# Dairy Institute
### Of California

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November 12, 2009

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**RE: November 9, 2009 Class 1, 2, 3, 4a and 4b Hearing -- Post Hearing Brief**

Madame 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 November 9, 2009. The paragraphs that follow build on the propositions that we put forth in our testimony.

**California Plants Must Remain Competitive**

We have argued that increasing California regulated prices will negatively impact sales of California products. This result occurs due to changes in consumer demand and competition from other states. As the regulated price for milk used in Class 1, 2, and 3 products is increased, those changes will be passed on to consumers, if possible. Consumers respond to higher prices by purchasing less product, and therefore, sales of California product will fall. At the same time, these higher finished product prices create an opportunity for out-of-state competitors to steal business away from California plants by offering lower product prices to customers. They are able to do this because they have not faced regulated milk price increases like their California counterparts.

The Alliance testimony indicated that its proposed price increases will not hurt California sales because of the high cost faced by competitors transporting product into California. This assertion presupposes both that all sales of California's Class 1, 2, and 3 products are deep within the state's territory and that costs, other than raw product, are relatively similar across states. In reality, California sells Class 1, 2, and 3 products both inside and outside California. Those outside sales will be especially vulnerable to out-of-state competitors if California regulated milk prices are increased. Also, California is not on an equal footing with respect to other states when it comes many business costs.

California energy, labor, tax, and regulatory costs are higher than many other western states. Even if California's regulated price is a bit below those in surrounding states, California processors do not necessarily have a competitive advantage because higher business costs within California are large enough to offset any small regulated price advantage.

The Secretary's rationale for the specific adjustments he made to Class 1, 2, and 3 prices last fall was stated in the Determinations from the hearing:

*This reduction is more modest than the cut recommended by some hearing witnesses and CDFA Staff. This more modest reduction is supported by the ten months of comparable surrounding state farm price data in the hearing record (Food & Agr. Code, § 62062.1) and <u>is consistent with the USDA make allowance adjustments implemented on October 1, 2008</u>.... The more modest Class 1 price reductions could help lessen financial hardships to producers while <u>balancing the need for California prices to remain competitive</u> (emphasis added).*

Despite the characterization by the Alliance witness, the decision by the Secretary was not an investment by producers with the goal of capturing new Class 1, 2, and 3 sales for the pool; rather, it was a regulatory move to maintain the competitive balance with processors in Federal orders and surrounding states with the goal of preserving our existing sales. Of course, the Secretary did not envision the severity of the downturn in the whole economy, which has negatively impacted dairy product sales across the country. Consumers respond to a drop in income by buying less, and dairy products are not immune from this trend. The lack of substantial new dairy product sales is by no means an indication that the Secretary made the wrong policy choice last fall. It is our view that losses in overall dairy product sales would have been much greater had the Secretary not reduced Class 1, 2, and 3 regulated prices.

## <u>Government Fixes That Don't Account For Market Signals Hurt Producers</u>

As we stated in our testimony, when government sets prices that are not supported by market fundamentals, the wrong economic signals get sent to industry and producers are ultimately harmed. If California were to increase regulated prices without regard to the market, California processors would either lose business outright or would attempt to hang on to business in the short run by accepting lower (or negative) margins. In the longer-run, California would have fewer sales because out-of-state competitors would take over business from California-based suppliers who are either unable to match the prices being offered or are out-of-business because they sustained inadequate margins for too long. In the meanwhile, higher regulated prices would have encouraged more investment (and more milk output) by dairymen than would otherwise have been the case. These new production assets would then be "stranded" in an industry without adequate demand to fully employ them. Producers would lose money both from the unneeded investments they made and from the sales that were lost by non-competitive California processors.

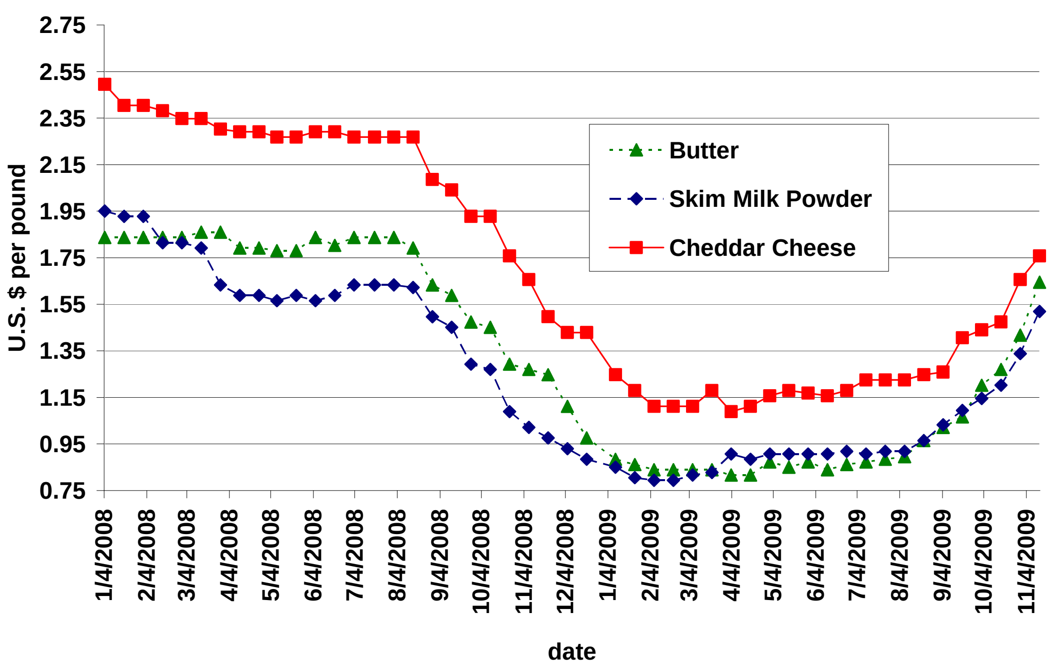
**This Year's Low Prices Have Set The Stage For The Price Recovery That Is Now Occurring**

Reductions in milk output and improvements in global demand that have resulted from low prices have brought supply and demand into better balance. The market can now support a higher level of prices than it could earlier. We noted in our testimony that international milk prices have been recovering and that international markets were now driving price movements in the U.S. market. Updated international prices for Oceania were released by USDA's *Dairy Market News* on its website today. The midpoints of the reported price ranges for the two weeks ending November 13, 2009 follow, along with a graph showing the ongoing recovery of international dairy prices.

**Oceania Dairy Commodity Prices, November 2-13, 2009**

| Commodity | Price Range Midpoint | Bi-weekly Change |
|---|---|---|
| | *U.S. dollars per pound* | |
| Butter | 1.6443 | +0.2268 |
| Skim Milk Powder | 1.5196 | +0.1814 |
| Cheddar Cheese | 1.7577 | +0.1021 |

**Oceania Prices For Dairy Commodities, 2008-2009**



Prices are not yet at the levels they attained prior to last fall's drop, but they are moving toward those levels rapidly. If these international prices were reflected today in U.S. commodity prices at the CME and in California, the Class 4a and Class 4b prices would be $17.86 and $15.77 per hundredweight, respectively. U.S. prices don't adjust instantaneously to global price changes, but if current global price levels are sustained, U.S. prices will eventually move to comparable levels. It is our view that the ***market*** is moving prices to more sustainable levels for producers. We do not believe that there is any economic justification for permanent changes to the formulas or large temporary price increases. If the Department feels that some price relief for dairymen is needed in spite of the rebounding dairy markets, then we urge the adoption of a modest temporary policy change as we have proposed. Thank you for your consideration of our post-hearing brief.

Sincerely,

William A. Schiek
Economist