

February 9, 2005

The Honorable A.G. Kawamura, Secretary
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814

Dear Secretary Kawamura:

Dairy Institute of California is requesting that the Department call a hearing to consider changes to the Class 1 pricing formulas in Northern and Southern California. Dairy Institute of California is a trade association representing over 70 percent of the fluid milk, cultured milk products, and frozen dairy products processed in the state. The attached extracts of the Stabilization and Marketing Plans for Market Milk for the Northern and Southern California Marketing Areas contain proposed changes to Class 1 pricing formulas and comprise Dairy Institute's petition for this hearing. This hearing is being requested pursuant to Division 21, Part 3, Chapter 2, Article 4 through Article 9 of the Food and Agricultural Code, including Sections 61891 through 62079.

Reasons why changes are needed:

In Section 61802(e) of the Food and Agricultural Code, the Legislature declares that: "It is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of commodities necessary to its citizens, including market milk, and to eliminate economic waste, destructive trade practices, and improper accounting for market milk purchased from producers. Section 61802(e) amplifies this theme by providing, in part, that "...it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that will promote the intelligent and orderly marketing of market milk in the various classes...." To promote these goals, the Food and Agricultural Code directs the California Department of Food and Agriculture (CDFA) to establish minimum prices that California processors must pay for market milk. In establishing these prices Section 62062(c) requires "That prices, including prices of components of milk, established by the director for the various classes of market milk bear a reasonable and sound economic relationship to each other."

At the present time, California's Class 1 pricing formula is not advancing these goals. Class 1 use is lower today than it was more than a decade ago, despite the fact that California's population has grown substantially. Class 1 utilization, the amount of Class

Class 1 milk marketed under the California orders expressed as a percentage of the total milk marketed, has fallen to an average of 16 percent during the first 11 months of 2004 and has averaged 15.4 percent since July 1, 2004. However, while Class 1 utilization has fallen, Class 1 prices in relation to other class prices have not changed significantly.

The imputed California Class 1 differential, which equals the difference between the Class 1 price and the higher of the Class 4a or Class 4b prices calculated using the same set of commodity prices that are used in the Class 1 formulas, has averaged \$2.30 per hundredweight in Southern California and \$2.03 per hundredweight in Northern California since January 2000. The imputed differential varies with changes in the national prices for dairy commodities and in recent years has been as high as \$3.43 per hundredweight.

While Class 1 milk use has stagnated, the production of milk in California has continued to increase at a rapid pace. In spite of occasional slowdowns in the rate of production expansion, average annual milk production growth has exceeded four percent per year. Milk output growth of this magnitude has surpassed what is needed to “insure an adequate and continuous supply, in relation to demand, of pure, fresh, and wholesome market milk for all purposes, including manufacturing purposes...” as required by Section 62062 (b). If milk production continues to grow at current rates, the supply of milk will exceed the capacity of the state’s dairy product plants in the near future. In light of the current supply/demand situation, Class 1 prices should be reduced to bring California’s marketing plans into compliance with the Food and Agricultural Code. Furthermore, Section 62062 provides that: “In establishing the prices, the director shall take into consideration any relevant economic factors...” California’s low Class 1 utilization and excessively high Class 1 differentials are relevant factors that must be considered.

Dairy Institute believes that a careful consideration of these factors highlights the immediate need to adjust California’s Class 1 formula. It is clearly within the jurisdiction of CDFA to establish price formulas that determine how much California processors must pay California’s producers and California dairy cooperatives for their milk. Dairy Institute’s members believe that an adjustment to Class 1 prices is necessary to “enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions...” (Section 61085(d)). Unnecessarily high Class 1 prices will continue to erode Class 1 use and Class 1 utilization, and violate Section 62062(b) of the Food and Agricultural Code which requires that the formulas result in “prices to consumers which, when considered with relevant economic criteria are fair and reasonable.” Maintaining high Class 1 prices denies consumers the potential savings in milk costs that could be realized if Class 1 prices were set at economically appropriate levels.

Description of requested changes

Dairy Institute proposes that the Commodity Reference Price (CRP) adjuster employed in the calculation of the Class 1 solids not fat and fluid carrier prices be changed from its

current value of +\$0.464 per hundredweight to a new value of - \$0.416 per hundredweight. These changes should be made to both the Northern (Plan 44) and Southern (Plan 59) California Stabilization and Marketing Plans.

In establishing Class 1 differentials relative to manufacturing Class prices, the Class 1 differential should be set at a level that compensates producers for the added cost of Grade A milk production relative to Grade B milk production, and provides an incentive to move milk to Class 1 uses. Given that Grade A milk currently accounts for over 98 percent of the milk produced in the state, it is questionable as to whether there continues to be a need for an incentive for producers to maintain Grade A status. However, the most recent estimate of the extra production costs associated with Grade A status is 15 cents per hundredweight. Given California's average Class 1 utilization of 16 percent, it would be necessary to set Class 1 prices about 94 cents per hundredweight higher than manufacturing milk prices to provide a blended Grade A incentive of 15 cents per hundredweight.

Southern California is the most deficit region of the state with respect to available milk supplies. Milk supplies in Kern County, combined with existing Southern California milk supplies, are adequate to provide for the region's Class 1 needs plus a reserve. The incentive needed to move milk from Kern County to Southern California is 48 cents (long haul cost of 73 cents less a local haul cost of 25 cents per hundredweight). Therefore the appropriate Class 1 differential for Southern California is \$1.42 per hundredweight (94 cents per hundredweight plus 48 cents per hundredweight). The proposed change in the Class 1 formula results in a Southern California Class 1 price differential that averages \$1.42 per hundredweight. The current 27 cent per hundredweight difference between Northern and Southern California Class 1 prices should be maintained.

Dairy Institute requests that a hearing to consider our petition be called so that any changes resulting from the hearing could be implemented as soon as possible. Thank you for your consideration of our request.

Sincerely,

William Schiek
Economist

cc Kim Myrman
Kelly Krug
Candace Gates

Southern California Stabilization and Marketing Plan (Plan 59), Proposed Changes:

Article III

Class Prices

Section 300.0. The minimum class prices for the milk fat and skim milk components of market milk, market cream, and market skim milk f.o.b. the pool plant or nonpool plant located within this Marketing Area where the milk was first received from producers, shall be as follows:

- (A) The minimum monthly prices for components used for Class 1 shall be determined prior to the beginning of each month, using the following formulas and procedures, except as such formulas and procedures may be modified by Paragraph (H) of this Section:
- (1) For all milk fat, not less than the price per pound computed by the formula using the butter price determined pursuant to Subparagraph (A)(5) of this Section, less a butter adjuster of ten cents (\$0.10), and the result multiplied by a yield factor of 1.2.
 - (2) For all milk solids-not-fat, not less than the price per pound computed by the formula using the Commodity Reference price per hundredweight determined pursuant to Subparagraph (A)(4) of this Section, ~~plus forty six and four tenths cents (\$0.464)~~ **less forty one and six tenth cents (\$0.416)**, less 3.5 times the fat price per pound determined pursuant to Subparagraph (A)(1) of this Section, all multiplied by 0.76 and divided by 8.7.
 - (3) For all fluid carrier, not less than the price per pound computed by the formula using the Commodity Reference price per hundredweight determined pursuant to Subparagraph (A)(4) of this Section, ~~plus forty six and four tenths cents (\$0.464)~~ **less forty one and six tenth cents (\$0.416)**, less 3.5 times the fat price per pound determined pursuant to Subparagraph (A)(1) of this Section, all multiplied by 0.24 and divided by 87.8.

Northern California Stabilization and Marketing Plan (Plan 44), Proposed Changes:

Article III

Class Prices

Section 300.0. The minimum class prices for the milk fat and skim milk components of market milk, market cream, and market skim milk f.o.b. the pool plant or nonpool plant located within this Marketing Area where the milk was first received from producers, shall be as follows:

- (B) The minimum monthly prices for components used for Class 1 shall be determined prior to the beginning of each month, using the following formulas and procedures, except as such formulas and procedures may be modified by Paragraph (H) of this Section:
- (1) For all milk fat, not less than the price per pound computed by the formula using the butter price determined pursuant to Subparagraph (A)(5) of this Section, less a butter adjuster of ten cents (\$0.10), and the result multiplied by a yield factor of 1.2.
 - (2) For all milk solids-not-fat, not less than the price per pound computed by the formula using the Commodity Reference price per hundredweight determined pursuant to Subparagraph (A)(4) of this Section, ~~plus forty six and four tenths cents (\$0.464)~~ **less forty one and six tenth cents (\$0.416)**, less 3.5 times the fat price per pound determined pursuant to Subparagraph (A)(1) of this Section, all multiplied by 0.76 and divided by 8.7.
 - (3) For all fluid carrier, not less than the price per pound computed by the formula using the Commodity Reference Price per hundredweight determined pursuant to Subparagraph (A)(4) of this Section, ~~plus forty six and four tenths cents (\$0.464)~~ **less forty one and six tenth cents (\$0.416)**, less 3.5 times the fat price per pound determined pursuant to Subparagraph (A)(1) of this Section, all multiplied by 0.24 and divided by 87.8, and then \$0.0031 per pound subtracted from the result.