TESTIMONY
of
William Schiek
on behalf of

Dairy Institute of California

at the
Consolidated Stabilization and Marketing Plan Hearing

Sacramento, California
October 30, 2008

Mr. Hearing Officer and members of the Hearing Panel:

My name is William Schiek. I am Economist for Dairy Institute of California and I am testifying on the Institute's behalf. Dairy Institute is a trade association representing 40 dairy companies which process approximately 75% of the fluid milk, cultured, and frozen dairy products, over 85% of the cheese products, and a small percentage of the butter and nonfat milk powder processed and manufactured in the state. Member firms operate in both marketing areas in the state. The position presented at this hearing was adopted unanimously by Dairy Institute's Board of Directors.

Dairy Institute appreciates the opportunity to testify at this hearing in support of our alternative proposal to adjust California's formulas for setting Class 1, 2, and 3 prices. We also thank the Department for the opportunity to comment on the petitions submitted by the Alliance of Western Milk Producers *et al.* (Alliance) and Milk Producers Council (MPC), which are also under consideration at this hearing.

At issue in this hearing are proposed changes to the pricing formulas for Classes 1, 2, and 3. In establishing pricing formulas, the Secretary is directed by the legislature to weigh the factors found within statute. Among other things, the legislature requires that the state's dairy policy should serve the public interest, foster the intelligent production and orderly marketing of milk, endeavor to provide for uniform prices to competing handlers, and provide an adequate supply of milk for all purposes.

With regard to milk pricing formulas, the statutes call for Class 1 prices that are in reasonable relationship to Class 1 prices in surrounding states, class prices that are in reasonable relationship to each other, and pricing standards that conform to current economic conditions. The Secretary is also directed to consider any other relevant economic factors when setting prices. More detail on the statutes as they related to milk pricing decisions by the Department is given on page 2 of Appendix B.

The Secretary must consider how to set prices and pricing formulas such that **<u>all</u>** of the declared intentions of the legislature are met as closely as possible. In so doing, the Department must look beyond the confines of any <u>single</u> Section of the Code. When all relevant economic factors are considered in tandem with the specific legislative directives regarding milk pricing, it is evident that the current Stabilization and Marketing Plans for market milk no longer provide for Class 1 prices that conform with these directives; and therefore, the plans must be changed.

Current Milk Market Situation

The prevailing milk marketing situation in California for the past couple of years could hardly be characterized as orderly. Milk production in California has been rising at an average annual rate of 3.5% over the past five years (2003-2007). Unfortunately, dairy plant capacity growth has not kept pace. In the past 12 months, milk has been dumped, fed to calves, and shipped long distances out of state to California plants' competitors at a discount. Worst of all, we have seen dairymen without homes for their milk in 2008. Any loss of commercial sales, no matter how small in terms of the state's total, will worsen the existing problem and put more dairy families at risk.

In 2007 and the first part of 2008, milk prices were at or near record levels. According to CDFA cost of production data, net returns to dairy operations (including returns for management and risk) were strongly positive for 2007 as shown in CDFA's "Background Material" exhibit for this hearing (Appendix A, Figures 1 and 2). During the first half of 2008, dairy farm revenues exceeded milk production costs as well. High milk prices have driven these trends.

There is no question that producers are now facing challenging times in the face of extreme volatility of milk revenues and input costs. Processors and manufacturers are experiencing the challenges of operating in this dynamic environment as well. While dairy input costs have fallen by over one-third from the high levels seen earlier this summer, they are doubtless higher than their historic norms. However, the important point here is that milk prices are not and should not be determined by milk production costs alone, but by supply and demand in the marketplace.

The folly of attempting to make producers "whole" through agricultural policy "fixes" in the face of low output prices or high input costs has been exposed by the past failures of such policies. One need only remember the milk price support program excesses of the early 1980s or the supplemental assistance programs for grain farmers in the mid to late 1990s. These programs led to both low product prices and surplus production. Guaranteed incomes lead to guaranteed growth in supply, which is fine as long as sufficient demand exists to accommodate the growth. However, adequate demand for California-produced dairy products is unlikely to materialize unless the state's regulated milk prices are lowered.

Consumers have been paying more for the dairy products they buy as farm milk prices have escalated and have been transmitted through the system to the retail level. Production of Class 2 and 3 products (a proxy for sales by California plants) is down. Production of all frozen dairy products was down 5.1% for the first eight months of the year. Likewise, production of cottage cheese and sour cream were down 10.2% and 19.2%, respectively. Class 1 sales were down slightly in 2007 and are about flat for the most recent 12-month period (Appendix A, Figure 3). Per capita consumption of Class 1 products continues to fall (Appendix A, Figure 4).

Against this backdrop, we have concerns that CDFA may not be enforcing minimum payment provisions on surplus milk. There have been rumors circulating in the industry this year that at least one milk broker has been taking milk from producers and not paying them the minimum price. A dairy policy that includes minimum pricing must enforce such prices equally on all handlers in the market. If doing so results in milk going un-purchased due to inadequate plant capacity, then the required solution is obvious: regulated minimum prices must be lowered.

We have also noted that the state's dairy cooperatives are investing more heavily in manufacturing facilities for the lowest returning products, and their producer trade associations have worked to squelch investment in higher class products through their hearing positions at this and previous hearings. The impact of such as strategy can be clearly seen. This year, the average annual Class 4b price will likely exceed the Class 4a price by $2.20 per hundredweight. In fact, in each of the last six years, the annual Class 4b price has exceeded the Class 4a price, with the average difference being $1.23 per hundredweight. Yet, producers have endeavored, through their hearing requests, to drive the cheese industry from the state, and they appear to be having some success. In 2008, California cheese production is down 8.8% from the same period last year, while nonfat dry milk output is up 8.3%. Class 4b pool utilization in 2008 is down compared to 2007, while Class 4a usage is up (Appendix A, Table 1). Judging from the producers' proposal at this hearing, they are looking to drive down production of Class 1, 2, and 3 products in the state as well.

Dairymen's pay prices are being dragged down by their growing milk output, increasing Class 4a utilization share, and inability to find adequate homes for milk in the state. Now they are expecting consumers of Class 1, 2, and 3 products to make up the shortfall created by their ill-advised policy positions and their dairy cooperatives' poor plant investment decisions. The impact of these efforts by producers on California processors' competitiveness would be bad enough, but while California producers have been trying to increase the state's regulated prices, USDA has increased manufacturing allowances in federal order pricing formulas, thereby ***lowering*** regulated prices in contiguous states. So even without the misguided efforts by California's dairymen, the competitive position of California processors has deteriorated, and downward adjustments to regulated prices will be required to protect Class 1, 2, and 3 sales and keep more dairymen from losing homes for their milk.

Dairy Institute's Proposals

Class 2 & 3 Pricing Issues

Effective with October pricing, Federal Order prices have been reduced as a result of increases in the manufacturing allowances contained in federal milk pricing formulas (Appendix B, page 3). These formula changes result in decreases in federal Class II prices of $0.0484 per pound of milkfat and $0.0107 per pound of nonfat solids. On a per hundredweight basis, the reduction is 26.25 cents. To restore the competitive position of California's Class 2 & 3 manufacturers to what it was before the federal pricing change, a reduction in California prices of the same magnitude would be in order.

However, a reduction in milkfat prices of more than $0.037 per pound in Northern California or more than $0.0393 per pound in Southern California would bring average Class 2 & 3 milkfat prices below those for Class 4a. Consequently, these reductions may represent the practical limit of downward adjustments to Class 2 & 3 fat prices. However, Class 2 & 3 nonfat solids prices can be reduced by an additional amount beyond the corresponding federal nonfat solids price reduction to compensate for the milkfat price reductions we are unable to make. Doing so would restore the price relationship that existed *on a per hundredweight basis* before the new federal make allowances took effect.

Therefore, with regard to Classes 2 and 3, we are proposing the following amendments.

1. Eliminate the differentials that are added to the average Class 4a fat price for Classes 2 and 3 in both marketing areas. For Northern California, this would be a reduction in Class 2 and 3 fat prices of $0.037 per pound. For Southern California this would mean a reduction in Class 2 and 3 fat prices of $0.0393 per pound.

2. Reduce the differentials that are added to the Class 4a solids not fat price by $0.0153 per pound for Classes 2 and 3 in both marketing areas.

The per hundredweight price changes indicated by the proposed component price changes would be a reduction of about 26 cents for Northern California and 27 cents for Southern California. It should be noted again that our proposed price reduction merely restores the average price relationship with surrounding states that existed prior to the recent federal order change. Failure to keep pace on pricing will lead to reduced sales of Class 2 and 3 products, as customers move to procure product from suppliers in nearby states, and lower pool prices, as Class 2 and 3 utilization falls and more milk moves into Class 4a. Mailbox prices to producers will fall even more if reductions in Class 2 and 3 sales mean that milk must be trucked out of the state to find a home.

Class 1 Pricing Issues

Section 62062.1 requires that Class 1 prices in California be in reasonable relationship to Class 1 prices in contiguous states. While we had argued that a lower Class 1 price level was needed, as a result of the 2006 Class 1 hearing the Secretary established interstate price relationships that he felt were reasonable. Given changes in the industry and differences in pricing formula structures, the Class 1 price relationship established with surrounding states at the time of the 2006 Class 1 hearing had deteriorated by 15 cents per hundredweight even before the recent change to federal order make allowances (Appendix A, Figures 5 and 6).

Furthermore, the federal order make allowance changes made in October will result in an average drop (calculated over the January 2004 to September 2008 period) in federal Class 1 prices of an additional 33 cents per hundredweight. So, just to maintain the price relationship with surrounding federal order Class I prices that was deemed reasonable by CDFA at the last hearing, Class 1 prices would need to be reduced by at least 48 cents per hundredweight ($0.15 +$0 33).

Unfortunately, changes to federal order price relationships aren't the only factors impacting the competitive situation faced by California processors today. In addition to changes in Federal order prices, the Nevada Dairy Commission has recently reduced Class 1 prices in Northern Nevada (Reno Area), where two Class 1 plants are located, by $1.00 per cwt. It is our understanding that this change was made to deal with competitive inequities within Nevada, owing to the ability of some plants there to procure California milk at a discount. Nonetheless, the change has ramifications for the competitiveness of California processors against their Nevada counterparts.

At past hearings we have argued that in establishing prices, existing statutes require that CDFA consider the reasonableness of the relationship of prices between classes within California and establish a price level that fosters intelligent and orderly marketing of milk. One way to look at what might constitute a "reasonable" relationship between the various class prices is to consider the relationship of the Class 1 differential to the utilization percentage of Class 1 milk in the pool (Appendix A, Table 2). The economic theory underlying classified pricing would suggest that lower Class 1 differentials accompany lower Class 1 utilization markets. A regression analysis of Federal order and California Class 1 differentials and Class 1 utilization illustrates this principle and suggests that California's Class 1 differential is at least $1.14 per hundredweight too high (Appendix A, Figure 7).

Another important indicator of the reasonableness of the relationship between the various classes of milk is the spread between Class 1 and Overbase prices (Appendix A, Figure 8). At the time of the last hearing decision, the 12-month average of this spread was $2.16 per hundredweight (calendar year 2006). At the time we submitted our proposal in September, we projected Class 1 and Overbase prices through the end of the year using futures prices for dairy commodities and a simple model of the California pool. Based on those calculations, the 12-month average spread for calendar year 2008 was projected to be \$3.51 per hundredweight, suggesting that a Class 1 price reduction of \$1.35 per hundredweight would be needed to restore the price relationship between the various classes of milk that was deemed to be reasonable at the time of the last Class 1 hearing decision.

For the 12-month period ending September 2008, the most recent month for which we have actual data, the Class 1-overbase spread was \$3.76 per hundredweight, suggesting a Class 1 price reduction of \$1.60 per hundredweight is needed to restore the spread to the level that existed at as of the last hearing. As of October 28^{th}, using the same method that we previously employed to forecast prices to the end of the year, we project the 12-month average spread for calendar year 2008 to be \$3.80 per hundredweight, implying a needed reduction in Class 1 prices of \$1.64 per hundredweight. Thus, the price change that we have proposed is not overreaching because the analysis suggests that even larger reductions are warranted. Still, we are proposing a \$1.35 per hundredweight reduction as appropriate because it moves Class 1 prices significantly in the right direction and acknowledges that there is some volatility in the size of the price spread over time.

Therefore, Dairy Institute's proposed Class 1 formulas are as follows:

Commodity Reference Price (CRP) =

Higher Of: (Advance CME AA Butter Price x 1.2) x 3.5
\+ (Advance CA NFDM Price x 0.99) x 8.7
OR
Adv. CME 40# Block Cheddar Price x 9.8
\+ (Adv. CME AA Butter Price - \$0.10) x 0.27
\+ (Advance Dry Whey Price x 5.8) - \$0.85

Class 1 Fat = (Advance CME AA Butter Price - **\$0.1315**) x 1.2

Class 1 SNF= (((CRP ***-\$1.203*** – (3.5 x Class 1 Fat Price)) x 0.76) / 8.7

South Class 1 Fluid Carrier (((CRP ***-\$1.203***) – (3.5 x Class 1 Fat Price)) x 0.24)/87.8

North Class 1 Fluid Carrier ((((CRP ***-\$1.203***) – (3.5 x Class 1 Fat Price))x0.24)/87.8)
-\$0.0031

The size of the Class 1–Overbase price spread has real competitive consequences for California processors. In particular, the P-D advantage (Class 1 price less quota price) has grown in direct relation to the Class 1-Overbase spread (Appendix A, Figure 9). Throughout the period 2000-2007, the P-D advantage in both Northern and Southern California averaged about 10 cents per gallon on exempt milk. Currently, it appears that exempt quota corresponds to about 18% of Type 70 P-Ds' total Class 1 usage. When the P-D advantage is blended over all of the P-Ds' Class 1 milk, their historic price advantage amounts to 1.8 cents per gallon. This is a substantial number given that customers change suppliers for a price difference of a few hundredths of a cent per gallon.

For the 12-month period ending September 2008, the P-D advantage on exempt quota had swelled to 19.8 cents per gallon or about 3.6 cents per gallon over all their Class 1 milk. By allowing this spread to grow in the manner that it has, it can be argued that the Department in violation of Section 61805(b) of the Food and Agriculture Code, which states that the Department will endeavor to provide for uniform milk prices to handlers operating within a marketing area. While we recognize that the law also states that no price will considered to be invalid if prices to handlers are not equal, the rapidly growing spread clearly violates the law's intent.

It is also interesting to note from the Department's Background Material for this hearing that the Class 1 sales trend for Type 70 Exempt P-Ds is increasing (Appendix A, Figure 10); just the opposite of the aggregate sales trend experienced by fully regulated Class 1 processors. The state's current Class 1 pricing policy is creating a windfall for a select group of handlers, and the situation should be remedied in the manner that we have prescribed.

Another crucial concern directly related to the size of the Class 1-Overbase price spread is the way it enhances the ability of out-of-state Class 1 processors to competitively round-trip California-sourced milk and capture Class 1 packaged milk business within California. While other witnesses will testify in more detail about the use of this milk procurement strategy, I will describe it here briefly. California's excess milk supply creates a situation where dairymen are looking for homes for their milk. Out-of-state processors are able to procure California milk from producers at Overbase prices and haul the milk to Class 1 processing plants located close to California's borders in contiguous states. The milk is processed and packaged, sometimes at a lower cost than can be done within California owing to more favorable general business costs and non-union labor. The packaged milk is then hauled back into California and sold in the state's retail outlets. The sad truth is that the current Class 1-Overbase price spread provides more than enough money to make this strategy viable.

Finally, the growing Class 1-Overbase spread is evidence that fluid milk consumers are being relied upon too heavily for producer revenue contributions. Total Class 1 sales are down from where they were in the early 1990s, and despite a growing population, they have been basically flat over the past decade and a half. Per capita consumption of fluid milk continues to plummet and California Class 1 plants have closed, resulting in fewer market outlets for dairymen and more milk going into lower-valued uses. Increased Class 1 prices have a direct impact on retail prices and on retail sales. Lest anyone be tempted to argue that retail milk prices are unrelated to raw milk prices, I have included a graph of Class 1 prices in comparison to the lowest lawful retail price in Southern California (Appendix A, Figure 11). The graph illustrates fairly convincingly that changes in Class 1 prices correspond directly to changes in retail prices. Furthermore, there does not appear to be a clear trend in the average farm-retail price margin over the past 10 years, even though a growing margin might be expected because of the inflation in marketing costs during the period. For further evidence of the strong relationship of Class 1 prices to retail prices, I ran a simple regression with the lowest lawful retail price as the dependent variable and the Class 1 price as the independent variable. The estimated model indicates that changes in Class 1 prices explain 94 percent of the variation in changes to retail prices (Appendix A, Figure 12).

It might be tempting to conclude that the widening spread between Class 1 and Overbase prices is a transitory problem that the market will eventually correct on its own. We do not believe this self-correcting hypothesis is correct. Our view is that the spread is unlikely to narrow to its historic level anytime soon without a pricing formula adjustment. The growth in milk powder production in California and abroad will continue due to expansions in milk powder plant capacity in California and New Zealand, We see slowing demand for nonfat milk powders due to worldwide economic difficulties and a loss of world powder demand, at least temporarily, because of the China melamine scandal. The sum of these factors will drive Class 4a prices lower.

Furthermore, we foresee that the growing share of Class 4a in the California pool will mean that Quota and Overbase prices will be more heavily weighed down by low Class 4a prices than in the past. Class 4b prices, while they are expected to decline from 2008 levels, are not expected to collapse to the same degree as Class 4a prices due to the relatively smaller investment in global cheddar cheese production capacity compared to powder. Meanwhile, Class 1 pricing that is based on the "higher of" concept will ensure that Class 1 prices stay relatively higher compared to Overbase prices than was true in the past. In order to prevent potentially significant losses in Class 1 sales and homes for producer milk, the Class 1-Overbase price spread needs to be reduced now, not at some time in the future after sales have already been lost. We urge the Department to adopt our proposal.

<u>Other Organizations' Proposals</u>

Milk Producers Council

MPC's position to recover milk movement incentive pool costs through a Class 1 price increase is uninformed and illogical. It would hurt the competitive position of Class 1 processors, and it ignores that the already high Class 1 price level provides ample revenue to the pool for milk movement. MPC's proposal ignores the historic commitment of the producer community to assure that Class 1 markets were served in exchange for processor support for milk pooling. This proposal should be rejected in its entirety.

Alliance of Western Milk Producers

The Alliance *et al.*'s proposed six-month $1.01 per hundredweight surcharge would hurt the competitive position of Class 1, 2 & 3 processors and lead to lost sales of California milk in those classes. It would encourage processors and retailers to procure products from sources in nearby states as opposed to California-made products and would encourage reconstitution in Class 2 & 3 product manufacturing. It would cause additional expansion of milk output when plant capacity is currently at its limit, leading to more milk being dumped, more milk fed to calves, more milk shipped out of state at a discount to California's competitors, and additional lost sales for the state's processors and manufacturers. California consumers, who have been paying higher prices for milk during the past 18 months, would be right to ask why they should be paying so much to give dairymen the privilege to produce and dump surplus milk, while the best milk price deals go to calf ranchers and out-of-state dairy product manufacturers. While proponents might argue that these surplus milk conditions are a thing of the past because the cooperatives have curtailed milk output through base plans, I would point out that the very existence of the cooperative base plans is a testimony to the failure of our current milk pricing formulas. Giving more money to dairymen when their output already must be controlled through production caps would be unwise at best. Frankly, adoption of this proposal would be an embarrassment to the industry and it should be rejected in its entirety.

Summary

Supply and demand conditions in California are such that regulated price increases should not even be contemplated, and regulated price reductions are needed immediately to preserve California's markets for milk and dairy products. The amendments we propose will restore competitiveness and protect sales of Class 1, 2, and 3 products produced in the state for the benefit of the entire industry. If the concerns we have outlined are not addressed as we suggest, markets will be lost and larger numbers of dairy farm families will be without homes for their milk. We strongly urge the Secretary to adopt our proposals. Thank you for the opportunity to testify. I am willing to answer any questions you may have, and I respectfully request the opportunity to file a post-hearing brief.