

Statement
of
Steve James
on behalf of
Swiss Dairy/
Dean Foods Company, Inc.
at the
California Department of Food and Agriculture Hearing
to consider changes to the Consolidated Milk Stabilization and Marketing Plans
Ontario, California
May 3 and 6, 2005

California Class 1 Pricing Hearing

My name is Steve James. I am President and General Manager of Swiss Dairy, a wholly owned subsidiary of Dean Foods Company. As General Manager, I am responsible for every aspect of my company's operation, from raw milk procurement to customer service, from production and quality to distribution. From this vantage point I have the opportunity to see all aspects of the competitive landscape that are pertinent to this hearing. I see and will testify to the sales that we are losing to unregulated competition.

I am here today to supplement testimony presented by Ernest Yates at the Northern California hearing held on Tuesday. I have included his testimony as Appendix I. My testimony, like that of Mr. Yates, 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 supplemental information regarding market conditions in Southern California—along with earlier testimony both today and Tuesday—so CDFA can clearly see that California's Class 1 Price must be lowered in order for us as an industry to become competitive.

I agree with Mr. Yates that 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 Swiss Dairy—and, ultimately, Dean Foods—to survive and prosper, it must purchase raw milk at competitive prices. For California's dairy farmers and processors to survive and prosper, prices must be competitive with alternative out-of-state milk. And since CDFA cannot prevent out-of-state milk from entering California, pricing is the only weapon available. The simple, sad fact is: California producers and processors are at a regulated disadvantage compared to their out-of-state neighbors—rather like going into a fight for your life with one hand tied behind your back. Our company believes strongly in the concept of free enterprise and in fair competition providing value to consumers. But the operative word here is "fair." We're not asking for special treatment, simply equal treatment.

California's loss of Class 1 sales. In Tuesday's testimony there were claims made that the accelerated loss of Class 1 sales had to do more with the demographics of California's population than it did with the milk prices relative to other parts of the country. I do not agree with that assertion; and as Chairman of the California Milk Processors Board, I can tell you that consumption and demographics are near and dear to my heart. I will concede that California's demographics are clearly different, but that difference does not necessarily mean less milk is consumed. On the contrary, if demographics are a contributing factor at all, then it could be argued that California's fluid milk consumption should benefit from our above-average Hispanic population and their consumption habits.

Mr. Jim Tillison, Western Dairy Alliance, testified that California's declining consumption is a result of the increased Asian and African American population. In his testimony he conveniently neglected to recognize the impact the growth of the Hispanic population has on consumption trends.

The United States census data (2000), provided by Mr. Tillison in a table, showed that Hispanics make up 32.4% of California's population versus 12.5% of the U.S. population. Syndicated data from Simmons and Nielson indicate that Hispanics spend 7% more on dairy than non-Hispanics and Hispanics spend 43% more on fresh milk than non-Hispanics. These facts should more than offset any negative effects of California's growing Asian and African American population referenced by Mr. Tillison. Thus, any claims made in this hearing record to the effect that the demographics of California are contributing to lower milk consumption are simply not true.

Milk Prices. We would all like to believe that consumers inherently recognize the value in a glass of milk, at any price, as contributing to their health and well-being. The truth is, that is utopia. Consumers do care about price. While I'm not an economist, I do see the impact of price changes and consumer retail buying patterns. I can assure you that higher prices result in less milk sold. To illustrate this point clearly I would like to step back in time to almost exactly a year ago when the Class 1 Price set a new record high. According to the Monthly Dairy Information bulletin, in May 2004, the retail price increased 28.7% in Southern California versus the same time period a year prior. The same bulletin showed Southern California beverage milk sales were down 11.4% versus the same month prior year (more detailed information is provided in Appendix 2). You can conduct all the elasticity studies you want, but to me, this kind of decline in consumption is the clearest possible illustration of consumers' responsiveness to price.

Let's take this example and apply it to a bigger picture. If consumers do in fact respond to price, and I'm convinced the prior evidence supports that, it is only fair to assume that given a chance to buy a similar product at a lower price they do so. Take the situation of private label versus brand. What is the purpose of a store choosing to have private label? It gives the store a chance to have a greater product choice and wider range of price points. We know from experience that many consumers make value decisions and that means they sometimes pass over a brand for a lower priced product.

Do we actually believe, as an industry, that consumers have some unwavering allegiance to a locally produced milk that will somehow weigh on their purchase decision such that they would be willing to pay more for California milk? I don't think so. Especially based on the fact that consumers don't know where packaged milk is produced or processed. They are making value decisions and price is a large part. As an industry that is heavily regulated by the government, we must recognize that consumers are the ultimate voters and they say price matters. CDFA owes it to consumers and processors—and I would even say to California dairy producers—to adopt the Dairy Institute's proposal.

California Processors are concerned.

As I mentioned earlier, I have the privilege of serving as Chairman on the California Milk Processors Board (CMPB). While I am not here to speak on their behalf, I would like to take this opportunity to give you an insight into our thoughts and concerns. Please know that the CMPB is aware of and concerned about the issues that inhibit fluid milk consumption and the evidence is clear that lower Class 1 prices help drive milk consumption. An additional concern and issue of ours that we consider one of fundamental fairness is the fact that out-of-state processors selling packaged milk in California don't contribute to our milk processors fund. Those funds are earmarked specifically for advertising that drive sales of fluid milk in California. So these out-of-state processors are enjoying the benefits of a program that they are not paying for.

Implications of California's uncompetitive Class 1 Price on Dean Foods.

As stated in my introduction I have the opportunity to see a lot of the issues germane to this hearing first hand. Swiss Dairy is literally in the crosshairs of this situation. From that perspective I would like to let you know our operations in southern California have been negatively impacted to the tune of millions of dollars. These losses have come in the form of lost volume and price concessions. This has resulted in plant consolidations, lost jobs, and significant impact on the communities where these plants are located.

Value of unregulated milk supply (raw and packaged).

The frustration of battling this issue day in and day out has led us to take the time to try to understand the financial advantage that our competition enjoys. In Appendix 3, I have presented two alternatives for supplying Los Angeles with packaged milk. Appendix 3 shows the average advantage that each of these strategies would have provided over each of the last five years. These are by no means the only alternatives for supplying Southern California Class 1 markets with unregulated milk but they should help to illustrate the seriousness of the problem.

The packaged milk opportunities that are summarized, outline alternatives for two out-of-state plants (one in Arizona and one in Nevada) to supply the Southern California market with packaged milk. The Arizona plant example uses Arizona milk at the Arizona blend price (though it could easily use even lower cost California overbase milk). The Las

Vegas example looks at using overbase milk in the Barstow California area as a milk supply for a Las Vegas plant to serve the Southern California market.

We prefer to buy California Milk, but buying competitively takes precedence. The above examples are real dollars for California Dairy producers. 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 to haul milk long distances. We don't think this is a good thing for California dairy. But, just like a dairy farmer will still cash a check from the government even though he disagrees with the program, we are prepared to hold our nose and do what is right for our company in order to keep us competitive.

Summary

We as the industry look to the Department to take leadership on crucial issues to the industry. We are not always able to, in fact we seldom, get total industry (producer and processor) agreement on all issues. This issue of out-of-state milk has brought the industry together more than any single issue in recent history. Why, because it has already cost California dairy interests—farmers, processors, labor, and retail—millions of dollars. While today not all parties offer the same solution, don't let perfect be the enemy of good. We need to seek improvement wherever we can. The Department, and its panel of experts, must take the lead in determining what is in the best long run interest of the industry in circumstances when industry consensus is difficult achieve.

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.

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 I 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 I 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.

CLASS 1 SALES, BY MARKETING AREA 1/

Table 6 - Sales of Selected Class 1 Products in California, by Marketing Areas,
May 2002, May 2003 And May 2004 2/

Products and Marketing Areas	Sales			Change To May 2004 From 3/	
	May 2002	May 2003	May 2004	May 2002	May 2003
	Gallons			Percent	
Whole Milk					
N. California	9,497,872	9,537,953	8,543,372	-10.0%	-10.4%
S. California	15,658,602	15,753,517	12,992,179	-17.0%	-17.5%
State Total	25,156,474	25,291,470	21,535,551	-14.4%	-14.9%
Reduced Fat Milk					
N. California	8,044,234	8,031,257	7,820,475	-2.8%	-2.6%
S. California	11,641,591	12,225,539	11,271,563	-3.2%	-7.8%
State Total	19,685,825	20,256,796	19,092,038	-3.0%	-5.7%
Lowfat/Light Milk					
N. California	4,737,935	4,409,800	4,455,006	-6.0%	1.0%
S. California	4,801,186	4,837,187	4,357,336	-9.2%	-9.9%
State Total	9,539,121	9,246,987	8,812,342	-7.6%	-4.7%
Skim/Nonfat/Fat Free Milk					
N. California	3,266,011	3,599,027	3,548,905	8.7%	-1.4%
S. California	6,134,635	6,107,626	5,875,300	-4.2%	-3.8%
State Total	9,400,646	9,706,653	9,424,205	0.3%	-2.9%
Beverage Milk Totals					
N. California	25,546,052	25,578,037	24,367,758	-4.6%	-4.7%
S. California	38,236,014	38,923,869	34,496,378	-9.8%	-11.4%
State Total	63,782,066	64,501,906	58,864,136	-7.7%	-8.7%
Half - And - Half					
N. California	651,891	693,496	632,110	-3.0%	-8.9%
S. California	520,889	709,652	713,861	37.0%	0.6%
State Total	1,172,780	1,403,148	1,345,971	14.8%	-4.1%

1/ Sales to N. Calif. and/or S. Calif. regions; not necessarily in area of plant.

2/ Data are subject to revision.

3/ Percent change may not agree with those in Table 5 due to rounding.

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

	Barstow - Las Vegas - So Cal Round-Trip Cost Advantage	Yuma - So Cal Packaged Milk Cost Advantage
	(\$ Per CWT)	(\$ Per CWT)
2000 Average	\$1.4198	\$1.5896
2001 Average	\$1.5276	\$1.4017
2002 Average	\$1.3503	\$1.3086
2003 Average	\$1.5387	\$1.6115
2004 Average	\$1.3458	\$1.0160
2000-2004 Average	\$1.4634	\$1.4119

Assumptions:

Barstow - Vegas Round Trip Milk:

Milk origination is Barstow, CA. Processing in Las Vegas, Packaged sales in Los Angeles
 Bulk freight at \$2.10 per mile. - Packaged freight at \$1.80 per mile.
 Milk Cost in Barstow is CA overbase less \$.40 local haul - premiums assumed to be equal to CA Class 1 premium - handler pays all freight
 Milk composition is California average Class 1 composition (2.17, 9.49 and 88.34)

Yuma, Arizona Out-of-State Milk:

Milk cost is Arizona-Las Vegas Blend at Yuma, AZ (Phoenix blend less \$.78 local haul)
 - 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)