

Statement
of
Ernest Yates
on behalf of
Dean Foods Company, Inc.
at the
California Department of Food and Agriculture Hearing
to consider changes to the Consolidated Milk Stabilization and Marketing Plans
Sacramento, California
May 3 and 6, 2005

California Class 1 Pricing Hearing

My name is Ernest Yates. I am employed by Dean Foods. Dean Foods operates 11 plants located in southern and northern California. I am here today because present California pricing regulations have not kept up with market events and are in fact creating disorderly marketing. My testimony is in support of the Dairy Institute of California proposal to lower the current Class 1 prices in California by \$.88 per cwt. I hope to provide enough information at this hearing so CDFA can clearly see that California's Class 1 Price must be lowered in order to become competitive.

My responsibilities include assuring that Dean plants purchase the highest quality raw milk at the most competitive price. Unfortunately, considering California's Class 1 utilization and the cost of available unregulated out-of-state milk, CDFA has not kept its Class 1 price competitive. For Dean Foods to survive, it must purchase raw milk at competitive prices. For CDFA's dairy program to survive, it must keep its prices competitive with alternative out-of-state milk, since CDFA cannot prevent out-of-state milk from entering California. California producers and processors are at a regulated disadvantage compared to their out-of-state neighbors.

California's Current Class 1 Differential is too high relative to other similar utilization markets. Historically, Class 1 differentials have served several purposes: 1) compensate producers for the additional costs of attaining and maintaining Grade A certification, 2) encourage suppliers to serve the Class 1 market (not a factor in the California pool) and 3) provide adequate price enhancement to producers to guarantee that a sufficient supply of milk is available to the marketplace. The implication of these factors is that in areas where Class 1 demand is greater relative to supply, differentials should be higher. In areas where supply is larger relative to Class 1 demand, differentials should be lower.

California's steadily growing milk production and declining fluid milk sales have resulted in Class 1 utilization rates declining to roughly 15.7% in 2004. In 2000, Class 1 utilization in California was 19.5%. This represents a 20% decrease in Class 1 utilization from 2000 through 2004. California's current Class 1 utilization is actually significantly

lower than the lowest Class I utilization percentage in the Federal Order system, Federal Order 30, the Upper Midwest Order.

The current implied Class 1 differential of roughly \$2.09 - \$2.36 is unjustifiably high in comparison to the \$1.60 - \$1.80 differential in Federal Order 30, a market with similar Class I utilization. The steadily increasing California milk production and steadily declining Class 1 utilization indicates that a lower differential is currently justified.

While there is no direct mechanism, like FMO shipping requirements, for California Class 1 prices to compensate producers and handlers for serving the Class 1 market, other than it does fund the pool of monies that is used to pay transportation credits and transportation allowances that do provide incentives to serve the fluid markets. The Dairy Institute of California witness has testified to the total costs of funding the transportation incentives and maintaining Grade A milk supplies. Any contribution to the pool above the funds required to service Class 1 markets serve little purpose other than price enhancement to dairy producers. Such price enhancement at a time when California's Class 1 price is not competitive makes little sense. Thinking this through to its logical conclusion would result in an enhanced uncompetitive California Class 1 price with zero Class 1 utilization. CDFA should lower California's Class 1 price due to California's low Class 1 utilization.

California's Class 1 Price is not competitive with near by unregulated milk. While it is true that the California Class 1 price is somewhat aligned with surrounding Federal Order Class I prices, it is also true that it is not competitive with available unregulated out-of-state milk being bought, processed and sold for Class 1 sales in California. In fact the surrounding Federal Order Class I prices currently don't matter. What matters is the price of available unregulated milk that does not have a California or FMO pool obligation and can displace Class 1 sales in California.

Out of State Milk is taking business away from in-state processors. California's uncompetitiveness became obvious about 2 ½ years ago when an unregulated out-of-state processor began shipping packaged milk into California. The aggressiveness of an unregulated out-of-state processor combined with California's uncompetitive Class 1 price and a limited quota system has created an environment for several market-distorting and disorderly marketing activities. Such activities include both out-of-state packaged and bulk milk coming into the state at prices that under-cut California's Class 1 price. Unregulated packaged fluid milk has cost us sales. In addition to lost sales we have had to decrease prices to customers in order to keep them competitive with retailers who are purchasing unregulated out-of-state milk that is exempt from paying the California Class 1 price.

We prefer to buy California Milk, but buying competitively takes precedence. Our preference is to buy California milk and bottle it at our California plants for our California customers. The result of moving unregulated out-of-state milk into California is to take dollars that could be returned to California dairymen and pay them instead to truck drivers and oil companies.

California Producers are being hurt

This attack from outside the state is not limited to processors alone. Indeed, California dairymen are being affected also. Unregulated out-of-state milk coming into the state, in either package or raw form, is displacing California Class 1 sales. This unpooled or unregulated milk reduces the value of the state pool and California dairy farmers receive fewer dollars. Over time, some California processors and producers have learned to play the game by selling their overbase raw milk to an out-of-state buyer and then repurchasing the same milk and hauling it back into California as out-of-state milk. Such milk movements, although beneficial to select individuals, exempt the buyer from paying California's Class 1 price and also reduces the dollars paid into the state pool. Unfortunately most California dairy farmers have not noticed the problem yet. California's pooling and quota system mask the actual monetary loss to producers. If there were a line item deduction on producers' milk checks indicating the amount of lost revenue due to unregulated out-of-state milk each month, producers would likely view this issue very differently.

For a California fluid bottler the problem is much more obvious and immediate. Unfortunately, the volume of unregulated out-state-milk continues to grow. More and more California processors are learning how to bring in bulk milk from out-of-state or learn how to round-trip California overbase milk to a California bottling plant and avoid paying into a market-wide pool. As long as California's Class 1 price is relatively too high, the California pool will continue to lose Class 1 sales and Class 1 dollars to out-of-state interests.

Some California Processors have yet to source out-of-state milk

As Class 1 sales leave the state those California fluid bottlers who, due to logistical or other business circumstances lack the ability to source out-of-state milk will be at a huge competitive disadvantage. As Class 1 dollars exit the state pool, the overbase price will erode. If played out to its logical conclusion, overbase prices will decline until they will not sustain milk production. If this happens there will be intense pressure on the California quota system.

Not just a Southern California Problem

Many assume this problem was confined to Southern California, however there are several out-of-state or round-trip alternatives available for Northern California processors wishing to avoid paying California's Class 1 price. I have presented a summary of three alternatives for supplying the Sacramento market in exhibit _____. I have presented two alternatives for supplying Sacramento with packaged milk and one alternative for supplying processors in Sacramento with out-of-state bulk milk.

Ignore California Pool Obligation

It is our position that if suitable resolution is not achieved as a result of this hearing process, we will have no alternative but to continue to procure out-of-state milk as necessary but to also take the additional step of looking at all available alternatives. If the California dairy industry is unwilling to take seriously the economic reality that we

face together with CDFA's obligations to keep us competitive (see for instance Section 62062.1) with Class 1 prices actually paid to dairy farmers in neighboring states, we then must seriously look at how such a failure impacts our continuing obligation, if any, to pay Class 1 minimum prices at our bottling plants in California. Again we owe it to our company to become and remain competitive. The economic reality is that we must work together if we are going to save this system. Right now, in the absence of a federal legislative solution, we look to the California industry and, on their behalf, CDFA to see past the rhetoric and short-term demands for more Class 1 dollars on an ever shrinking Class 1 share of the market. But if necessary, we are reluctantly prepared to go it alone. Please believe us, we have worked for over 2 ½ years for a fix that could work for everyone. We have not simply thrown in the towel early; there simply comes a point when we must see industry and CDFA action consistent with economic reality.

No Legislative Solution

We, together with a large number of industry allies, have sought legislation to correct many of these problems identified today. We thank those in this room who have participated in those efforts, but we have been stymied at every turn. We believe all possible legislative solutions have been exhausted. Even the California Congressional delegation has no interest in this California problem or a solution. In fact, even California dairy farmers have looked the other way as Class 1 dollars have left the state. Some producers want to stick their heads in the sand and hope the problem will just go away. For those of us who understand the magnitude of this problem, it is obvious the only solution now is to make California's Class 1 price competitive. We support the Dairy Institute of California's proposal to lower California's Class 1 price by \$.88 per cwt. We believe such action is necessary to make California's Class 1 price competitive with the effective cost of raw milk in surrounding states that is available to be bottled out-of-state and shipped into California or is available (either as out-of-state milk or round tripped California over-base milk) to be hauled to California processors.

Summary

Better to take action now to prevent further deterioration of market conditions than to find ourselves looking back crying over spilled milk.

Thank you for allowing me to express the views of Dean Foods Company. I would be happy to answer any questions. At this point I would like to respectfully request the opportunity to submit a post-hearing brief.

Cost Advantages of Round Trip and Out-of-State Packaged Milk

	Reno to Sacramento Round-Trip Advantage (\$ Per CWT)	Medford to Sacramento Out-of-State Advantage (\$ Per CWT)
2000 Average	\$1.9220	\$0.4909
2001 Average	\$1.9068	\$0.2875
2002 Average	\$1.7295	\$0.2234
2003 Average	\$1.9180	\$0.7658
2004 Average	\$1.7250	\$0.3070
2000-2004 Average	\$1.8681	\$0.4371

Assumptions:

Round Trip Milk:

Milk origination is Stockton, CA. Processing in Reno, Packaged sales in Sacramento

Bulk freight at \$2.10 per mile. - Packaged freight at \$1.80 per mile.

Milk Cost in Stockton is CA overbase - premiums assumed to be equal to CA Class 1 premium - handler pays all freight above producers current local haul.

Milk composition is California average Class 1 composition (2.17, 9.49 and 88.34)

Stockton local haul is assumed to be \$.40

Medford, Oregon Out-of-State Milk:

Milk cost is Pacific-Northwest Blend at Medford, OR - premiums are assumed to be equal to CA Class 1 premium - handler pays all freight

Packaged freight at \$1.80 per milk

Milk composition is California average Class 1 composition (2.17, 9.49 and 88.34)

Cost Advantages of Out-of-State Bulk Milk

	Reno to Sacramento Out- of-State Bulk Milk Advantage (\$ Per CWT)
2000 Average	\$4.0078
2001 Average	\$3.6519
2002 Average	\$3.2157
2003 Average	\$2.5004
2004 Average	\$1.8054
2000-2004 Average	\$3.1027

Assumptions:

Reno, NV Out-of-State Milk:

Milk cost is CA 4b - premiums are assumed to be equal to CA Class 1 premium - producer pays freight

Bulk freight at \$2.10 per milk

Plant Utilization - **Skim** - 95% Class 1 and 5% Class 2, **Butterfat** - 85% Class 1 and 15% Class 2