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California Department of Food and Agriculture
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RE: October 30-31, 2008 Class 1, 2, and 3 Hearing -- Post Hearing Brief

Mr. Hearing Officer and Members of the Panel:

Dairy Institute appreciates the opportunity to submit the following post-hearing brief to amplify portions of our testimony presented in Sacramento on October 30, 2008. The paragraphs that follow build on the propositions that we put forth in our testimony.

<u>California Plants Must Remain Competitive</u>

We have argued that increasing the overall Class 1, 2, and 3 price level as proposed by the petitioners would hurt the competitiveness of California processors in the marketplace. While we do not doubt that producers are facing higher costs than has been the case in recent years, we firmly believe that any pricing decision that results in a diminished competitive position for California processors will have a serious and immediate negative impact on the industry.

At the hearing, we noted in our testimony that positions taken by producer groups at previous hearings have contributed to the problems the industry is facing today. While some could accuse us of being overly harsh in our comments, we did not intend them to be so. Rather, our purpose was to make the point that policy decisions have market consequences. Understandably, the Department has endeavored at past hearings to strike a balance between producer and processor interests. However, when producer requests for additional revenue from the regulated system are extreme, charting a “middle course” between producer and processor positions can actually be detrimental to the industry’s long run health and competitiveness. Sometimes industry conditions and economic reality require that Department adopt a position that is closer to one side or the other.

When we look at the industry conditions today, we see a situation where there is not enough market access available for all of the milk that producers in California want to produce. While this situation is often characterized as a shortage of plant capacity, the problem is really broader than that. We have a situation where demand for California milk and dairy products and the derived demand for California bulk milk from the farm is inadequate for the size of the milk supply. Dairy institute members testified at the hearing that there is some space in Class 1, 2 and 3 plants to take additional milk supplies, but unfortunately there are no sales for the additional products that would be made from that milk.

A significant part of the reason for that lack of demand for California milk is the state's pricing policy. It might be tempting to compare price levels in surrounding states and California and draw the conclusion that as long as they are in the same "neighborhood" California processors are probably doing okay. However, such an analysis misses on crucial points. First, California's business costs are higher than in many other states. This fact has been demonstrated at previous hearings and is a frequent subject of political debates in Sacramento. Therefore, <u>even if California's milk prices were identical to prices in surrounding states, California's processors would still be at a competitive disadvantage</u>. Second, as we pointed out in our testimony, the growing gap between Class 1 and Overbase prices, reflective of a growing divergence of prices for the different classes of milk within the state, damages the competitiveness of California processors; a fact that is not revealed by interstate price comparisons. <u>Finally, because of recent changes to prices in Northern and Southern Nevada and surrounding Federal Orders, a *status quo* decision, where no changes are made to California's pricing policy, will imperil California Class 1, 2, and 3 sales</u> because of the reductions in California's competitiveness that would not be redressed.

The argument by producers that cooperative base plans have brought the state's oversupply problem under control fails to recognize the consequences of these supply control mechanisms. To say that the base plans are unpopular with producers would be an understatement. Dairymen who want to grow their operations are especially concerned. Consider the impact on California's dairy industry of continued reliance on base plans to control production. Producers who are among the lowest cost and most innovative are also most often those who wish expand their operations. In many cases, these are also younger dairymen, the future of our industry. If these younger, innovative, and low-cost producers are unable to grow in California, they will likely move their operations to states where they *will* have the opportunity to grow. As a result, California will lose its most efficient producers, and the overall cost of production in California will rise relative to other states. California will become less competitive from a milk production cost standpoint as well as from a processing cost standpoint. The industry's demise will then be a question not of if, but of when. Prices, not artificial supply constraints, should be the mechanism that properly aligns supply with demand, giving the most efficient and forward-looking producers the opportunity to thrive.

<u>Temporary Price Increases Have Short-Term *And* Long-Term Consequences</u>

It may be tempting to think that adoption of a short-term price increase, such as the one proposed by producer groups, could be effectuated with little long-term negative impact to the industry. At the hearing, processors testified that California sales would be lost during the period while the price increase was effective. We also pointed out that recovering lost business will not happen automatically when the "temporary" price increase ends. Once the sales are held by other states' processors, they can be expected to do everything they can to hang onto that newly acquired business, and all they will have to do is meet the California price. California plants will not be able to regain the lost business unless they have a clear price advantage, and even then, the result will depend on what other states' milk pricing agencies do in response.

A crucial point to remember is that a series of short term pricing decisions effectively becomes viewed as the state's long-term pricing policy. Plant investment decisions are made based on the cumulative record of the Department in making decisions that encourage plants to locate within the state, with more weight being given to the most recent set of decisions. The decision by the Department in 2003 to break with past policy and put cheese plant returns in great jeopardy is a large part of the reason why we have had no significant investment in new cheese plants since that time. A decision by the Department that fails to keep Class 1, 2, and 3 plants competitive, when the California bulk milk market is already oversupplied, will have a similar chilling impact on processors' willingness to maintain investments in the state.

Therefore, in light of the preceding arguments, we urge the Secretary to reject the producers' petition and alternative proposal, and adopt Dairy Institute's proposal. Failure to address the competitive concerns we have raised will lead to lost Class 1, 2, and 3 sales and to more producers losing homes for their milk. Thank you for the opportunity to submit this post-hearing brief and for your consideration of our position.

Sincerely,

William A. Schiek
Economist