) the contiguous neighboring states or, (2) the economic factors/analysis affecting supply/demand?
- What level of uniformity of raw product costs among handlers is appropriate?
- Is the Class 1 price level fair and reasonable to consumers?
- Would round-tripping still occur despite the $0.88 per cwt. reduction in the Class 1 price?
- Will the potential for round-tripping be realized and how quickly?
- If the Class 1 price is reduced by $0.88 per cwt., how much revenue would dairy producers lose?
- If Class 1 prices are raised, how much additional Class 1 sales of California milk will be lost?
- If no adjustment is made to the Class 1 price level, how much will Class 1 sales decrease?
- If Class 1 prices are decreased by $0.88 per cwt., how much will California fluid milk sales increase?

In any consideration of this type, there is always an element of subjectivity whenever economic conditions and factors are weighed against the statutory mandates of the Code.

After thoroughly evaluating the hearing record and considering all the options, there are three distinct options available to the Department. Each option is listed below with the brief justification for each. Each option also affords countless variations.

Option 1: Make no adjustment to the Class 1 Price

Basis: The reduction of $0.88 per cwt. will not completely resolve all competitive problems of California fluid products. Increasing the Class 1 price will worsen the competitiveness of California fluid milk products. Increasing the Class 1 price will provide economic incentives to produce surplus production beyond the state's current processing capacity, while decreasing the price might remove the revenues that are necessary to sustain current milk supplies for the state's current processing usages.

Option 2: Increase the Class 1 Price

Basis: Cannot lower the Class 1 price low enough to completely resolve the competitive issue and still maintain a reasonable relationship with the other classified prices. For 2004, the weighted average California Class 1 price was below those in neighboring states.

Option 3: Decrease the Class 1 Price

Basis: There are ample California milk supplies for all purposes. Lowering the Class 1 price will make California fluid milk prices more competitive. This action will reduce the round-tripping incentive. This action will result in lower retail prices and some additional Class 1 sales.

The Panel recommends the adoption of Option 3. The Panel is of the opinion that changes in the market plus other economic factors have created a marketplace where California fluid products that incorporate regulated minimum prices are increasingly uncompetitive.

Moreover, with less than one fifth of California's milk supply being used for Class 1 products there are ample milk supplies within the state to satisfy all California fluid needs. Therefore, it is the Panel's recommendation that lowering the Class 1 price by $0.88 per cwt., will tend to:

- Promote, foster, and encourage the intelligent production and orderly marketing of milk in California.
- Eliminate economic waste, destructive trade practices, and improper accounting of market milk purchases.
- Conform the minimum prices for market milk established under these provisions to current economic conditions.
- Align Class 1 prices with the varying factors of cost of production, health regulations, transportation, and other factors in the state.
- Endeavor to achieve uniformity of cost to handlers within a marketing area.
- Provide more appropriate Class 1 revenues to ensure that the combined income from the milk class prices are in proper relation to the cost of producing and marketing market milk for all purposes.
- Insure an adequate and continuous supply, in relation to demand for milk for all purposes, at prices to consumers which when considered with relevant economic criteria, are fair and reasonable.
- Bear a reasonable and sound economic relationship with the other class prices.

Therefore, the Panel recommends decreasing the Commodity Reference Price adjuster from +0.464 to -0.416, thereby lowering the California Class 1 price by $0.88 per cwt. (equivalent to 7.6¢ per gallon of whole milk).

This Hearing Panel Report has been prepared and submitted by:

_____	_____
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_____	_____
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Appendix A

Summary of Hearing Petition And Alternative Proposals

Petitioner

1) Dairy Institute of California

    a. decrease the Commodity Reference Price (CRP) adjuster from +0.464 to -0.416.

Alternative Proposals

2) Alliance of Western Milk Producers

    a. increase the Commodity Reference Price (CRP) adjuster from +0.464 to +0.739.

    b. change the fluid carrier adjuster for Northern California from -0.0031 to -0.0014.

3) Western United Dairymen

    a. change the fluid carrier adjuster for Northern California from -0.0031 to -0.0011.

4) California Dairy Campaign

    a. Adopt the federal order Class I pricing formula structure.

    b. Use federal order differentials of $1.80 and $2.05, respectively, for Northern and Southern California.

    c. Allocate the federal skim price to solids-not-fat and fluid carrier by:

        i. Solids-not-fat = $\frac{(\text{skim} * 0.76)}{9}$

        ii. Fluid carrier = $\frac{(\text{skim} * 0.24)}{91}$

Appendix B

Summary of Panel Recommendations With Pros and Cons

The Panel recommends:

- That the proposed changes in the Class 1 pricing formula to mirror the structure and operation of the federal Class 1 pricing structure be denied.

- That no changes should be made in the Northern California Class 1 price to decrease the differential with the Southern California area.

- Decreasing the Commodity Reference Price adjuster of the Class 1 pricing formula from +0.464 to -0.416, thereby lowering the California Class 1 price by $0.88 per cwt. (equivalent to 7.6¢ per gallon of whole milk).

Price Effects of Panel Recommendations

Had the Panel recommendations been in effect from January 2000 to December 2004, the five-year average annual revenue impact would have been:

- A Northern California Class 1 price decrease of $0.88 per cwt.;
- A Southern California Class 1 price decrease of $0.88 per cwt.; and
- A decrease of $0.18 per cwt. for California pool prices.

Panel Recommendation

The Panel recommends that the proposal to reduce the current $0.27 per cwt. Class 1 price differential between the Northern and Southern California Marketing areas be denied.

Pros

1. Insufficient data/analysis relating to production and market conditions between the two areas. There was no analysis on the potential short and long term impact of the proposal.
2. A number of economic factors within both the Southern and Northern California marketing areas are changing. Rather than taking a partial approach based on hurried and rather incomplete analysis, careful, deliberate and a more comprehensive approach is more appropriate.
3. Are the proposals to make the Northern and Southern California Class 1 prices more uniform the primary motive? Both producers and processors had hearing proposals to reduce the Class 1 price differentials. Producers have favored raising the Class 1 price in the market area having the lowest price, while processors have favored reducing the Class 1 price in the market area having the highest price.
4. Makes Northern California fluid milk products less competitive.
5. Requires associated changes in the transportation credits for plant to plant milk movements. Both a supply plant in Northern California and deficit fluid plants in Southern California opposed the proposal.

Cons

1. There are large variations in milk production costs within one area, versus the difference between the two areas.

2. Southern California is more dependent on Northern California milk production to supply its needs.
3. Section 62062.1 justifies an increase in the Northern California Class 1 price. It would better align California's Class 1 price with contiguous states.
4. Increases producer revenues.

Panel Recommendation

The Panel recommends that the proposed changes in the Class 1 pricing formula to mirror the structure and operation of the Federal Order Class I pricing formula be denied.

Pros

1. Current announcement of the monthly Class 1 price will remain on or before the 10th of the prior month - limits adverse impacts to dairy stakeholders that require advance notice.
2. Class 1 price formula will reflect more up to date market signals by using the CME and not depending upon the NASS survey of dairy plants
3. Class 1 prices will provide more flexibility in accommodating change, while the federal order formula tends to remain more constant over time.

Cons

1. California's monthly Class 1 price changes would have been uniform/consistent with the change in the federal order Class I price.
2. California's monthly Class 1 prices would have been based on the same factors as used in the federal order Class I price.
3. Alignment of California Class 1 price level with the federal order Class I price would be far easier.

Panel Recommendation

The Panel recommends decreasing the Commodity Reference Price Adjuster from +0.464 to -0.416, thereby lowering the California Class 1 price level by $0.88 per cwt. (equivalent to 7.6¢ per gallon of whole milk).

Pros

1. By lowering the Class 1 price, it helps resolve the current price misalignment problem that has created competitive disadvantages for California fluid milk products.
2. Fosters intelligent production and orderly marketing of milk.
3. Removes substantial economic incentive to round trip California milk, helping to limit this destructive trade practice.
4. Helps improve the competitiveness of California fluid milk products.
5. By lowering the raw product costs, it will encourage lower retail milk prices.
6. Consumers will benefit from lower prices.
7. Helps establish California's Class 1 price at levels more consistent with California's market conditions (supply/demand).
8. California's milk supply far exceeds the amount needed to supply its Class 1 needs. The continued rapid growth of California milk supply will translate into ever higher proportions of the supply being used in manufacturing usage, typically dairy products having the lowest value.

Cons

1. In accordance with Section 62062.1, for the year 2004, California's statewide average Class 1 prices fell below levels in contiguous states, which justifies an increase in the Class 1 price level.
2. Reduces the dairy producer revenues.
3. The lower retail price for fluid milk may not fully reflect the decrease in farm price.
4. Non pricing factors are more important than the price level (i.e., changes in state demographics, advertising by bottle water, etc.) for the declining per capita fluid milk consumption.
5. Higher Class 1 revenues are needed to compensate farmers for their cost of milk production.
6. California's current milk production level is necessary and appropriate to satisfy current processing.
7. Very difficult to decrease California's Class 1 price to a level low enough to make California fluid products competitive, while maintaining a reasonable relationship with the other classified prices.
8. No guarantee that decreasing the Class1 price will eliminate or significantly reduce round-tripping.

Appendix C

Summary of Testimony

Dairy Institute Of California

- State Code requires that prices for market milk bear a reasonable and sound economic relationship to each other.
- Class 1 prices are too high relative to Class 2, 3, 4a, and 4b prices in the state. This is due to the following.
    - Class prices no longer bear an economically sound and reasonable relationship to each other.
    - Current stabilization plans create a combined income for dairy farmers that is more than necessary to maintain a continuous milk supply.
    - Current Class 1 pricing formulas do not conform to current economic conditions.
    - Current Class 1 prices do not have a reasonable relationship to prices in contiguous states.
    - Current plans fail to achieve uniformity of raw product costs to processors competing in a marketing area.
    - Current plans encourage economically wasteful and inefficient milk marketing practices.
- The Class 1 differential (defined as the difference between the Class 1 price and the higher of the Class 4a or 4b price) should cover the cost of converting Grade B milk to Grade A milk, the cost of drawing fluid milk to deficit markets, and a price/income enhancement for dairy producers so that an adequate milk supply exists.
- Per capita milk production currently exceeds per capita consumption. California is said to have a surplus of milk given this statistic. The state's milk supply has grown by 4.4% on average since 1990.
- Milk is currently priced using a price discrimination model. This model is no longer effective as demand elasticities for fluid milk and manufactured milk do not differ significantly. Economic conditions no longer warrant effective use of price discrimination model.
- Per capita fluid milk consumption has declined more rapidly in California than on a national basis during the last twenty five years.
- Study by UC Davis, Agricultural Economics Department confirms that lower Class 1 prices are passed onto the consumer. This proves that the farm-to-retail milk price spread does not increase when Class 1 prices are decreased.
- *Regarding section 62062.1:* California Class 1 prices are in "reasonable relationship" to contiguous states' prices when the Class 1 prices are significantly lower than those in contiguous states. "Reasonable relationship" does not mean equal prices.
- Exempt producer-distributors (PDs) have a competitive advantage in the marketplace. They incur no pool obligation on their exempt quota holdings.
- Reduce the Class 1 differential so as to encourage the use of the closest milk when serving the state's Class 1 market.
- The transshipment model of the U.S. dairy industry calculates shadow prices. These prices should be viewed as a relative value of the product across space and not as the absolute value of a good. This model can not predict the optimal commodity value at any one location.
- Dairy Institute is opposed to the alternative proposals submitted by the Alliance, CDC, and WUD. All three would increase effective Class 1 price differentials. Furthermore, all three would reduce the $0.27 per cwt. difference between Northern and Southern California

Class 1 prices. The Institute believes the $0.27 per cwt. difference should be maintained, if not increased.

  - Dairy Institute opposes CDC's proposal to calculate California Class 1 prices on a federal-order-based pricing method. This will delay the ability of fluid milk bottlers to give notice of price changes to their customers anywhere from one and two weeks. Additionally, because NASS data lag the Chicago Mercantile Exchange, the transmission of price signals in the marketplace will be delayed. Finally, CDC's proposal would relate California's fluid milk prices to those of Federal order manufacturing milk prices.
  - Dairy Institute opposes the Alliance proposal because it does not advance the legislative goals for the Stabilization and Marketing Plans set forth by the legislature.

Alliance of Western Milk Producers

- Only one section of the Food and Agriculture Code requires the Department to take action: section 62062.1.
- Calculations show the weighted average of California's producer Class 1 price was $16.32 per cwt. for 2004. This figure averaged $16.91 per cwt. in Oregon, Nevada, and Arizona.
- Alliance believes CDC is only other alternative proposal that would maintain a reasonable relationship between California producer prices and producer Class 1 prices in contiguous states on an annual basis.
- On average, the Department's cost of production studies show that the overbase price during 2000 through 2004 did not cover the average cost of producing milk during those years.
- Price is the only true measurement of whether milk supply for all purposes is adequate.
- Various milk classes in California and under the Federal Order bear a reasonable and sound economic relationship to one another.
- A dislocation of class prices has resulted from the volatility experienced at the Chicago Mercantile Exchange and the different time periods that are used for price calculations. None of the proposals as presented at the hearing will correct this price dislocation.
- Industry research has concluded that fluid milk consumption is affected by the following factors.
  - retail price of milk
  - retail price of milk substitutes
  - per capita disposable income
  - current and past generic marketing expenditures
  - seasonality variables
  - consumer expenditures on food consumed away-from-home
  - percent of population under six years of age, and
  - percent of African-American population.
- Per capita milk consumption needs to consider ethnic differences
- California milk prices are not that far out of alignment as Dairy Institute argues.

Western United Dairymen

- Opposes hearing petition submitted by the Dairy Institute.
- Primary historical rationale for $0.27 per cwt. differential between Northern California and Southern California includes the following.

    - use as a tool for interchange of milk between areas.
    - cost of production differences between both areas.
    - production and marketing differences between both areas.
- Difference between transportation credits and allowances creates an uneven playing field for all involved.
- Revenues derived from $0.27 per cwt. differential far exceed the cost of the transportation credit system in any given month. WUD proposes paying a credit only on the amount of milk that actually moves.
- Production costs have increased across California during the last five years. Most notably, the North Coast region has seen a 20% increase in production costs.
- Variance in production costs between Northern and Southern California has declined.
- Current market conditions suggest processors in both marketing areas are competing for the same milk supply.
- Northern California Class 1 price should be increased because there is no justification for a reduction in the Southern California Class 1 price.
- California's Class 1 prices during 2004 are not in reasonable relationship with minimum Class 1 prices paid to producers in contiguous states. Class 1 prices should be increased, given Section 62062.1 of the Food and Agricultural Code.
- Rebuttal to Dairy Institute's hearing petition.
    - Lowering Class 1 prices will not provide additional plant capacity.
    - Farm and retail price margins have continued to grow. Retailers don't always pass on reduced milk prices to consumers.
- WUD takes no position on the Alliance's alternative proposal.
- WUD is opposed to CDC's alternative proposal that will result in lower farm prices.

California Dairy Campaign

- Need to make fundamental changes to the current Class 1 pricing formula enabling the California Class 1 prices to more closely track federal order Class I prices.
- CDC's proposal is the only hearing proposal that addresses the issue of reasonable relationship between California's Class 1 price and those in contiguous states (section 62062).
- In 2004, California's Class 1 Price was well below the Federal Order Class I price received in nearby states.
- California dairy pricing system should be altered so that it can incorporate the best aspects of both the California and federal milk marketing order systems.
- CDC's proposal closes the growing gap between the California Class 1 Price and the federal order Class I price in contiguous states by incorporating the following aspects of the federal order pricing formula:
    - Replacing the current pricing procedure that uses the 26th of the last week of the prior month to capture changes in market prices by incorporating the federal order procedure that uses the first two weeks of the prior month.
    - Replacing the existing procedure of using the Chicago Mercantile Exchange (CME) in the Class 1 formula by using the National Agricultural Statistic Service (NASS) data.
    - Incorporating the federal order location differentials listed in Part 1124 Pacific Northwest Marketing Area section 1000.52 into California's Class 1 pricing formula. (CDC averaged the differentials for counties having Class 1 plants and combined them into either of California two marketing areas).

    - Replacing the use of Commodity Reference Price (CRP) in the Class 1 pricing formula with the Federal Advanced Skim Price, and added the appropriate location differential.
    - By incorporating the existing 76/24 percent split in value for SNF and Fluid components, and then converted these to per pound values by dividing the SNF by 9 and the fluid portion by 91.
    - By incorporating the federal order advanced butter price (take the per pound value of the location differential and add it to the Advanced Butter Fat price.)
- California's milk market is no longer geographically isolated from other parts of the nation.
- Increasing amount of out-of-state milk entering into the Los Angeles market from Nevada and other areas.
- Joining a Federal Order while combining certain elements of the California and federal systems, will ensure that prices paid will remain close to contiguous states.
- The fact that so much milk is pouring into the state and circumventing the state pooling system is creating an even stronger incentive for a California federal milk marketing order.

Dean Foods Company, Inc.

- Considering (a) California's Class 1 utilization and (b) the cost of available unregulated out-of-state milk, California has not kept its Class 1 price competitive.
- For Dean Foods to survive, it must purchase raw milk at competitive prices.
- For CDFA's dairy program to survive, it must keep its prices competitive with alternative out-of-state milk, since CDFA cannot prevent out-of-state milk from entering California.
- California producers and processors are at a regulated disadvantage compared to the out-of-state neighbors.
- Historically Class 1 differentials were established to ensure that sufficient milk supplies were available to serve the needs of Class 1 market.
    - In areas where Class 1 demand is greater relative to supply, the Class 1 price differentials were higher.
    - In areas where supply is larger relative to Class 1 demand, the Class 1 price differentials were lower.
- California's steady growth in milk production and declining fluid milk sales have resulted in a 20% decrease in Class 1 utilization in the four year period from 2000 (19.5%) to 2004 (15.7%).
- California's current Class 1 utilization is actually significantly lower than the lowest Class I utilization percentage in the Federal Order System, Federal Order 30, the Upper Midwest Order.
- California's implied Class 1 differential of roughly $2.09 to $2.36 is unjustifiably high in comparison to the $1.60 to $1.80 Class I differential for Federal Order 30.
- Any contribution to the pool above that necessary to fund the transportation allowance and credit system serves little purpose other than price enhancement to California dairy producers.
- While California Class 1 price is somewhat aligned with contiguous Federal Order prices, it is not competitive with available unregulated our-of-state milk being bought/sold as Calif. Class 1 sales.
- An aggressive unregulated out-of-state processor combined with California's uncompetitive price, and limited quota system has created an environment for several market-distorting and disorderly marketing activities.
    - Out-of-state packaged and bulk milk coming into the state at prices that under-cut California Class 1 Prices.

    - Unregulated packaged fluid milk has cost Dean Foods lost sales and forced Dean Foods to decrease its finished product prices to remain competitive.
    - Without appropriate reduction in the Class 1 price, there is ample opportunity to remain competitive by paying truck drivers and oil companies to move milk longer distances than appropriate.
- Dean prefers to buy California milk, but buying competitively takes precedence.
- The unregulated or unpooled milk reduces the value of California pool and the revenues California dairy farmers receive.
- Over time, some California producers and processors have learned to play the game by selling/buying overbase milk to an out-of-state buyer and then repurchasing the same milk and hauling it back into California as out-of-state milk.
    - While such milk movements are beneficial to select overbase producers, it also reduces the total dollars in the pool.
- Since California's Class 1 price and quota system mask the actual monetary loss to producers, most California producers are not aware of the problem.
- Those California processors that lacked the ability to engage in such practices will be at a huge competitive disadvantage in the market.
- This is not just a problem confined to Southern California; there are several options available for Northern California processors that choose to avoid paying the Class 1 price.
- If a suitable resolution is not achieved as a result of this hearing, Dean Foods will take the additional steps of looking at all available options.
- If the economic reality that faces the California dairy processor cannot be addressed, Dean Foods must seriously look at how such a failure impacts their continuing obligation, if any, to pay Class 1 minimum prices at their California bottling plants.

Safeway, Inc.

- Fully supports Dairy Institute's testimony.
- California's Class 1 price is higher than needed to insure an adequate supply of fluid milk.
- Class 1 sales are languishing and per capita consumption of fluid milk products has fallen faster in California than in the rest of the country.
- Class 1 consumers are paying more than their fair share to support dairy industry.
- Class 1 prices need to be reduced so as to foster more equality of raw product costs among processors.
- Panel/Department needs to understand the situation and choices that Safeway faces on a daily basis.
    - Processors are facing increasing pressure from outside the state.
    - Everyday there is milk (packaged and bulk) moving into California from nearby areas.
    - Some analysis suggests that there is more than a $2/cwt. advantage to bring milk from out-of-state compared to California's Class 1 price.
    - Millions of gallons of raw and packaged milk move into California each month.
    - This is taking away revenues from California processors and producers.
    - Safeway has millions of dollars invested in its California processing plants and as more & more milk enters the state, Safeway will continue to lose volume, and become unprofitable and eventually be forced to exit the California market.
    - Safeway store divisions have the option to source milk from non-Safeway plants if Safeway processing plants in California are unable to provide them with a competitively priced product.
- The single largest component of the cost of a carton of milk is the milk itself.

- There are times that it makes sense for processors to bring milk in form out-of-state, either in raw or packaged form; to lower costs and remain competitive.
- If California maintains a different dairy policy mechanism and milk pricing system from other states, California. must ensure that state policy keeps California dairy products competitive with contiguous marketing areas. Otherwise, the California dairy industry will face continued erosion of the Class 1 usage and reduction in the blend price. This will result in the loss of income to California producers.
- Safeway prefers to procure milk from local sources, all things being equal, and will endeavor to do so as long as the California's milk supply is competitively priced.

Milk Producers' Council

- Opposes Dairy Institute's proposal, claims it is illegal.
- Supports The Alliance of Western Milk Producers proposal, California prices are too low when comparing prices citing Section 62062.1 analysis for 2004.
- Supports the California Dairy Campaign proposal, wants a price relationship closer to the federal order prices.
- Opposes the call of the hearing.

Land O' Lakes

- Supports current program, opposes all proposals.
- States there is no justification for reducing prices.
- Does not support any changes to the current area differentials.
- If a change is made as a result of the hearing that reduces the area differentials, then supports a penny for penny adjustment in the transportation credits.
- Maintain the California system to move the California Class 1 price.

Super Store Industries

- Fully support Dairy Institute's testimony. Class 1 prices are too high, given:
    - California's low Class 1 utilization, stagnant Class 1 usage,
    - low cost of milk production, and
    - high Class 1 price relative to manufacturing classes.
- Low cost, unregulated milk has been entering southern California for some time now.
- An equitable market place cannot exist when some of the players are regulated while others are not. The deliberate deregulation of the federal milk marketing order in Utah and loopholes in the federal milk marketing order provisions has resulted in the following.
    - Low cost, unregulated milk supplies have been entering the Southern California market for some time now, and are now at the California doorsteps in the Reno, Nevada market.
    - Finished packaged product is shipped from Layton, Utah and sold for $2.00 per gallon, a lower price than those offered by Sam's Club, Super-Wal Mart and WinCo, (the stores who have a reputation for having the lowest legal prices).
- Using the adjacent regulated Class 1 price in areas outside California is no longer appropriate measuring stick for evaluating whether the California Class 1 prices are appropriate.
- It is critically important that California's dairy industry be able to compete with lower-priced unregulated milk.

- Dairy Institute's proposal to reduce the cost of raw milk is consistent with an independent estimate of the cost advantage for year 2004.
- It is clear that in contiguous unregulated area, effective Class 1 prices are lower.
- Dairy Institute's proposal is an effective way of working within the system to address both the economic fundamentals of the California fluid milk market structure and the growing influence of unregulated milk.

Crystal Cream and Butter Company

Crystal is in support of the Institute proposal. They feel that when all relevant economic factors are taken into account and judged relative to the statutory requirements, a downward adjustment in statewide Class 1 prices is warranted.

Crystal believes California should have Class 1 prices lower than contiguous states because California has the lowest cost, most efficient milk supply, combined with the lowest market Class 1 utilization in the country.

Crystal opposes the three alternative proposals submitted by WUD, the Alliance and CDC.

- WUD and the Alliance proposals would increase the price of Class 1 milk, which would have a negative impact on Crystal's competitive position relative to fluid milk in their area.
- The WUD and Alliance proposals would increase the advantage of the P/Ds over conventional processors by $0.16 per cwt. and $0.35 per cwt. respectively.
- CDC's proposal, while not carrying the economic negative impact, would impact the ability to calculate monthly price changes and communicate those changes to their customers prior to the first of the month.

Summary of Post-Hearing Briefs

Dairy Institute of California

- Methodology used to calculate per capita sales of beverage milk products:
  - Annual beverage milk sales for California and US were divided by their respective populations (population from US Census Bureau and CA Dept of Finance).
- If Class 1 price is reduced, processors may have an obligation to pay compensatory payments on shipments of packaged milk into federal order areas.
- Compensatory payments are positive difference between CA Class 1 price from federal order price applicable at the plant's location.
- Compensatory payments would be offset by a reduction in Class 1 price.
- Consumers would benefit from reduced Class 1 price.

Alliance of Western Milk Producers

- Only way to achieve a more reasonable price relationship is to reduce difference between the Class 1,2,3 time frame (26^{th} – 10^{th} of each month) and 4a/4b time frame (26^{th} -25^{th} of each month).
- Table provided shows Class 1 utilization in all U.S. marketing areas is more a function of declining milk production in some areas and the de-pooling of manufacturing milk in other areas.

    - Twelve of fifty states increased milk production over last 5 years – None are in Northeast, Appalachian, Southeast, Florida, or Upper Midwest areas.
- Only in 2 of the last 5 years did the California overbase price exceed the California cost of production.
- Cornell model used by USDA for differentials is based on milk production distance from market areas.
- Feels milk supply in California is only adequate. Industry didn't sell any dairy products to the Commodity Credit Corporation in 2004 or 2005 (even though per capita consumption did not account for all of California's milk supply).
- Feels the Institute's proposal wants to reduce producer Class 1 prices to counter unregulated packaged fluid milk from entering California. Legislation is the only way to address this problem.
- Lower California Class 1 prices would be counter to legislative directive.
- California per capita milk consumption is less than national average due to racial make up of population in California.

Western United Dairymen

- Feels Institute proposal only addresses competition of out-of-state milk.
    - Notes Dean Foods' testimony on round-tripping and avoiding payment into the pool.
    - Notes Safeway's testimony in losing volume and having to possibly exit the California market.
- Lowering Class 1 price will only tax producers and not resolve out-of-state milk issue.
- PD share of Class 1 market has stayed relatively steady since Jan 2003 at 18%.
- Raising Northern California's Class 1 price will have no impact on competitive situation between PDs and other processors.
- Any additional competitive advantage will only serve as additional profit for Northern California processors without resulting in increased market share or Class 1 utilization.
- Does not feel lower Class 1 prices will be passed on to consumers.

Dean Foods Company, Inc.

- Attached new exhibit with Northern Class 1 prices.
- Does not feel changing differential is warranted as cost of moving milk and dependence on Northern California milk have both increased.
- Lowering differential will impact competitiveness with contiguous milk supply, causing out-of-state milk inflow.
- It is clear that the price of out-of-state milk is cheaper than Class 1 price in California.
- Round-tripping of milk is caused by spread between Class 1 price and overbase price. It makes economic sense. This is a reaction to the problem.

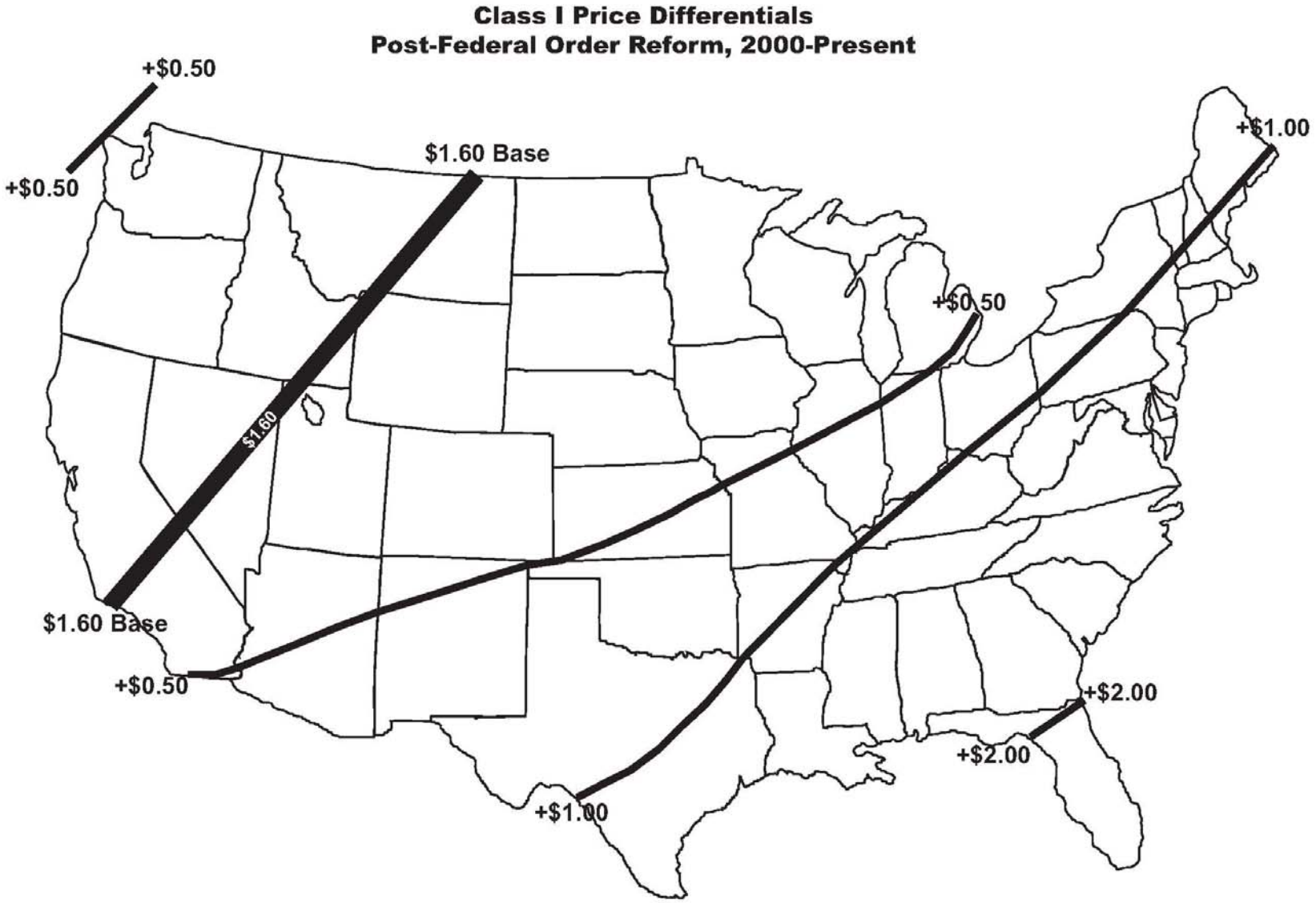
Land O'Lakes

- Cost of production data referenced in testimony was for Jan. 1- June 30, 2003.
- Feels some of WUD testimony was outside call of hearing.
- Under purely economic conditions, Class 1 prices in Tulare would be different than Los Angeles or Riverside counties. Price differences would be larger than differential is today

ORDINAL RANKING OF CLASS 1 UTILIZATION, CLASS 1 DIFFERENTIAL, AND COST OF PRODUCTION FOR VARIOUS FEDERAL ORDERS AND CALIFORNIA

Market	Class 1 Utilization	Class 1 Differential	Cost Of Production	
			USDA	Genske-Mulder
Florida	12	12		
Appalachia	11	9	9	
Southeast	10	9	7	
Southwest	9	8	4	6
Northeast	8	11	6	
Mideast	7	4	8	
Arizona	6	6		5
Central	4	4	5	4
Pacific Northwest	4	2		2
Western	3	2	2	2
Upper Midwest	2	1	3	
CALIFORNIA	1	7	1	1

Source: Dairy Institute Testimony


Class I Price Differentials
Post-Federal Order Reform, 2000-Present
+$0.50
+$0.50
$1.60 Base
+$1.00
+$0.50
$1.60
$1.60 Base
+$0.50
+$2.00
+$2.00
+$1.00