The Big Picture

For the first six months of 2006, the California dairy industry surpassed all expectations of increased milk production, posting record production increases for January, February, and March, compared to 2005. Milk production in California has reflected an average growth rate of 4.2 percent for the first six months of 2006, compared to the 12-month average growth rate in 2005 of 3.0 percent. For each of the first six months of 2005, California recorded milk production over three billion pounds and continues to set new records in production. U.S. milk production also showed an increase and plants across the country (including California) scrambled for plant capacity to handle the surplus milk supply. For the U.S. overall, for January-June 2006 compared to the same period in 2005, milk production was up 50 pounds per cow.

Dairy Products

California continues to lead the nation in the production of market milk, butter, and nonfat dry milk, producing an estimated 21, 30, and 46 percent, respectively, of the nation’s total production. Following the trend of 2005, the first six months of this year continued the steady growth of California cheese production, averaging a 1.5 percent increase in production over the same period in 2005. If the current trend in cheese production continues, California will surpass last year’s record setting 2.1 billion pounds of total cheese by year-end. Many California plants diverted the increased milk supplies to the production of butter and nonfat dry milk. This resulted in very bold increases when compared to the same period of the previous year. The first half of 2006 recorded increases of 21.2 percent in butter production, and 32.3 percent in nonfat dry milk production. The large amounts of powder diverted to custom-tailored powder in 2005 (for the overseas market) declined for the first half of 2006. Utilization in the first six months of 2006 continued to reflect recent production trends with butter, cheese, and nonfat powder production accounting for 78 percent of all California-produced milk available on a total solids basis.

Shifting Dairy Landscape Continues

In 2005 (compared to 2004), the northern California and southern California areas recorded a net loss of 79 dairies - while the mid-section valley area of California only showed a net gain of 14 dairies. These totals equate to 65 California dairies either shutting down or moving to areas out of state. San Bernardino and Riverside counties accounted for 28 of the dairies either shutting down, moving north to the Valley region, or moving to other states. The northern California region recorded a loss of 49 dairies (with no counties reporting new dairy operations), compared to a loss of only 20 dairies in 2004. This shift of dairy operations relocating to the Valley region over the last few years appears to be changing, with more dairies either ceasing to operate or moving out of state in 2005. Southern California now only accounts for approximately 10 percent of the state’s milk production. With nearly two-thirds of the state’s population in the Los Angeles basin and a full complement of plants to supply dairy products to that population, in the future it will become increasingly important to move milk to those processing facilities by means that are efficient, orderly, and sustainable.

Milk Prices

The high milk prices experienced by producers in mid-2004 are a distant memory as prices leveled off to an average price paid to California producers of $13.93 for the first six months of 2005, and $11.43 for the first six months of 2006. Low farm prices reflect the imbalance between the milk supply and commercial demand for milk and dairy products nationwide. If the high milk production continues as experienced in the first half of 2006, coupled with the current large inventories of Cheddar cheese and Grade AA butter, milk prices may remain flat for quite some time. Looking back at the low prices of 2003 and early 2004, and the record high prices of mid-2004, provides just another example of how milk prices can and do move both up and down rapidly. The level of milk prices is very reflective of the supply/demand of the dairy commodity markets.

Continued next page
Hearings and Related Issues

On January 31st and July 6th of 2006, the Department held public hearings regarding transportation issues in the dairy industry: a reflection of the dynamic changing landscape of the California dairy industry. These hearings addressed the competitiveness of milk movement costs in light of the structural changes in the state’s dairy industry.

The Department also held a hearing on June 1 and 2, 2006, to consider amendments to the Class 2, 3, 4a, and 4b pricing formulas, namely as follows: changes to the manufacturing cost allowances and f.o.b. California price adjuster in the Class 4a and 4b pricing formulas; changes to the cheese yield employed in the Class 4b formula; and changes to the dry whey manufacturing cost allowances in the Class 4b formula, with eventual removal of the dry whey factor from the 4b formula. The Department announced its decision on this hearing, however the implementation of the changes is pending at this time.

The Department has also called a hearing on December 5, 2006 to consider amendments to the Class 1 pricing formula, as requested by the Alliance of Western Milk Producers and Western United Dairymen.

All hearing related information can be found on the Dairy Marketing Branch website at: www.cdfa.ca.gov/dairy (go to Hearings)
The Size of California’s Dairy Farms, May 2006

<table>
<thead>
<tr>
<th>Range of Milk Marketings</th>
<th>Number of Grade A &amp; B Farms</th>
<th>Percent of Total Grade A &amp; B Farms</th>
<th>Percent of Total Grade A &amp; B Milk Marketings</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 250,000 Lbs.</td>
<td>187</td>
<td>9.65%</td>
<td>0.82%</td>
</tr>
<tr>
<td>250,000 to 500,000 Lbs.</td>
<td>263</td>
<td>13.58%</td>
<td>2.97%</td>
</tr>
<tr>
<td>500,000 to 750,000 Lbs.</td>
<td>229</td>
<td>11.82%</td>
<td>4.24%</td>
</tr>
<tr>
<td>750,000 to 1 Million Lbs.</td>
<td>207</td>
<td>10.69%</td>
<td>5.42%</td>
</tr>
<tr>
<td>1 to 1.5 Million Lbs.</td>
<td>299</td>
<td>15.44%</td>
<td>11.05%</td>
</tr>
<tr>
<td>1.5 to 2.4 Million Lbs.</td>
<td>322</td>
<td>16.62%</td>
<td>18.01%</td>
</tr>
<tr>
<td>2.4 to 5.0 Million Lbs.</td>
<td>306</td>
<td>15.80%</td>
<td>30.82%</td>
</tr>
<tr>
<td>&gt; 5.0 Million Lbs. (up to 18.2 Million Lbs.)</td>
<td>124</td>
<td>6.40%</td>
<td>26.67%</td>
</tr>
</tbody>
</table>

California Farms by Size, Comparison

- The 430 top-producing dairy farms (22% of the state’s dairies) produce 58% of the state’s milk marketings.
- The 679 lowest-producing dairy farms (35% of the state’s dairies) produce only 8% of the state’s milk marketings.
- The group of dairies producing less than 250,000 pounds of milk per month (187 dairies) accounted for less than 1% of the state’s milk marketings.
- In May 2006, there were 124 dairies producing greater than 5 million pounds of milk per month, 15% more dairies than in May 2005.
- Despite the fact that the total number of dairies is decreasing, the number of cows is increasing, thus the number of dairies producing over 5.0 million pounds of milk each month is increasing.

Distribution of Farms by Size of Milk Marketings, May 2006

- 750,000 to 1 Million Lbs.
- 500,000-750,000 Lbs.
- 250,000-500,000 Lbs.
- < 250,000 Lbs.

Net Milk Available in California

<table>
<thead>
<tr>
<th>Year</th>
<th>Production Entering California</th>
<th>Production Leaving California</th>
<th>California Milk Production</th>
<th>Net Milk Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>409,301</td>
<td>151,199</td>
<td>16,527,272</td>
<td>16,785,374</td>
</tr>
<tr>
<td>2002</td>
<td>601,210</td>
<td>286,287</td>
<td>17,490,758</td>
<td>17,805,681</td>
</tr>
<tr>
<td>2003</td>
<td>634,164</td>
<td>335,284</td>
<td>17,953,364</td>
<td>18,252,244</td>
</tr>
<tr>
<td>2004</td>
<td>730,164</td>
<td>139,284</td>
<td>18,183,980</td>
<td>18,774,473</td>
</tr>
<tr>
<td>2005</td>
<td>639,799</td>
<td>161,063</td>
<td>18,793,595</td>
<td>19,272,331</td>
</tr>
</tbody>
</table>
Where Do Consumer Milk Dollars Go?
Sacramento, May 2006

Under both California and federal milk marketing orders, minimum farmgate prices are regulated, but retail prices are not. Consumers often assume that most of their milk dollar goes to dairy producers. The chart below shows that dairy producers receive only about one third of the retail price of milk.

Average Retail Prices per Gallon

Costs to meet California’s higher nutritional standards ($0.06 (2%) for reduced fat milk; $0.11 (4%) for lowfat milk)
Retail price data for Sacramento for May 2006 obtained from A.C. Nielsen Company

Average Retail Gallon Prices for Whole Milk, Selected Cities, May 2006

U.S. Average Retail Price for Whole Milk, May 2006: $2.96/gallon
Source: A.C. Nielsen Scantrack Reports
U.S. Milk Production:
- U.S. milk production for January-June 2006, showed an overall 3.7% increase compared to the same period in 2005.
- In the top ten milk producing states for the first six months of 2006 compared to 2005, New Mexico and Texas showed the strongest increases in production, 15.2% and 12.8%, respectively.
- Interesting to note that even though one half of the 50 states reported decreases in production for the period January-June 2006, compared to the same period in 2005, overall U.S. production still recorded a 3.7% increase.

U.S. Total Milk Cows (Per 1,000 Head) - June 2006
Percent Change is June 2006 vs. June 2005

Milk in the U.S.:
- U.S. total milk cows for January-June 2006, showed an overall 1.0% increase compared to the same period in 2005.
- Interesting to note that the eastern half of the U.S. experienced the majority of the decreases in cow numbers for the first six months of 2006.
- Just over half of the 50 states reported a decrease in the number of cows compared to the same period in 2005.
- One fifth of the 9.1 million U.S. dairy cows are located in California.