



June 9, 2006

Mr. David Ikari  
Dairy Marketing Branch  
California Department of Food & Agriculture  
1220 N Street  
Sacramento, CA 95814

**Subject: Post Hearing Brief, June 1, 2006**

Dear Mr. Ikari:

This letter is to supplement our testimony given on June 1<sup>st</sup> and 2<sup>nd</sup> 2006.

We would again offer our strong support for a make allowance that encourages balancing capacity. California's butter and powder plants perform the very important job of balancing the growing milk supply and as milk production grows and the size of cheese plants continues to increase, the balancing function becomes even more critical. We experience large fluctuations in volumes through our butter and powder plants on a daily basis because of the balancing function these plants provide and currently there is inadequate balancing capacity to meet California's needs on a year round basis. All producers in this State benefit from a balanced milk supply and an orderly market and more balancing capacity is needed to help assure an orderly market for the future.

In our testimony we stated that the California dairy industry has recently become a major supplier of milk powders to the world and investment in California's powder manufacturing is needed to provide the capacity to process the milk solids that need to be exported to balance the State's growing milk supply. We have attached an article from the "2006 North American Food & Agribusiness Outlook" (Exhibit A), prepared by Rabobank International. The article states that exports account for 7 percent to 8 percent of the U.S. dairy sector's output and that milk powder exports are growing and were projected, at the time the article was written, to account for 60 percent of U. S. dairy exports for 2005, with Mexico accounting for the majority of U. S. powder shipments. The article concludes that "supply conditions worldwide point to the U. S. as one of the most viable regions for increasing production and exports". We believe that investment to meet this world market should be encouraged and should be considered in the Department's Hearing findings.

---

**CORPORATE OFFICE**

**ARTESIA**

11709 E. Artesia Blvd.  
P.O. Box 6210  
Artesia, CA 90702-6210  
Telephone: 562-865-1291  
FAX: 562-860-8633

**FRESNO**

755 "F" Street  
P.O. Box 11865  
Fresno, CA 93775-1865  
Telephone: 559-233-5154  
FAX: 559-268-5101

**LOS BANOS**

1155 Pacheco Blvd.  
P.O. Box 2198  
Los Banos, CA 93635-2198  
Telephone: 209-826-4901  
FAX: 209-826-6717

**TIPTON**

11894 Avenue 120  
P.O. Box 837  
Tipton, CA 93272-0837  
Telephone: 559-752-5200  
FAX: 559-752-5201

**TURLOCK**

475 South Tegner  
Turlock, CA 95380  
Telephone:  
209-668-6150  
FAX: 209-668-6162

**OPERATIONS OFFICE**

**VISALIA**

2000 N. Plaza Drive  
Visalia, CA 93291  
Telephone:  
559-625-2200  
FAX: 559-625-5433

Additionally, we believe that California has been well served in a balanced utilization of its milk supply and would point out that balanced usage (diversification of milk usage) also allows for a more stable industry; one that is less subject to temporary swings in the price of a single commodity.

In regards to CDI cost information requested at the time of the Hearing, our most current completed monthly financial statement and complete energy cost information is for the month of March, 2006. Therefore, we are submitting the following cost information:

**For natural gas, the average cost per therm for our five plants was as follows:**

Average Rate October 2005 – March 2006	\$ .8998
March 2006 Actual Rate	\$ .8223
September 2005 Actual Rate	\$ .8180
September 2004 Actual Rate	\$ .6046

**For electricity, the average cost per Kwh for our five plants was as follows:**

Average Rate October 2005 – March 2006	\$ .1013
March 2006 Actual Rate	\$ .0895
September 2005 Actual Rate	\$ .1052
September 2004 Actual Rate	\$ .1024

These average rates paid for the month of March 2006 and the six months ended March 2006 equate to the following cost per pound increases when compared to the rates paid for September 2004:

	<b>POWDER</b>	<b>BUTTER</b>
Cost per pound increase (March 2006)	\$ .0071	\$ .0000
Cost per pound increase (Oct 05 – Mar 06)	\$ .0117	\$ .0010

Page 3  
Mr. David Ikari

The fact of the matter is that energy costs are up significantly and the make allowance needs to be adjusted to recognize this.

Next, in regard to the butter price surveys, we continue to dispute the results for calendar year 2004 included in the Department's exhibit titled "CME Butter Prices vs. Audited California Butter Sales".

A summary of previous Department results for butter sales vs. CME is as follows:

**Department results (California less CME):**

Nov 02 – Oct 03 (Exhibit B)	(\$0.0348)
Nov 03 – Oct 04 (Exhibit B)	(\$0.0222)
Jan 04 – Dec 04 (Exhibit C)	(\$0.0088)
Jan 05 – Dec 05 (Exhibit C)	(\$0.0270)

**CDI data included in the Department's results:**

Jan 02 – Dec 02	(\$0.0350)
Jan 03 – Dec 03	(\$0.0370)
Jan 04 – Dec 04	(\$0.0362)
Jan 05 – Dec 05	(\$0.0256)

As you can see, the CDI price data for 2004 which is included in the Department's results for calendar 2004, results in a difference of (\$0.0362), a much larger price difference, in direct contradiction to the Department's extremely low calendar 2004 results.

We can not understand how the results for 2004 could be so different. Potential explanations may be that freight costs associated with sales or inter-company transfers have not been subtracted from the associated sales revenues or, as previously stated in our testimony, sales were made at above CME prices. Again, as stated in our testimony, sales at above the CME price seem unrealistic since a customer could buy butter at the exchange for the CME price less a credit for delivery in western warehouses of \$.04 per pound.

Our point is that the results of the Department's report for calendar 2004 are so different from any previously reported period, including the Department's own results for November 2003 to October 2004 (ten months overlapping time frame), and also so different from CDI's audited data, that we believe the calendar 2004 information included in the Department's exhibit should be removed from consideration, as the results are an aberration.

We continue to be concerned over the additional freight cost it will take to move the growing supply of butter to markets outside of California. Current freight rates to the Midwest markets are \$.0689 per pound by truck and \$.0482 per pound by rail. These are

actual rates paid by CDI earlier this year and copies of these invoices were submitted as evidence and are attached to our testimony given at the Hearing.

We continue to encourage the Department to make the changes to the butter and cheese sales price reporting process that we have suggested in our Hearing testimony. We believe this would provide guidance to processors as to what specific information is being requested, smooth the sales information gathering process throughout the year, and allow for efficient audits of the information supplied by the industry. It would provide consistent reporting by all California butter and cheddar cheese manufacturers, and include the weekly sales volume information necessary to perform the weekly weighted average calculations. *Weighted average* calculations are necessary to achieve an accurate estimate of the sales revenues received by manufacturers; a *simple average* is a very poor estimator of sales revenues, especially for products that sell seasonally like butter.

We also believe this change would save both manufacturers and the Department valuable time. Manufacturers would save time because they are already preparing weekly reports for NASS and the Department's Cost Audit Unit would save time because the information would be available on a more current basis and would be provided to the Cost Audit Unit in a consistent format by all manufacturers. In our opinion this simply makes good sense.

In regards to the objections raised as to appropriateness or validity of the Department's Exhibits titled "Estimated Impact Analysis of 2005 Utility and Labor Rates":

- 1) We are amazed at this objection to a "time tested" cost study update process which is to apparently support a lower make allowance position and believe the objection, if honored, would be a leap backward in the accuracy and relevance of the cost study to the current costs of manufacturing at the time of any future Hearing.
- 2) We believe the objection is unfounded:
  - i. The cost study models the costs of plants based on historical cost information
  - ii. The update models the results of the same cost study based on more current rate information. There is no manipulation of data to achieve a desired result and results have been disclosed to the industry at each previous Hearing for over 20 years.
  - iii. The more current rate information used in the update accounts for 50% of the manufacturing costs. The other 50% of costs are not increasing at as rapid a rate as those for energy and labor (health and welfare benefits).

- iv. The updated cost study model's results reflect the most current estimate of costs available at the time of a hearing.

We have also reviewed the recommendations contained in the Department's exhibit titled "Cost Study Consulting Report #1" prepared by CPS Human Resource Services. We do not agree with all of the recommendations included in that report, especially the recommendation to abandon the practice of preparing annual updates.

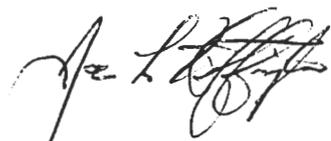
It is critical that the most up to date and accurate information be available for the Hearing process and from which the Department can make the most informed decisions. Eliminating the updated cost study model from the Hearing exhibits would be a huge step backwards for California and, in fact, would slow the adjustment process to the make allowance (both up and down), thereby unduly harming both producers and processors.

In our Hearing testimony, we stated that the consistent adjustment to costs and other factors in California has created stability, and that consistent adjustment is the key to the expansion and financing of facilities in California. We have found that financial institutions appreciate this consistent adjustment, and that brings stability to the financing of facilities in California. Timely adjustments yield financial results that make sense, untimely adjustments yield unusual results. We encourage the Department to base adjustments on as current of costs as can be estimated at the time of a Hearing, and we believe that the updated cost model helps achieve this.

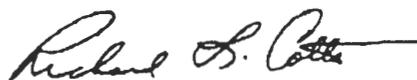
In summary, we encourage the Department to increase manufacturing allowances on butter/powder to help cover our costs to accommodate the expanded milk production, but not to over react to those seeking significant increases on make allowances for cheese. Increased capacity will come from new butter/powder production, which is more cost effective to producers.

Respectfully submitted,

CALIFORNIA DAIRIES, INC.

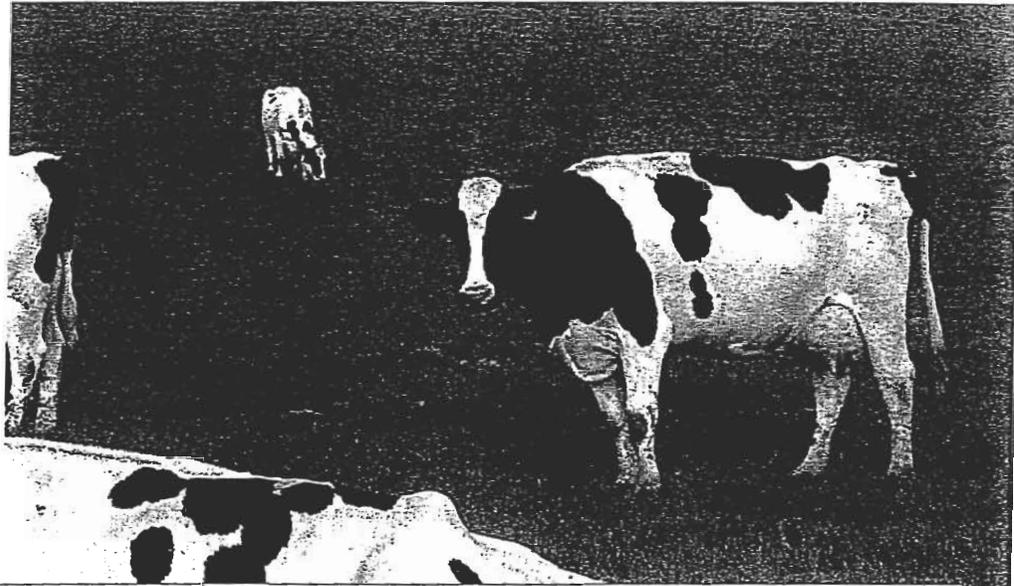


Joe Heffington  
Senior Vice President &  
Chief Financial Officer



Richard Cotta  
Senior Vice President of  
Governmental & Producer Relations

Attachments: Exhibits A, B & C



## 7 U.S. Dairy

### Record Production Facing New Markets and Uses

by Alejandro Reca, Food & Agribusiness Research, Rabobank International, New York

With an estimated 3 percent increase relative to 2004, milk production in the United States (U.S.) is expected to reach a record volume of 176 billion pounds in 2005. This is well above the 1.5 percent increase projected for world production, and will result in the U.S. accounting for a greater share of both world production and trade in dairy products. This volume growth can be attributed to a number of factors: a more efficient production setting and better managerial techniques; favorable price conditions; together with a slightly larger number of cows.



Global demand for dairy products is steadily increasing but supply from traditional exporters is limited resulting in low levels of world stocks and high world prices. Thus, the increasing milk production in the U.S. is concurrent with higher milk prices, overturning the traditional high production, low milk prices cycle.



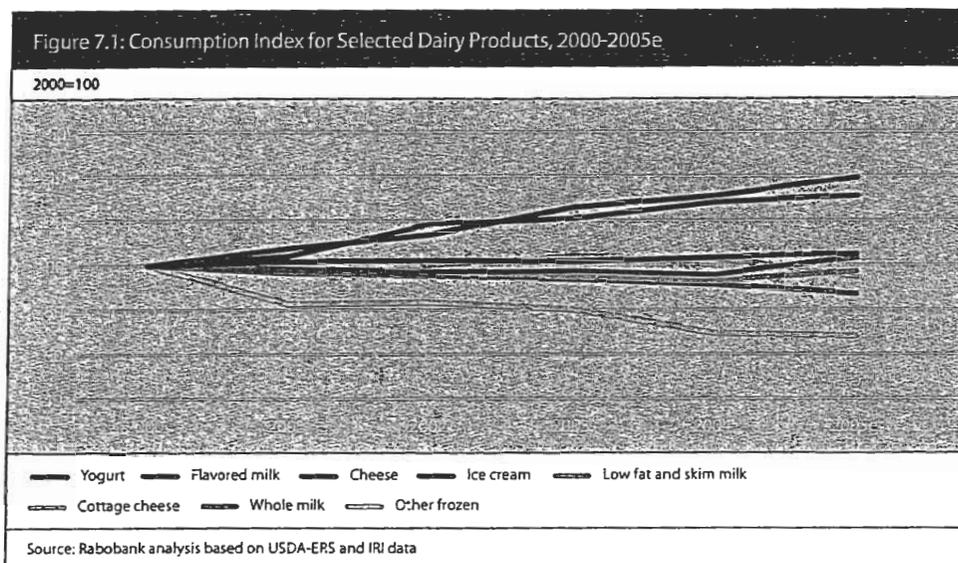
This supply/demand scenario has led to increased demand for U.S. dairy exports, which are also benefiting from the favorable exchange rate. According to U.S. Department of Commerce data through July 2005, U.S. exports of dairy-based products have expanded by approximately 40 percent, compared to the same period in 2004, reaching almost USD 630 million. Most of

the dynamics are found within the powder and whey categories. Mexico accounts for the majority of U.S. powder shipments, while those of whey are more balanced between China, Canada and Mexico.

Key demand drivers for U.S. dairy products include the following: developments in the export market; increased use of cheese by the foodservice sector; higher demand for cultured products; and decline in the importance of fluid milk among U.S. consumers. On the supply side, increasing concentration and consolidation throughout the value chain, relocation of production, and establishment of larger farms and processors have been ongoing trends. More recently, management changes within some of the largest dairy processors are opening up the possibility of further changes in the role that these companies will be playing at both, regional and national levels. Rabobank expects additional changes and streamlining to take place further improving the competitiveness of the U.S. dairy sector.

#### Domestic Market Dynamics

The growth in consumption of dairy products in the U.S. continues to favor cheeses and yogurts over fluid milk. While per capita consumption of yogurts and



cheese has increased by almost 6 percent and 1 percent per year, respectively, since 2000, during the same time period consumption of whole and low fat milk has declined annually by about 2 percent and 0.4 percent, respectively (see Figure 7.1). While consumption of flavored milks has expanded by almost 5 percent, the volume increase does not compensate for the decline in the nonflavored types, which has been taking place for over twenty years and thus, has a structural aspect.

Italian soft cheeses, mainly mozzarella and cheddar varieties, still account for over 65 percent of total cheese consumption in the U.S., with a steady annual increase in demand of about 2.5 percent. However, within the cheese category, not all cheese varieties present a growing demand. Since 1999, the most dynamic growth has been in the demands for Hispanic, Swiss and Italian hard varieties. Demand for these cheeses increased by almost 50 percent, 25 percent and 23 percent, respectively. Key factors explaining these dynamics include the following: the expanding role that the foodservice sector is playing and higher demand for convenience by consumers (evident by increasing consumer expenditures on food away from home); and the more sophisticated taste of consumers and more diversified consumer base (mostly, but not limited to, the demographic shift involving Hispanics, the demand for more cheese varieties, and the increasing use of dairy ingredients via novelty products, such as drinks and snacks).

Consumer concerns regarding carbonated beverages are providing ample room for growth in milk-based drinks, particularly in light of the proactive attitude from school boards regarding the convenience of using vending machines for distribution. In general, vending machines are proving to be a strong vehicle for driving growth in flavored milk consumption. In addition, some concerns regarding production conditions are driving up the consumption of organic milk, which is consistent with the overall demand for other organic products. Analysis of a sampling of schools that now supply flavored milk drinks in their vending machines shows demand increases in the 15 percent to 20 percent range. The nonrefrigerated, extended shelf-life milk required for these machines is significantly increasing the further processing of milk, for instance, under ultra high temperatures.

Despite the increase in demand for flavored milks, organic milks and milk-based drinks, there is an aggregate decline in the consumption of fluid milk. The increasing presence of alternative drinks, such as soy-based beverages and juices, combined with some concerns regarding the overall healthiness of fluid milk, contribute heavily to this decline. Furthermore, available market data shows that U.S. consumers currently drink more coffee, bottled water and soft drinks than milk.

Most importantly, children and teenagers constitute the two groups that drive milk consumption upwards, and there is already

evidence that they are drinking more milk than their equivalents a decade ago. According to the U.S. Bureau of the Census the percentage of children under five years of age, currently stands at 6.8 percent. While this share is slightly higher than in 2000, it is still down from 7.4 percent in 1995 and 7.6 percent in 1990. Thus, while the current youngsters might be drinking more milk than their counterparts a decade ago, there is an overall decline in their headcount.

Driven by consumers' search for value and retailers' desire to increase their presence, the share of private label products continues to increase throughout all dairy categories. When compared to other product groups, the share among the most innovative dairy product categories, such as yogurts and flavored milks, is significantly lower (see Figure 7.2). In addition to the more mature nature of the product, the significantly higher incidence of private label in the nonflavored milks product group is largely explained by the active role that food retailers still have in the manufacturing and distribution of fluid milk.

The U.S. imports a significant volume of dairy products. Cheese is the major dairy product being imported by the U.S., accounting for over 44 percent of the value of dairy imports or USD 2.1 billion during 2004. Casein and milk protein concentrates, which are both increasingly important food ingredients in the U.S. food sector, account for about 25 percent and 6 percent of imports. Over the past three years, imports of these products increased at a faster pace than

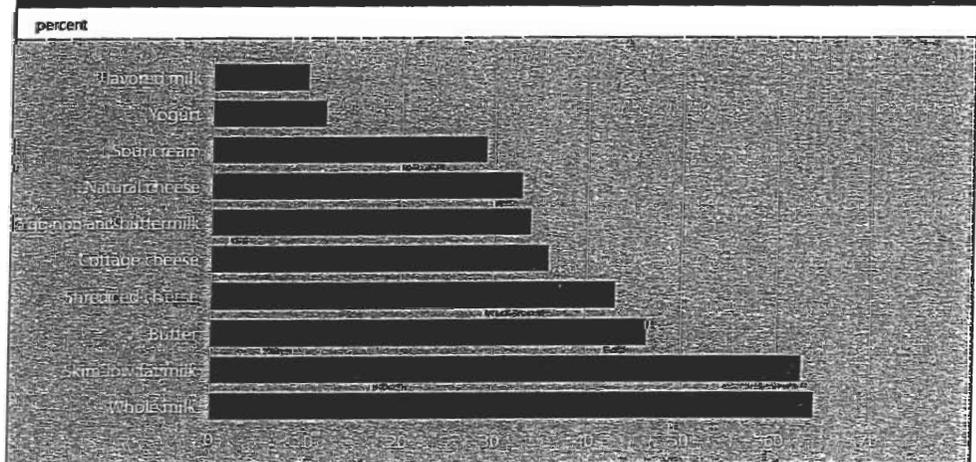
those of cheese: 12 percent versus 3 percent through September 2005.

**Export Shipments Increase Without Government Intervention**

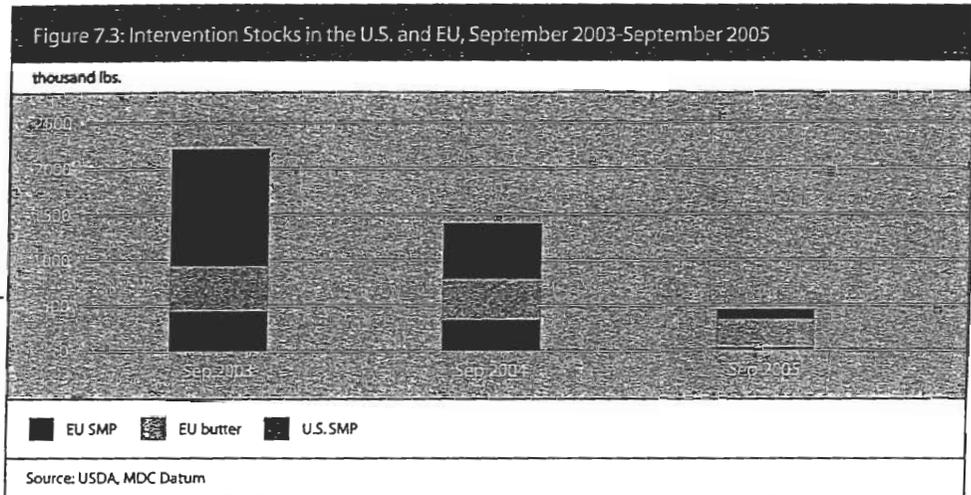
World demand for dairy products has been expanding steadily as a result of income and population growth, mostly in China and India. The existence of specific government sponsored school milk programs such as those being implemented in China and Brazil are also having a structural impact in the demand for dairy products. These programs are not only fostering the current demand for (mainly) milk, but are setting the basis for stronger consumption in the years to come. Yet, due to production constraints among leading and traditional world dairy producers such as New Zealand, Australia and the European Union (EU), the systematic increase in demand has not been fully matched by supply. As a result, during the past two years, over 1.8 billion pounds of dairy products have been removed from the respective intervention stocks held by the U.S. and the EU; stocks have now reached historically low levels (see Figure 7.3).

The tight world supply/demand ratio combined with the lower stocks has resulted in increasing world prices over the last 24 months. During this time period, world prices for skim milk powder (SMP), cheese and butter, measured via FOB prices at selected Oceania ports, increased by about 30 percent, 57 percent and 65 percent, respectively.

Figure 7.2: Private Label Share for Selected Dairy Products, 2005



Source: Dairyfield and Rabobank estimates



The higher prices have prompted an increase in U.S. exports of dairy products, which reached approximately USD 1 billion in 2004, embodying an almost 100 percent increase relative to 2002. In addition, exports through July 2005 show an increase of approximately 60 percent relative to 2004. There has also been a shift in the composition of U.S. dairy exports. In 2004, milk powders accounted for slightly over 45 percent of dairy exports, up from 22 percent in 2002. Through 2005, driven by favorable relative prices and consistent with the stock withdrawals, milk powders will account for 60 percent of U.S. dairy exports. The most significant export destinations now include Indonesia, Algeria, China, Thailand and even Canada, in addition to the Philippines and Mexico.

On an aggregate basis, exports currently account for approximately 7 percent to 8 percent of the U.S. dairy sector's output. This increase in exports could be considered to be

temporary in nature; due to the current favorable market conditions, driven by supply and demand imbalances combined with the deterioration of the U.S. dollar relative to most of its trading partners. Rabobank believes, however, that structural changes within the U.S. dairy sector will result in the U.S. playing a larger role in world dairy trade going forward.



**Restructuring and Relocation Underlying the Increasing Competitiveness of U.S. Dairy Farming**

Fewer, larger and more productive farms characterize dairy farming dynamics in most countries, and the U.S. is no exception. Available data shows that relative to 1999, the number of dairy farms with a herd size larger than 500 heads expanded by about 19 percent, with the largest increase found in the over 2,000 heads segment (see Figure 7.4). Overall, the U.S. dairy sector embodies about 81,000 farms, although only about 70,000 can

Figure 7.4: Selected Indicators in U.S. Dairy Across Different Production Segments, 2004

Herd size (heads)	2004			% Change, 1999-2004			
	Share in milk production (%)	Number of farms	Productivity, pounds per cow per year	Number of farms	Share in total milk production	Productivity per cow	Production per farm
≤99	22	63,300	15,953	(30.0)	(26.0)	4.3	5.2
100-199	14	10,445	17,953	(21.0)	(16.0)	3.9	6.2
200-499	16	4,685	19,825	(11.0)	(3.0)	5.2	9.6
500-999	14	1,700	20,883	6.0	18.0	3.5	11.5
1,000-1,999	13	815	20,667	18.0	23.0	(1.0)	3.8
≥2,000	20	495	20,718	102.0	126.0	(0.9)	11.8

Source: Rabobank analysis based on USDA-NASS data

be considered as economically viable, with approximately 3,010 (or only 4 percent) holding herds larger than 500 cows, including 495 farms with herds over 2,000 cows.

We find that the smaller dairy farms still have a 30 percent productivity gap relative to the larger ones. Yet, analysis of the changes in productivity shows that the smaller farms are improving faster than the larger farms and narrowing the gap. The highest change is observed in the 200 to 499 head segment. The higher production costs associated with the lower scale can be partially compensated with some government support and production of a differentiated product such as organic milk or specialty cheeses. Industry data shows that because of the supply/demand imbalance, organic milk reaches USD 23 per cwt to USD 25 per cwt commanding strong premiums at the farm level. Nevertheless, the overall lower productivity and higher cost structure undermines the long-term competitiveness of the smaller dairy farmers. In addition, the managers of larger dairies are able to negotiate better payment terms from processors, widening their profitability gap even further.

At an aggregate level since 1999, almost 30,000 or about 27 percent of dairy farms are no longer in business. Most of the decline has taken place within the segment that embodies less than 100 cows. As smaller farms move out of the business their herds are bought by larger farms or eliminated

through the Cooperatives Working Together (CWT) initiative.

Production continues to move away from more traditional areas in Wisconsin, Minnesota and New England, and relocate westward, as far as California, and to the Midwest, namely Indiana, Ohio and Michigan (see Figure 7.5). To a lesser extent, relocations or expansions also include South Dakota and Iowa. While the recent price increase in mailbox prices led to a slight production recovery in Florida, and partially slowed the exodus of smaller dairies, the relocation trend is still evident.

As relocation of dairy herds continues and government officials and habitants in the destination counties become aware of the some of the unperceived side effects of the significantly larger cow populations, we expect some frictions (environmental and zoning among others) to arise.

As increasing volumes of milk are allocated to cheese manufacturing, the location of dairies is no longer driven by proximity to consumption centers. Rabobank analysis shows that availability of low-cost inputs (feed being the most important one), the existence of expansion possibilities, access to water and adequate environmental conditions have been driving the relocation of dairy farming during recent years (see Figure 7.6).

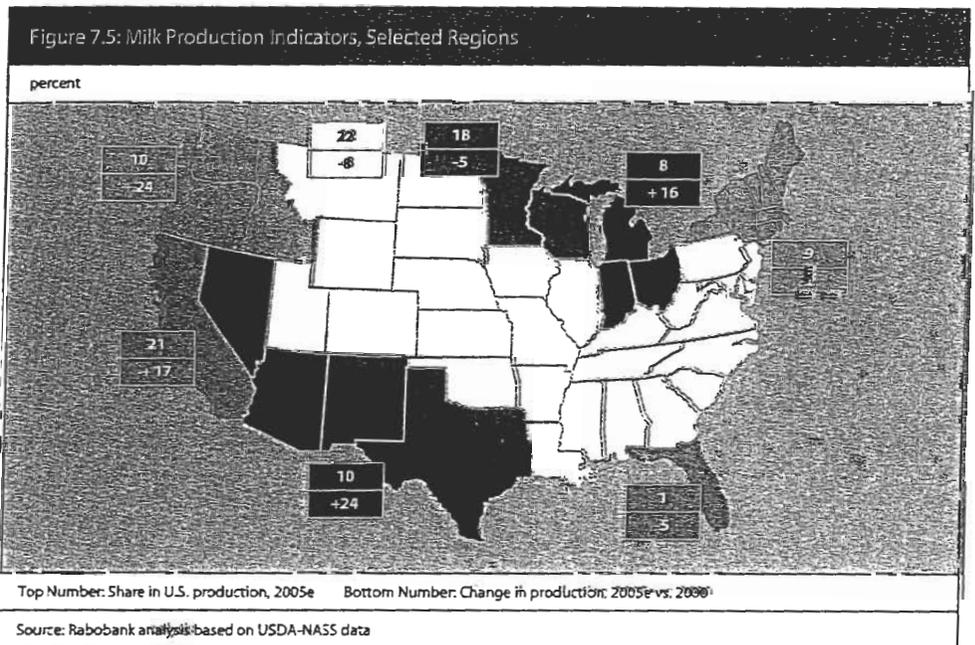


Figure 7.6: Farming Location Drivers in the Future

Driver	Rationale	Location ranking	
		Favorable	Unfavorable
Feed and other costs	Provides structural aspects as most important item in production costs. Looking to minimize distance from originating regions or optimize use of available feed and other cost inputs, including labor.	Indiana, Ohio, Nebraska, SW Kansas, Wisconsin, west/panhandle Texas, South Dakota	Florida, New York, Pennsylvania
Expansion	Necessary to realize economies of scale.	E. New Mexico, west/panhandle Texas, Idaho, Oregon, South/North Dakota	Florida, Minnesota, Wisconsin
Water availability	Availability given by rainfall or well. Becoming increasingly important via cost and abundance given dairies are becoming larger.	Oregon, Indiana, Wisconsin, Ohio, Washington, Michigan, South Dakota, New York, Pennsylvania	Florida, California
Environment	Becoming increasingly important due to urbanization requirements and dairies overall are becoming larger (heavier concentration of animals). Can limit expansion possibilities. Not (yet) so important.	New Mexico, west/panhandle Texas, Oregon, South/North Dakota	Florida, California, Ohio, Wisconsin

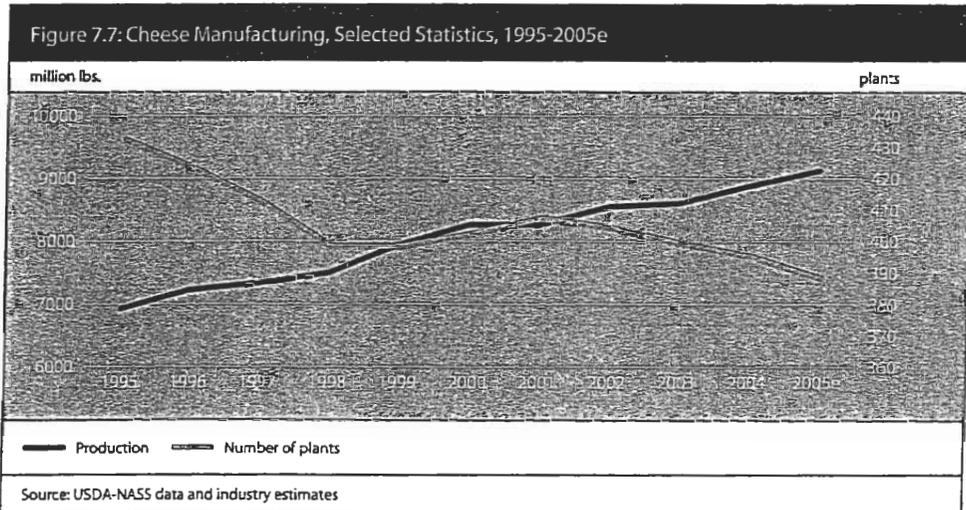
Source: Rabobank analysis

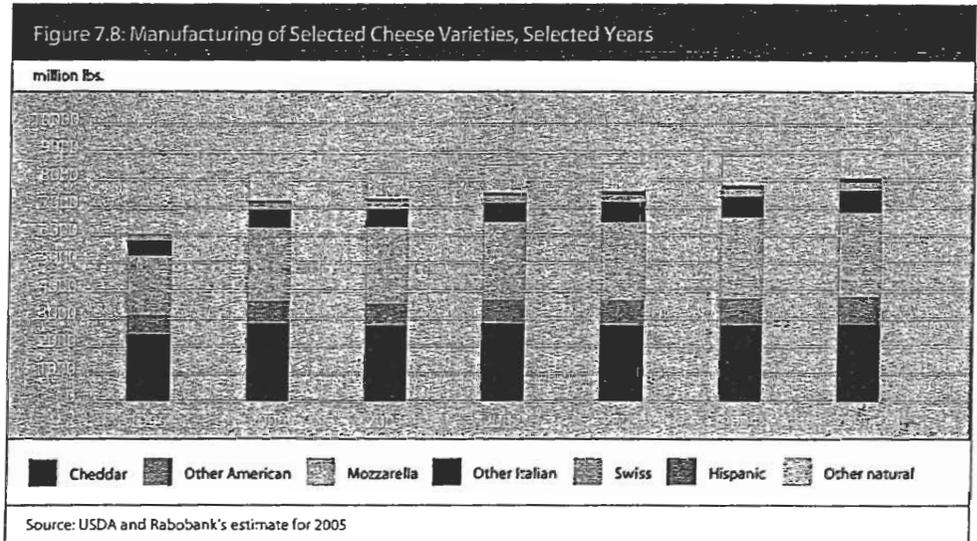
More and more dairy operators (predominantly larger scale) are looking to own or establish long-term leasing of sizeable tracts of land for control of feed production and manure application. According to the USDA's Economic Research Service, current cost data shows production costs in Texas to be the lowest, about USD 13.34 per cwt in May 2005, approximately 30 percent below those estimated for Wisconsin and New York farms. South Dakota, with its abundance of

available quality land, is also a good region for low-cost feed production. Despite its overall importance, California does not currently appear as attractive for relocating dairy herds.

**Processing: Increasing Scale, Relocating Production and Shifting Product Mix**

Since 1998, more fresh milk is being transformed into cheese than into fluid milk.





During 2004, about 39 percent of the fresh milk produced was processed into cheese and 31 percent into fluid milk. The remaining volume has been increasingly processed into dry whole milk and frozen products, and decreasingly into butter, creamery, creamed cottage cheese and evaporated and condensed milk.

According to Census data, between 1997 and 2002, there has been a 22 percent decline in the number of companies involved in bottling. The number of fluid milk plants dropped from 608 to 524, while industry sources suggest there have been additional closures of about 15 plants since 2002 (see Figure 7.7). The average-size plant increased production by 13 percent to almost 23 million pounds per year, while the number of plants shows a downward trend.

Larger cheese-manufacturing plants are now being built close to the expanding dairy farming regions. Existing expansions include those undertaken by Land O'Lakes (in joint venture with Mitsubishi) for mozzarella production in California, Leprino's mozzarella plant also in California and Glanbia's joint venture with Dairy Farmers of America (DFA) in Idaho. Ongoing projects, in turn, involve those also led by Glanbia with Select Milk Producers and DFA in New Mexico. In all cases, these regions show production expansions above the national average. Furthermore, California has become the largest manufacturer of mozzarella.

Clearly, cheese manufacturers are seeking high volume and relatively lower priced raw milk supplies, which favors states as

mentioned above including Idaho and the west/panhandle Texas areas. This production shift away from traditional areas will likely have a negative impact on plants in the upper Midwest, specifically Wisconsin and Minnesota. Therefore, such plants will need to adjust their cost structure and/or specialize in order to remain relevant in the market.

Mozzarella now accounts for about 33 percent of manufactured cheese in the U.S. (see Figure 7.8). In volume terms, its growth represents approximately 40 percent of the sector's expansion, and industry estimates indicate that foodservice currently accounts for about 70 percent of mozzarella sales. During the last 10 years, cheddar manufacturing has grown by only 0.4 million pounds and has been stable at about 2.8 billion pounds since 2000, standing second to mozzarella.

Embodied in the pricing scheme of milk is the importance of Class I milk (used as a beverage) that due to its nature always carries a higher price. As less milk is used in fluid milk manufacturing, the share of the higher priced component will decline lowering the mailbox price. The analysis of prevailing mailbox prices for June 2005 shows that the difference between the two extremes—Florida (declining production, high population) and New Mexico (increasing production, low population)—to be over 20 percent (see Figure 7.9).

As milk use changes, the pricing mechanism set by the marketing order system will need to be adjusted to reflect the actual usage. The rigidity in the milk pricing scheme, that leads

to some "artificially" high prices is being pointed to by some leading manufacturers as the source of some additional plant closures, particularly in those regions characterized by a less dynamic production setting with an increasing population.

Safeway and Kroger Company, which are among the largest retailers following Wal-Mart, are also among the top five U.S. dairy companies. Yet, they mostly specialize in nonflavored fluid milk, and thus, their presence in manufacturing of the more dynamic categories (cheeses, flavored milks, drinkable yogurts) is limited. Rabobank expects this presence to decline over time as retailers look further into their core business strategy and search for ways of optimizing their return on capital. Although not driven by strategic aspects, the retailer Winn-Dixie is in the process of disposing of its dairy and nondairy manufacturing assets.

**Outlook**

Demand for dairy products continues to increase, particularly for selected cheeses and fluid products, including all types of flavored drinks, product enhanced (such as omega-3, extra calcium) and smaller size presentations. Changes in U.S. consumer preferences together with the growing Hispanic population will continue to fuel the demand not only for Hispanic cheeses, but also for other Italian varieties, such as provolone, parmesan and romano cheeses. In addition, and for selected fluid products, children and teenagers are supporting this trend and provide the basis for a larger consumer base in the coming years.

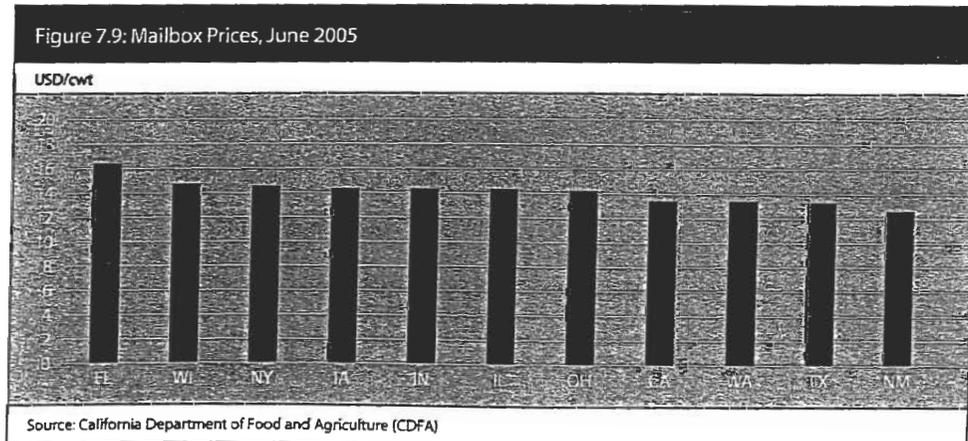
Preliminary expectations for milk production for 2006 indicate an additional 2 percent to 3 percent increase relative to 2005. As for 2005, higher yields per cow (more BST available and better feed rations) combined with a slightly larger herd are behind these figures. These changes are above those expected for world supply and demand, which will lead to an increase in the relative importance of the U.S. in world markets and also provide the basis for relatively strong domestic prices.

USDA's current forecast for the 2005 All Milk composite stands at USD 15.05 per cwt to USD 15.35 per cwt after being revised upwards (because of the increasing role of exports) through the year. The current forecast is slightly below the prevailing level in 2004, but significantly above the 2003 level of USD 12.5 per cwt. In the context of the stronger market conditions, the current forecast for the 2006 All Milk composite is in the USD 13.10 per cwt to USD 14.10 per cwt range, embodying an 8 percent to 12 percent price decline. To the extent that the importance of the export market increases, we believe that this forecast will be revised upwards once again.

The recent extension of the milk income loss contract (MILC) that assures a minimum income to smaller farmers once milk price falls below a certain federally regulated level, while providing a safety net for the smaller producers might not be needed.

In the context of lower milk prices, production efficiencies will continue to be critical. Smaller farmers and processors should look further into specialty niches such as organic milk, for which we expect strong

Figure 7.9: Mailbox Prices, June 2005



demand to continue. The lower prices will also call for further action by producers under the CWT and support under the existing government programs.



Supply conditions worldwide point to the U.S. as one of the most viable regions for increasing production and exports.

Rabobank believes that there are structural aspects that indicate a larger role for the U.S. in world dairy trade will take place. These structural aspects are driven by production conditions that are leading to lower production and processing costs. This will allow U.S. dairy farmers to have access to a larger, more dynamic and, probably, less regulated market. The ongoing changes at the processing level will continue to be led not just by local companies, but also by large, and specialized, foreign players.

## CME Butter Prices vs. California Butter Sales

### Introductory Remarks

Data was collected from 5 butter plants, representing sales of salted bulk butter from November 2002 through October 2004. The 5 plants reported monthly sales volume and sales revenue for the twenty-four month period. CME butter prices are the monthly simple averages for butter prices released by CME, using the 26<sup>th</sup> of the prior month through the 25<sup>th</sup> of the current month. Weighted average California butter prices represent the monthly price per pound received by each plant and then weighted by sales volume.

	CME Butter	CA Weighted	Difference	Summary of Results - CA less CME	
Nov-02	\$1.0371	\$0.9928	-\$0.0443		
Dec-02	\$1.1139	\$1.0868	-\$0.0271	All 24 Months	-\$0.0285
Jan-03	\$1.0982	\$1.0629	-\$0.0353	Nov 02 - Oct 03	-\$0.0348
Feb-03	\$1.0471	\$1.0386	-\$0.0085	Nov 03 - Oct 04	-\$0.0222
Mar-03	\$1.0823	\$1.0532	-\$0.0291		
Apr-03	\$1.0917	\$1.0584	-\$0.0333	Largest Positive Monthly Difference	\$0.0335
May-03	\$1.0888	\$1.0583	-\$0.0305	Largest Negative Monthly Difference	-\$0.1011
Jun-03	\$1.1104	\$1.0705	-\$0.0399		
Jul-03	\$1.1833	\$1.1309	-\$0.0524	Average without largest positive and negative differences	-\$0.0280
Aug-03	\$1.1835	\$1.1323	-\$0.0512		
Sep-03	\$1.1652	\$1.1264	-\$0.0388		
Oct-03	\$1.1829	\$1.1264	-\$0.0269		
Nov-03	\$1.1998	\$1.1710	-\$0.0288		
Dec-03	\$1.2956	\$1.2529	-\$0.0427		
Jan-04	\$1.3743	\$1.3713	-\$0.0030		
Feb-04	\$1.6579	\$1.6289	-\$0.0290		
Mar-04	\$2.1275	\$2.0264	-\$0.1011		
Apr-04	\$2.2052	\$2.1490	-\$0.0562		
May-04	\$2.0958	\$2.1293	\$0.0335		
Jun-04	\$1.9160	\$1.9217	\$0.0057		
Jul-04	\$1.7818	\$1.8000	\$0.0182		
Aug-04	\$1.5630	\$1.5482	-\$0.0148		
Sep-04	\$1.7369	\$1.7196	-\$0.0173		
Oct-04	\$1.6863	\$1.6553	-\$0.0310		

*Revised by CDFA Dairy Marketing Branch 01/18/2005*

CME Butter Prices vs. Audited California Butter Sales

Introductory Remarks

Data were collected and audited from six butter plants, representing sales of salted bulk butter from January 2004 to December 2005. The six plants reported monthly sales volume and sales revenue for the 24 month period. CME butter prices are the monthly simple averages of butter prices released by CME, using the 26th of the prior month through the 25th of the current month. Weighted average California butter prices represent the monthly price per pound received by each plant and then weighted by sales volume. The data represents 100% of the salted bulk butter sold by California plants.

	CME Butter	CA Weighted	Difference
Jan-04	\$1.3743	\$1.3733	-\$0.0010
Feb-04	\$1.6579	\$1.6475	-\$0.0104
Mar-04	\$2.1275	\$2.0463	-\$0.0812
Apr-04	\$2.2052	\$2.1872	-\$0.0180
May-04	\$2.0958	\$2.1296	\$0.0338
Jun-04	\$1.9160	\$1.9218	\$0.0058
Jul-04	\$1.7818	\$1.8002	\$0.0184
Aug-04	\$1.5630	\$1.5480	-\$0.0150
Sep-04	\$1.7369	\$1.7207	-\$0.0162
Oct-04	\$1.6863	\$1.6642	-\$0.0221
Nov-04	\$1.8558	\$1.8332	-\$0.0226
Dec-04	\$1.7705	\$1.8214	\$0.0509
Jan-05	\$1.5725	\$1.5544	-\$0.0181
Feb-05	\$1.6071	\$1.5833	-\$0.0238
Mar-05	\$1.5543	\$1.5375	-\$0.0168
Apr-05	\$1.5179	\$1.4914	-\$0.0265
May-05	\$1.4025	\$1.3835	-\$0.0190
Jun-05	\$1.4923	\$1.4603	-\$0.0320
Jul-05	\$1.6402	\$1.6090	-\$0.0312
Aug-05	\$1.6665	\$1.6332	-\$0.0333
Sep-05	\$1.7098	\$1.6751	-\$0.0347
Oct-05	\$1.6427	\$1.6181	-\$0.0246
Nov-05	\$1.4627	\$1.4251	-\$0.0376
Dec-05	\$1.3648	\$1.3359	-\$0.0289

Summary of Results: CA less CME

	Average Differences	
	Simple	Weighted
All 24 Months	-\$0.0168	-\$0.0181
12 months ending Dec. 2004	-\$0.0065	-\$0.0088
12 months ending Dec. 2005	-\$0.0272	-\$0.0270
Smallest Monthly Difference		-\$0.0812
Largest Monthly Difference		\$0.0509
Average without smallest and largest differences	-\$0.0170	-\$0.0176

Difference of Monthly CME Average Price and California Weighted Average Price Received

