



Alliance of Western Milk Producers

Representing California's dairy cooperatives and their produce owners since 1991

1225 H Street, Suite 102 • Sacramento, California 95814 • 916-447-9941

EXHIBIT

~~40~~ 47

Class 1 Price Hearing Testimony

on behalf of

The Alliance of Western Milk Producers

Presented by

James E. Tillison
Executive Vice President/CEO

May 3 & 6, 2005

My name is Jim Tillison. I am Executive Vice President and CEO of the Alliance of Western Milk Producers. The alternative proposal I am testifying in support of was unanimously approved by the Board of Directors of the Alliance.

Of all the Food & Agriculture codes that the Department referenced in the call of this hearing, only one, 62062.1, specifically requires the Department to take action. It states:

62062.1. Any designation of a class 1 price by any method or formula that is used to develop class 1 prices paid to producers in the various marketing areas, shall provide, on a calendar year basis, a statewide weighted average minimum price level for a hundred weight of milk testing 3.5 fat and 8.7 solids not fat that is in reasonable relationship with minimum class 1 milk prices paid to producers in contiguous states. If the statewide weighted average class 1 prices paid to producers are not in a reasonable relationship with the class 1 prices paid to producers in contiguous states, the secretary shall immediately hold a hearing to consider adjustments to the class 1 prices.

What the 2004 data shows

Section 62062.1 states that the analysis should compare a "statewide weighted average minimum price level for a hundred weight of milk testing 3.5 fat and 8.7 solids not fat" with the minimum class 1 milk prices paid to producers in contiguous states.

For the 2004 calendar year the Alliance's analysis puts the weighted average minimum California Class 1 producer price at \$16.32. This price was calculated using the following percentage of Class 1 milk component utilizations between Northern and Southern California.

	Northern California	Southern California
Butterfat	50.04%	49.96%
Solids not fat	50.18%	49.82%
Fluid Carrier	50.85%	49.15%

These percentages were multiplied times the 2004 monthly butterfat, solids not fat and fluid carrier values for Northern and Southern California and then multiplied times the monthly pounds of butterfat, solids not fat and fluid carrier. The total dollars generated in 2004 for each component was then divided by the total pounds in 2004 of each component. This results in a weighted average component value that when plugged into the hundredweight calculation (3.5 times butterfat plus 8.7 times solids not fat plus 87.8 times fluid carrier) equals \$16.32, the 2004 weighted average California producer Class 1 price.

A weighted average producer Class 1 price was also generated for the contiguous states. This was done by taking the monthly Class 1 producer hundredweight price in Oregon, Nevada and Arizona and multiplying it times the monthly producer milk utilized in Class 1. As with the California calculation, the total dollars generated in 2004, was divided by the total Class 1 milk volume to achieve a weighted average contiguous state producer price of \$16.91.

Clearly, a weighted average California producer Class 1 price of \$16.32 is not in a reasonable relationship to the weighted average producer Class 1 price in contiguous states when the difference is 59 cents per hundredweight.

Even if one compares the weighted average California producer Class 1 price (\$16.32) to the simple average Class 1 producer price of contiguous states (\$16.76), a difference of 44 cents cannot be considered reasonable.

The Alliance proposal

In order to bring the California Class 1 producer 3.5% butterfat, 8.7% solids-not-fat price into a more reasonable relationship with Class 1 producer prices of milk of the same composition in adjoining states, the Alliance proposes two changes to the Class 1 price formula:

1. Increase the Commodity Reference Price (CRP) adjuster used in the calculation of the Class 1 solids not fat and fluid carrier prices from the current value of +\$0.464 per hundredweight to a new value of +\$0.739 per hundredweight in both Northern California and Southern California Class 1 formulas.
2. In addition, the Alliance proposes that the fluid carrier adjustment in the Northern California formula be changed from -\$0.0031 to -\$0.0014.

The Alliance finds it interesting, given the requirement of Section 62062.1, that the Department's analysis focuses so much on five year averages. Remember, Section 62062.1 says look at Class 1 prices on a calendar year basis.

The five year analyzes in Table 6 of the workshop handout show that only the CDC proposal maintains what the Alliance would consider a reasonable relationship between California producer prices and producer Class 1 prices in contiguous states on a year-to-year basis. However, looking at the calendar year 2004, the Alliance proposal creates a reasonable relationship while staying below surrounding states' producer prices.

Just as important is the impact of the proposals going forward. When comparing the simple average producer Class 1 price for 2005 (January through May) in California to the simple average of producer Class 1 prices in contiguous states the following results:

Ave. FMMO	\$16.84
Current	\$16.46
Institute	\$15.58
Alliance	\$16.81
Western	\$16.54
CDC	\$17.26

As the above table shows, the Alliance proposal clearly results in the most reasonable relationship between producer Class 1 prices in California and producer Class 1 prices in contiguous states.

The Alliance proposal and factors for consideration in making a decision

In its call of the hearing the Department said its decision will include consideration of all relevant economic factors including, but not limited to, the following:

- The reasonableness and economic soundness of market milk prices for all classes, giving consideration to combined income from those classes, in relation to cost of production and marketing for all purposes including manufacturing;

Alliance analysis of the Department's annual cost of production charts in the annual "California Dairy Statistics and Trends" shows that, on average, the overbase price 2000-2004 has not covered the average 2000-2004 cost of producing milk. For the five year period, the overbase price averaged \$11.74 while the cost of production averaged approximately \$12.79. In fact, in only two of the past five years have the average overbase price covered the cost of production.

The Alliance proposal would reduce the average difference by \$0.07 per hundredweight while the Dairy Institute would widen the gap between the overbase price and cost of production from \$1.05 to \$1.23.

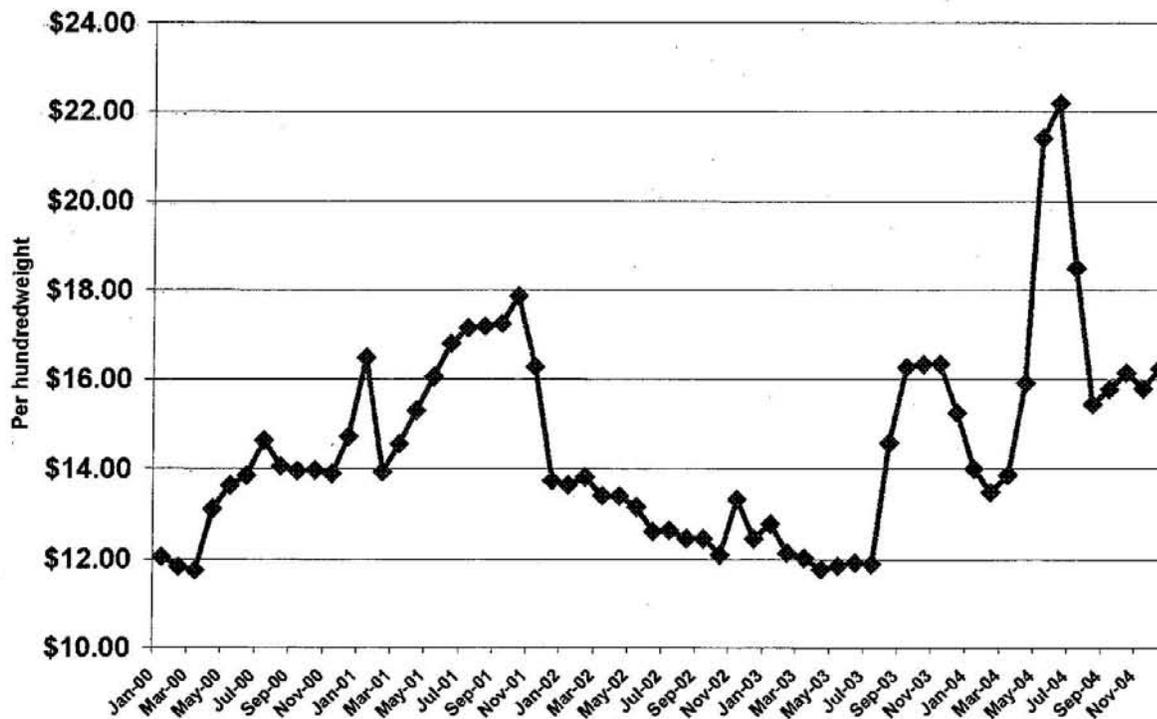
- Whether prices will insure an adequate and continuous supply, in relation to demand, of pure, fresh, wholesome market milk for all purposes, including manufacturing purposes, at prices to consumers which, when considered with relevant economic criteria, are fair and reasonable;

The one true measure of whether the supply of milk for all purposes is adequate is price. In 2004, a strong argument can be made that there was not an adequate supply of milk available for all purposes.

The 2004 average Class 4b price, \$14.88, exceeded the five year (2000-2004) average price, \$11.68, by \$3.20 per hundredweight. The 2004 Class 4a price, arguably the milk surplus measure, was \$12.87, a full \$1.20 over the five-year average of \$11.67.

Record high commodity prices and extreme CME market volatility resulted in 2004 Class 1 prices reaching extreme price levels.

Average California Producer Class 1 Prices



Clearly market forces and not pricing formulas contributed to higher than normal consumer dairy product prices. However, considering the producers' share of retail fluid milk and other retail dairy product prices, other factors contributed to price increases as well.

- Whether prices, including the prices of components of milk, established by the Secretary for the various classes of market milk bear a reasonable and sound economic relationship to each other;

Given the way California (as well as the federal milk market order system) establishes milk and milk component prices, the various classes of market milk clearly bear a reasonable and sound economic relationship to each other.

All milk prices start with the market value of basic commodities – cheddar cheese, butter and nonfat dry milk powder. The Class 4a component prices are the basis of Class 2 and Class 3 products. The Class 4a value of butterfat becomes the butterfat value in Class 4b. The market values of cheddar cheese, butter and nonfat dry milk, although over a different time period, are the basis from which Class 1 prices are determined.

The extreme volatility of commodity values at the Chicago Mercantile Exchange combined with the difference in time frames used in determining average cheese and butter values has resulted in somewhat of a dislocation of class prices. However, the time-frame difference is due to Class 1, 2, and 3 processors wanting to know in advance what their milk component costs will be.

The Department tried to address the dislocation between classes 1, 2, 3 and classes 4a, 4b by using the commodity prices from the 26th of the previous month to the 10th of the current month for Class 1, 2, and 3. However, day-to-day CME market volatility has rendered this approach less than successful.

It is the Alliance's opinion that none of the proposals being considered at this hearing will correct the price dislocation. However, it is clear that the Dairy Institute proposal will make worse the overbase-Class 4b price inversion situation which is a clear threat to the California milk pricing and pooling system.

The Dairy Institute's proposal would have increases the Class 4b price exceeding the overbase price in the last five years by 32%. The Alliance proposal, on the other hand would have decreased the number of times the Class 4b price exceeds the overbase price by 12% .

- Whether the amendments would be in accord with all the purposes, policies, and standards contained in Sections 61801, 61802, 61805, 61806, 61807, 62062, 62063, 62074.5, 62076 and 62077.

As stated previously, only one of the above sections is specific regarding the Department's obligation as regards Class 1 milk prices, the subject of this hearing. That is Section 62062.1.

The Alliance firmly believes that its proposal best satisfies the requirement of Section 62062.1 of all of the proposals that will be considered by the Department. Our proposal narrows the price gap that existed between California producer Class 1 prices and producer Class 1 prices in calendar year 2004 on either a weighted average basis or a simple average basis. An average difference of -24 cents is preferable to the current average difference of -59 cents.

The Dairy Institute's proposal clearly ignores the requirement of Section 62062.1 by increasing the difference between the weighted average California producer Class 1 price and the producer Class 1 prices in contiguous states. Should the Department adopt the Institute's proposal, or fail to narrow the price gap that existed in 2004, it would be ignoring a mandate from the State Legislature.

Why the Department must reject the Dairy Institute's proposal

In addition to the fact that it is contrary to the State Legislature's desire, the Dairy Institute proposal does not address the many sins it attributes to what it calls producer Class 1 prices that are too high.

The producer Class 1 price accounts for less than half of the retail price that consumers pay for milk and is not the only reason. The table below shows this. (Whole milk prices)

Year	Total Beverage Milk (gallons)	Average Retail Price	Average Farm Price	Retail Minus Farm Price
2000	739,936,030	\$2.61	\$1.16	\$1.45
2001	734,386,155	\$2.99	\$1.38	\$1.61
2002	746,315,974	\$2.72	\$1.12	\$1.60
2003	746,992,114	\$2.83	\$1.17	\$1.66
2004	737,207,113	\$3.14	\$1.43	\$1.72

Perhaps the Institute is trying to address the situation that concerns all of us in California, out-of-state packaged milk taking markets from California processors (and producers). Here again, Department data shows that the adjustment the Institute proposes won't accomplish that either as the table below shows.

Southern California Class 1 less Arizona Uniform Price

	2000	2001	2002	2003	2004	Average
Current	\$2.00	\$1.70	\$1.55	\$1.80	\$1.13	\$1.64
Institute	\$1.12	\$0.82	\$0.67	\$0.92	\$0.25	\$0.76

Maybe the Institute is concerned about having to compete in the Las Vegas market with fluid milk plants located in Clark County. After all, plants located in Clark County are not subject to federal order pricing. That means that their Class 1 price is 60 cents less than if Clark County plants were regulated by the federal order rather than the Nevada Dairy Commission.

Here again the Dairy Institute proposal does not make California milk more competitive in the Las Vegas market. That is because Clark County is still regulated by federal orders. This means that packaged milk coming into Clark County from lower cost market areas (like California) is subject to compensatory payments. These payments raise the price of outside milk to the federal order Class 1 price equivalent which is 60 cents above the Southern Nevada price.

Or, the Institute could be worried about packaged milk from Clark County plants coming into the Southern California market. What the Institute is proposing isn't needed in this case. That's because the cost of moving a gallon of milk from Clark County to Los Angeles is about 11 cents a gallon or about \$1.27 cents a hundredweight.

Summary

The bottom line is that the Dairy Institute is trying to address policy issues through the Class 1 milk pricing formula. From all the information provided above and from past experience, it should be clear that type of approach just doesn't work.

As far as the economics are concerned, the Dairy Institute's claim that high farm prices are negatively impacting consumption does hold water for a number of reasons. There are a number of different factors that affect consumption as pointed out by Harry M. Kaiser, at the Cornell University Extension Education Committee Workshop held in Sacramento on March 30, 2005.

His study identified the following factors as impacting fluid milk sales:

- Retail own price
- Retail price of substitutes
- Per capita disposable income
- Current and past generic marketing expenditures
- Seasonality variables
- Expenditures on food consumed away-from-home
- Percent of population under 6 years old
- Percent of African Americans

He did not agree with some economists who theorize that fluid milk sales are more price sensitive than has been generally accepted.

As the Alliance has stated previously, Section 62062.1 requires that the Department adjust the California Class 1 prices immediately to address the unreasonable relationship that existed between the weighted average California producer Class 1 price and producer Class 1 prices in contiguous states. We therefore urge the Department to adopt the Alliance proposal.

Thank you and I'll answer any questions that the panel may have.



Jim Tillison, CEO
Alliance of Western Milk Producers

**Decomposition of Changes in Milk and Cheese
Demand: A Tale of Two Products**

Harry M. Kaiser
Cornell University

Presentation at Extension Education Committee Workshop
Sacramento, California
March 30, 2005

Purpose: To examine key factors affecting the demand for fluid milk and cheese since 1995

Methods: Graphical overview of changes in demand and important demand determinants for milk and cheese

Two econometric demand models: (1) milk and (2) cheese.

Resulting demand elasticities are used to decompose the total change in per capita demand for each product by each major demand factor

Outline: Present fluid milk demand results first, followed by cheese demand results

Average Elasticity Values (1995-2004) for Factors Affecting the Retail Demand for Fluid Milk.¹

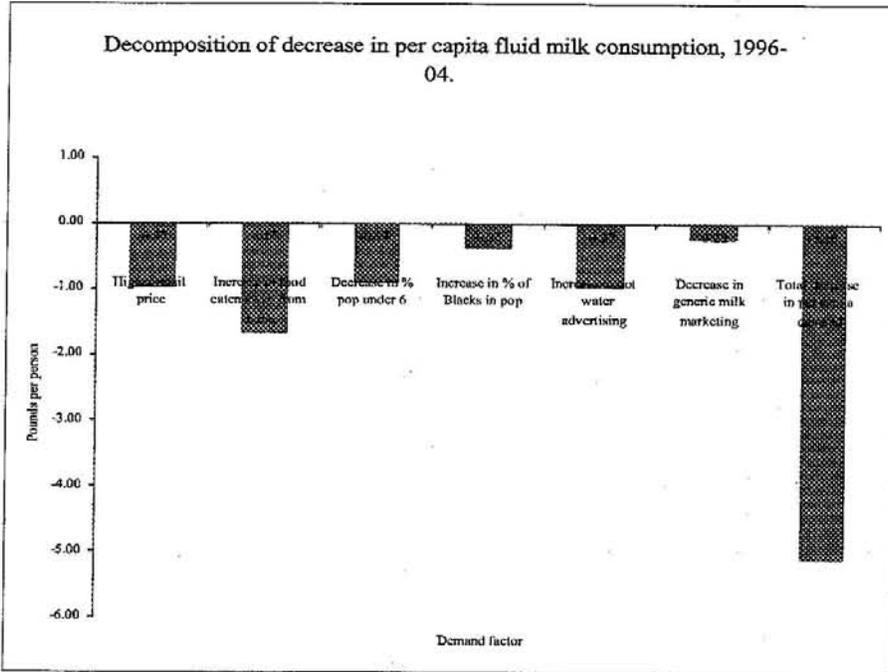
Demand Factor	Fluid Milk
Retail price	-0.121*
Per capita food away from home expenditures	-0.252*
Percent of population age < 6	0.343*
Percent of population African American	-0.343*
Bottled water advertising	-0.009*
Generic milk marketing	0.034*

¹ Example: a 1.0 percent increase in the retail price of fluid milk is estimated to reduce per capita sales of fluid milk by 0.121 percent.

* = Statistically significant at the 1% significance level or less.

Percentage changes in each demand factor, 1996-2004.

Item	Percent change
Per capita fluid milk consumption	-9.9%
Demand factor	
Real retail Price	+18.9%
Per capita food away from home expenditures	+15.5%
Percent of population age < 6	-6.2%
Percent of population African American	+2.4%
Real bottled water advertising	+248.6%
Real generic milk marketing	-15.4%



Observations

Most important factors affecting per capita fluid milk demand 1996-2004 have been

- ⇒ Per capita expenditures on food away from home
- ⇒ Higher retail fluid milk prices
- ⇒ Increased bottled water advertising
- ⇒ Percent of population < 6 years of age

Increase in African Americans and decreased real generic fluid milk marketing, while less important, also played role in declining per capita milk consumption

California QuickFacts

EXHIBIT

48

California

People QuickFacts	California	USA
Population, 2003 estimate	35,484,453	290,809,777
Population, percent change, April 1, 2000 to July 1, 2003	4.8%	3.3%
Population, 2000	33,871,648	281,421,906
Population, percent change, 1990 to 2000	13.6%	13.1%
Persons under 5 years old, percent, 2000	7.3%	6.8%
Persons under 18 years old, percent, 2000	27.3%	25.7%
Persons 65 years old and over, percent, 2000	10.6%	12.4%
Female persons, percent, 2000	50.2%	50.9%
White persons, percent, 2000 (a)	59.5%	75.1%
Black or African American persons, percent, 2000 (a)	6.7%	12.3%
American Indian and Alaska Native persons, percent, 2000 (a)	1.0%	0.9%
Asian persons, percent, 2000 (a)	10.9%	3.6%
Native Hawaiian and Other Pacific Islander, percent, 2000 (a)	0.3%	0.1%
Persons reporting some other race, percent, 2000 (a)	16.8%	5.5%
Persons reporting two or more races, percent, 2000	4.7%	2.4%
White persons, not of Hispanic/Latino origin, percent, 2000	46.7%	69.1%
Persons of Hispanic or Latino origin, percent, 2000 (b)	32.4%	12.5%
Living in same house in 1995 and 2000', pct age 5+, 2000	50.2%	54.1%
Foreign born persons, percent, 2000	26.2%	11.1%
Language other than English spoken at home, pct age 5+, 2000	39.5%	17.9%
High school graduates, percent of persons age 25+, 2000	76.8%	80.4%
Bachelor's degree or higher, pct of persons age 25+, 2000	26.6%	24.4%
Persons with a disability, age 5+, 2000	5,923,361	49,746,248
Mean travel time to work (minutes), workers age 16+, 2000	27.7	25.5
Housing units, 2002	12,507,767	119,302,132
Homeownership rate, 2000	56.9%	66.2%
Housing units in multi-unit structures, percent, 2000	31.4%	26.4%
Median value of owner-occupied housing units, 2000	\$211,500	\$119,600
Households, 2000	11,502,870	105,480,101
Persons per household, 2000	2.87	2.59
Median household income, 1999	\$47,493	\$41,994
Per capita money income, 1999	\$22,711	\$21,587
Persons below poverty, percent, 1999	14.2%	12.4%