

Dairy Institute

Of California

May 13, 2005

Mr. David Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
560 J Street, Suite 150
Sacramento, CA 95814

RE: May 6, 2005 Class 1 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 Ontario, California on May 6th, 2005. The paragraphs that follow respond to the panel's questions and build on the propositions that we put forth in our testimony.

1. Is The Departmental Exhibit That Refers To Milk Movement Data Correctly Referred To As Hearing Exhibit #2 As Stated On Page 7 Of Dairy Institute's May 6th Testimony?

No. The hearing exhibit containing the data on milk movement that we are referring to is Hearing Exhibit # 7 b) 2).

2. The Witnesses For Milk Producers Council And The Alliance Of Western Milk Producers Stated That Our Class 1 Utilization Data Was Not Appropriate Because It Ignored The Impact Of Depooling.

It is true that milk was depooled in many of the federal orders during periods of large wholesale cheese price increases. A fact that the Alliance and MPC witnesses failed to mention is that throughout the period since January 2000, quite a large amount of out-of-area milk was pooled on federal orders. All of this distant milk is pooled on the orders to obtain greater revenue for the dairymen and cooperatives located in lower Class 1 utilization markets or in unregulated areas. Much of this milk never actually serves the market where it is pooled and is not really available as a reserve supply. This milk is often described as "paper pooled" milk because it is not associated with the marketing area in any physical or historic sense. Paper pooled milk has also included milk that was delivered in California and pooled on the California order, but also pooled on the federal order (double dipping). If we take a look at the federal order with the lowest Class 1

utilization, the Upper Midwest, we can examine the impact of depooled milk and this “paper pooled” milk on the market’s Class 1 utilization. To undertake this exercise, we obtained data from the Upper Midwest Order Milk Market Administrator’s office on the amount of depooled milk by month, from 2000-2004. We also obtained information from published data on sources of federal order milk for the Upper Midwest order on the amount of milk pooled on the Upper Midwest that originated in California, Utah, and Idaho. Our analysis of this data is included as Attachment 1. The analysis shows that when depooled milk is added back into the order receipts, and when paper pooled milk is removed from order receipts, the average Class 1 utilization in the Upper Midwest order from 2002-2004 is about 20%. The data we submitted in Table 1 of our May 3rd testimony listed the average 2000-2004 Class 1 utilization in the Upper Midwest as 21.5 percent. While the calculated number is somewhat lower than the “official” Class 1 utilization number, our basic assertion that current Class 1 utilization in California is the lower than in any federal order market is still accurate; and therefore, our assertion that the Class 1 price in California is too high considering its Class 1 utilization is still valid.

3. *The Milk Producers Council Witness Stated That Our Federal Order Class 1 Differential Numbers Were Not Valid Because The Over Order Premiums That Were Being Paid In Federal Orders.*

Regulated price differentials are what we are addressing in this hearing and our analysis focused on differences in the differential between regulated manufacturing milk prices and regulated Class 1 prices. Premiums are paid for both fluid use milk and manufacturing use milk in many markets around the country. In some cases, premiums are paid because of competition for milk; while in other cases, premiums are paid because of the market power of the milk suppliers. In California, we have had our own experiences with Class 1 premiums. Class 1 premiums under the Western Milk Marketing Agency reach upwards of \$2.00 per hundredweight in Southern California during the 1999-2000 period, but these premiums were not needed to ensure an adequate supply of fluid milk for the Southern California market. The premiums were made possible by the creation of a marketing agency in common where all of the cooperative suppliers joined together to enforce a premium on the market. The Chicago region also has had a marketing agency in common (CMPC) that has priced milk to fluid processors in the region. The extent to which premiums are driven by competition for milk or by market power is not easily attainable. Cheese plants have paid premiums in the Upper Midwest as the milk supply has declined there, but there is still no shortage of milk for fluid use.

4. *California Prices Are More Than Adequate To Generate Milk Supplies For All Purposes.*

We have argued that the supply of milk in California is and has been more than adequate for all uses. We presented evidence of growing milk production that has increased on average 4.4 % per year since 1990 and 3.7% per year since 2000.

This is hardly the type of milk production growth that one would expect to see in an industry where milk income was not adequate. Yet the Alliance witness points out that the overbase price was less than the average milk production cost in California for three of the last five years. First of all, to be consistent, if we are using the weighted average cost of milk production we should be comparing it to an average price for the industry, such as the average price received by Grade A and Grade B producers. We do not know what the average cost structure is for producers that have 100% of their production as overbase, and the Secretary is under no obligation to ensure that the overbase price will always cover the cost of production. Second, the Alliance comparison that looks only at prices and costs from 2000 through 2004 ignores the fact that 1998 and 1999 were both extremely good years for dairymen with respect to milk prices. We have included a table that shows California's weighted average cost of production, and several measures of milk prices received by dairymen (see Attachment 2). The bottom line here is that milk prices relative to costs have been more than adequate to generate needed milk supplies and Dairy Institute's proposal, which will reduce pool prices by 13 to 14 cents per hundredweight, will not lead to producer revenues that are inadequate for generating necessary milk supplies.

5. California Consumers Will Benefit From Reductions In The Class 1 Price

As we expected, producer representatives have stated that consumers will not benefit from reductions in the Class 1 price for milk. We have noted that studies which are pertinent to California have shown that retail milk prices respond to changes in Class 1 prices. Producer representatives have questioned this and have argued that the large spread between farm and retail prices is evidence that consumers are being unfairly treated by processors and retailers. Producer representatives have apparently forgotten that it costs money to assemble, process, package, distribute and merchandise fluid milk and that these costs have grown, not diminished, over time. We have attached (Attachment 3) a review by Cornell University Economists, Charles Nicholson and Andrew Novakovic that puts the farm-retail price spread and farm-retail price transmission into some perspective. The evidence is fairly clear that retail prices for milk are closely associated with movements in the Class 1 price for milk, a point also recognized by the Department in Hearing Exhibit #8b (Hearing Background Resource).

There has also been some discussion about the causes of California's more rapid decline in per capita consumption of fluid milk. The Alliance witness has suggested that California's lower percentage of white population is responsible and that pricing considerations have nothing to do with demand for fluid milk. The Alliance witness cites a paper by Jacobson and Outlaw that shows the "black" and "other" race groups consume fewer dairy products than do "whites". The problem with this study is its level of racial aggregation. There is no indication as to which group contains Hispanic consumers. Data entered by the Alliance into testimony at the May 3rd hearing showed that Hispanic persons made up 32.4% of the California population versus 12.5% of the total U.S. population (See Hearing Exhibit #48 from the May 3rd hearing). A review of dairy

product demand studies by Charles Nicholson and Craig Alexander of Cornell University shows that Hispanic consumers drink more milk and consume more dairy products than do white consumers (See Attachment 4). Hence, the demographic explanation offered by the Alliance for California's lower per capita consumption appears to be in error. Based on the information we have submitted, the following facts are indisputable: consumers purchase more fluid milk when retail prices decrease (own-price elasticities are not zero), retail prices increase when Class 1 prices increase and decrease when Class 1 prices decrease (there is positive retail price transmission), therefore a decrease in Class 1 prices in California will result in California consumers purchasing more milk and paying less per unit of milk purchased. Thus, the consumer benefit of lower Class 1 milk prices that we noted in our testimony is real and will be experienced by consumers if Class 1 prices are reduced.

6. *Section 62062.1 Is Only One Of The Relevant Sections Of The Food And Agricultural Code That The Secretary Must Consider.*

The Alliance witness has suggested that Section 62062.1 be given greater weight than the other code sections which give direction to the Secretary with respect to setting Class prices for milk. Our testimony in Ontario noted that Section 62062.1 was added after some of the other code sections that we cited, but it should also be noted that the other provisions of the code were not revoked, nor was there any direction given by the legislature nor any instruction set in code that would allow the Secretary to ignore or give less weight to the other sections of the code that we have cited. The argument advanced by the Alliance and WUD that Section 62062.1 is the controlling section of code regarding Class 1 price cannot be substantiated and is therefore without merit.

Regarding the meaning of Section 62062.1, we have stated that the term "reasonable relationship" does not require equal price with surrounding states and we gave an extensive explanation as to how we reached that conclusion in our testimony on May 3rd and May 5th. Our rationale applies just as well to the notion that the legislature did not intend for the Secretary to "peg" the California Class 1 price to those in contiguous states in some fixed or formulaic way. Thus, the legislature did not mean that a "reasonable relationship" requires California Class 1 prices to be equal to, nearly equal to, slightly less than, or approximate to Class 1 prices in surrounding states. The plain meaning of "reasonable relationship," with respect to price levels is one where there is a logical, justifiable ground of defense. Allegations that the legislature never would have meant that our proposal could be construed as "reasonable" are without merit, evidence or substantiation, and there is *nothing* in the legislative history of the bill that would suggest otherwise. Our proposal is justified as being "reasonable" under the plain meaning of the statute, and no evidence has been offered to the contrary.

7. *Dairy Institute’s Proposal Would Not Handicap Sales Of Out Of State Shipments Of Milk Into California.*

Some witnesses have suggested that Dairy Institute’s proposal would constitute a violation of the dormant interstate commerce clause of the U.S. Constitution. The following paragraphs refute these suggestions.

A. *The Class 1 Price Formula Adjustments Proposed In Dairy Institute’s Petition Do Not Handicap or Regulate Interstate Commerce.*

In earlier correspondence to the Department and in their post-hearing briefs, Western United Dairymen (“WUD”) and the Alliance of Western Milk Producers (“Alliance”) make repeated references to the Department’s inability to regulate interstate commerce. For example, WUD quotes the Department’s letter of October 1, 2004, which states:

California may not adopt regulations, the motivation of which is to handicap out-of-state shipments of milk into California. ...The regulation of interstate commerce in milk is not within CDFA’s jurisdiction.

On that same theme, the Alliance stated in a letter to the Department, dated February 14, 2005, that Dairy Institute’s petition will “result in a handicap to milk coming into California at the expense of California producers.” However, both WUD and the Alliance incorrectly interpret and apply the relevant interstate commerce principles to the issues raised by this proceeding. The Class 1 price formula adjustments proposed in Dairy Institute’s petition are not designed to handicap out-of-state-shipments of milk into California, and will not have that effect.¹

The Department’s earlier concerns regarding its regulatory powers over the milk markets (which WUD and the Alliance prominently cite) were undoubtedly made in response to United States District Court Judge Garland E. Burrell, Jr.’s order granting summary judgment in *Hillside Dairy, Inc. vs. Kawamura* on May 7, 2004. However, those concerns can easily be laid to rest. The issues the Department must consider in this proceeding are significantly different from the milk pooling regulations that Judge Burrell enjoined in *Hillside Dairy*.

¹ Both WUD and the Alliance have additionally suggested that Dairy Institute harbors an improper motive in this proceeding that could somehow taint any final regulations resulting from this process. Dairy Institute, both now and in its testimony, has shown that this suggestion is baseless. More significantly, Dairy Institute has already presented testimony noting that the Secretary, working in conjunction with the Department (and its legal advisors), has the ultimate responsibility of reviewing all testimony delivered at the hearing, considering other factors and issues identified in the Food and Agricultural Code, and then reaching a decision calculated to advance the policies and principles established by the Legislature. This process effectively eliminates the possibility that a petitioner’s allegedly wrongful motive could survive into and infect the final regulations.

In Hillside Dairy, Judge Burrell held that the 1997 amendments to §900 of Article 9 of the Pooling Plan improperly discriminated against out-of-state raw milk producers because payments by California Processors for both out-of-state and in-state raw milk sales were included in the Pool, but only in-state producers received benefits from the Pool. On Page 7 of the Order, Judge Burrell explained:

Since the 1997 amendment to §900 requires out-of-state raw milk producers to pay for benefits received exclusively by California dairy businesses, it is similar to the milk pricing order invalidated in West Lynn [Creamery, Inc. v. Healy, 512 U.S. 186, 114S. Ct. 2205, 129 Led. 2d. 157 (1994.)]. Like the charge in West Lynn, this charge attendant to interstate milk sales, which is evident on the face of the Pooling Plan and just benefits certain California dairy businesses, renders §900 discriminatory “because it, like a tariff, neutralizes advantages belonging to the place of origin.” West Lynn, 512 U.S. at 196 [114S Ct. at 2213] (citation and quotation marks omitted).

Dairy Institute’s petition in this proceeding involves issues that are completely different from those in the Hillside Dairy. The pricing formulas at issue in this proceeding are designed by the Legislature only to establish minimum milk prices payable by handlers to producers within marketing areas located only *in the State of California*. (Food & Ag. Code §§ 61830; 61805(b).) While the Department must ensure that Class 1 prices in California are in reasonable relationship to Class 1 prices in surrounding states (Food & Ag. Code §62062.1), the Department will not, and cannot, enforce those prices on sales of milk originating outside the state. Furthermore, Dairy Institute’s petition does not raise the possibility that out-of-state producers will somehow have to pay for benefits received by California producers. Thus, the issues raised by the defective regulations Judge Burrell described in Hillside Dairy are simply not present here.

B. The Department May Set Minimum Prices On In-State Sales of Class I Milk In A Manner that Makes California-Produced Milk More Competitive Than Out-Of-State milk.

In earlier correspondence to the Department, the Alliance claimed that the Commerce Clause analysis adopted by Judge Burrell in Hillside Dairy case prohibits the Department from eliminating the economic incentive for out-of-state milk to move to California which results from high minimum prices for in-state-milk. However, the Alliance’s arguments misapply the dormant Commerce Clause.

While a state may not “tax” interstate transactions in order to favor local business over out-of-state business,” it is undisputed “that a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry.” (Bacchus Imports, Ltd v. Dias, 468 U.S. 263, 271-272, 104S. Ct. at 3049, 3055, 82 L.ed. 2d. 200 (1984.)) The Supreme Court explained:

“The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State’s regulation of interstate commerce*. Direct subsidization of domestic industries does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufactures does.” [New Energy Company of Indiana v. Limbach, 486 U.S. 269, 278, 108, S.Ct. 1803, 1810, 100 L.ed. 2d. 302 (1988) (emphasis in original). See also Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine, 520 U.S. 564, 582 fn 16, 117S. Ct. 1590, 1601, fn. 16, 137 L.ed. 2d. 852 (1997) (*accord*).]

In Hillside Dairy, Judge Burrell relied on the Supreme Court’s decision in West Lynn. In West Lynn the Supreme Court repeated the rule that “[d]irect subsidization of domestic industry does not ordinarily run ‘afoul’ of the negative commerce clause.” 512 U.S. at 199 fn. 15, 114S. Ct. at 2214 fn. 15. The Supreme Court added:

In addition, it is undisputed that states may try to attract business by creating an environment conducive to economic activity, as by maintaining good roads, sound public education, or “low taxes.” [Ibid. (emphasis added).]

In support of this principle, the West Lynn Court cites the concurring opinion of Justice Stevens in Hughes v. Alexandria, 426 U.S. 794, 96S. Ct. 2488, 49 L.ed. 2d. 220 (1976). In Hughes, Justice Stevens stated that the Commerce Clause “does not impose on the states any obligation to subsidize out-of-state business.” [Id. at 815-816, 96S. Ct. at 2500.]. Justice Stevens added:

Nowhere in my judgment, does that clause inhibit a state’s power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital, it should not be characterized as a “burden” on commerce. [Id. at 816, 96S. Ct. at 2500-2501.]

In short, the Department may benefit California businesses by lowering the minimum prices of Class I milk sold in California in such a way as to make California’s milk more competitive with out-of-state-milk. Essentially, this is a form of direct subsidization of domestic industries that is permitted under the Commerce Clause.

C. *The Department May Change The Class 1 Price Formulas In California, Even If Such Changes Do Not Address All Of The Issues Involving Out-Of-State Milk Sales.*

In its post-hearing brief, WUD concludes that the Department should not reduce Class 1 prices until “the Department can take appropriate actions to address *all* the competitive issues surrounding out-of-state milk.” (Emphasis in original.) The Alliance similarly suggests, in its post-hearing brief, that federal legislative action is the only way the out-of-state milk situation “can truly be addressed.” However, nothing in the applicable Food and Agricultural Code statutes allows the Department to postpone or set aside its administrative obligation to regulate minimum prices in California merely because Congress has been addressing larger interstate commerce issues. Furthermore, legislative and administrative bodies may reasonably address a public issue in an incremental way. (See generally, Hayes v. Wood, 25 Cal.3d 772, 791 (1979); City of Malibu v. California Coastal Com'n, 121 Cal.App.4th 989, 995 (2004).) In addition, the Alliance’s admission that Congress has worked on this issue for over two years, with no resolution of the matter, demonstrates that Congress may not be able to address “all the competitive issues surrounding out-of-state milk.” Congress’ delay is certainly a compelling reason for the Department to act now and not wait for a full resolution of “all” the issues involving out-of-state milk sales.

8. *Impact of Unregulated Packaged Milk Sales Into Southern California.*

We have attempted to estimate the total impact of unregulated packaged milk sales on California milk processors by aggregating data supplied by individual Dairy Institute members. The aggregated data is presented in Attachment 5. Clearly, the impact is substantial and could be mitigated by adoption of Dairy Institute’s proposal to reduce Class 1 prices.

9. *In Response To Alliance Witness’s Assertion That The Only Problem With The Relationship Between Manufacturing Milk Prices And Fluid Milk Prices Is Due To Timing Of The Price Calculations.*

Our testimony clearly stated our belief that the California Class 1 price did not bear a sound and reasonable relationship to other California class prices. That assertion was based in part on the fact that the implied Class 1 differential is \$2.36 per cwt. We also clearly stated that that differential was calculated by subtracting from the actual monthly Class 1 prices the higher of the 4a or 4b price calculated using the advance price data (26th to the 10th). Our purpose in stating the differential this way was to provide an apples to apples comparison by comparing the Class 1 and Class 4a and 4b prices using the same weekly data.

In spite of our efforts to provide that “apples to apples” comparison, in his post-hearing brief filed following the Northern California hearing in Sacramento, Jim Tillison indicated that any unreasonable relationship between Class 1 prices and manufacturing class prices was caused solely by the fact that the formulas incorporate different weeks of commodity price data.

In response to his assertion, we have attached a summary comparison of Class 1 prices and the higher of 4a or 4b prices (Attachment 6). The summary shows

calculated Class 1 prices for the period 2000-2004 using the current Class 1 price formulas. The Class 1 prices were calculated first using the advance pricing commodity price data and then using the monthly commodity price data. In each case, the higher of Class 4a or 4b were subtracted from the calculated Class 1 prices. The net difference in implied Class 1 differentials under the two scenarios is the contribution of the differences in pricing time-frame to the unreasonable relationship that exists between Class 1 prices and the manufacturing class prices.

If Mr. Tillison's assertions are correct, this difference in the implied differentials will be very large. In fact, the opposite is true. Over the period 2000-2004 this difference averages an insignificant \$.05 per cwt. That is to say that of the \$2.36 difference between Class 1 prices and the higher of the manufacturing class prices only \$.05 is due to the differences in commodity pricing weeks. This is hardly a significant impact.

We have also attached our post-hearing brief for the May 3rd hearing. This is included as Attachment 7.

Thank you for your consideration of our post-hearing brief.

Sincerely,

William A. Schiek
Economist