

Testimony of Dr. William Schiek,
Representing Dairy Institute of California
May 2009 Federal Milk Marketing Order Hearing
Cincinnati, Ohio
Docket No. AO-14-A78, et al.

Introduction

My name is William Schiek. For the past 12 years I have been Economist for Dairy Institute of California, a trade association representing fluid milk processors and dairy product manufacturers with plants in California. Dairy Institute provides member companies with market and regulatory information services and advises them on regulatory and legislative issues impacting their business operations. We also serve as our members' primary advocate on dairy legislative and regulatory matters. Prior to joining Dairy Institute's staff, I was Assistant Professor of Agricultural Economics at Purdue University in West Lafayette, Indiana from 1991 to 1997. At Purdue, I had responsibility for teaching courses in Agricultural Marketing and Food Business Management. I conducted research on a variety of food and agricultural marketing topics, including dairy marketing topics. From 1982 to 1989, I was employed by the New York-New-Jersey Milk Market Administrator's Office (Federal Order Number 2) as Cooperative Relations Specialist (1982-84) and Economist (1985-89). I have a Bachelor of Science degree from Cornell University in Applied Economics and Business Management and M.S. and Ph.D. degrees from the University of Florida in Food and Resource Economics.

I am testifying today at the request of the National Milk Producers Federation for the purpose of describing the producer-handler exemption that exists under California's state milk pooling plan and its impact on market structure and competition within the state. It is my belief that the Secretary will find the California experience helpful in formulating policy as it pertains to producer handlers in federal orders, especially since the California producer handler exemption is similar to one of the proposals under consideration at this hearing (Proposal No. 17). A testament to the relevance of California's experience with producer handlers was provided at the March pre-hearing information session by the representative of Mallorie's Dairy, the proponent of Proposal No. 17. In describing Mallorie's alternative proposal, its representative characterized Proposal 17 as being inspired by the producer handler exemption in California.

Proposal 17, in the words of its proponents, "...would allow producer-handlers, whose plants would become regulated pool distributing plants, to "grandfather" their existing farm milk production, up to 3 million pounds per month, by exempting such production from obligations to pay money into (or receive money from) the pool producer-settlement fund. Such pool-exempt milk would essentially be treated as milk in an individual handler pool. Milk production from the handler's own farm in excess of the grandfathered (exempt) volume, along with receipts of milk from other producers, would

be subject to market-wide pool obligations and payments to the fund just like milk received by other handlers.”

Some in the industry refer to the type of exemption described in Proposal 17 as a “soft cap” because a specified volume of the producer handler’s milk production/receipts remains exempt from pooling even as the operation’s milk volume grows, either by increased own-farm production or by receipts from other sources, beyond the exempted volume. This type of exemption stands in contrast to a so-called “hard cap,” like the ones operative for producer handlers in the Pacific Northwest and Arizona orders, where once a threshold volume is exceeded, the producer handler is subject to regulation on all its production/receipts. As you will see from my description that follows, the soft cap exemption contained in Proposal 17 is quite similar to the producer handler exemption in California, although there are some differences.

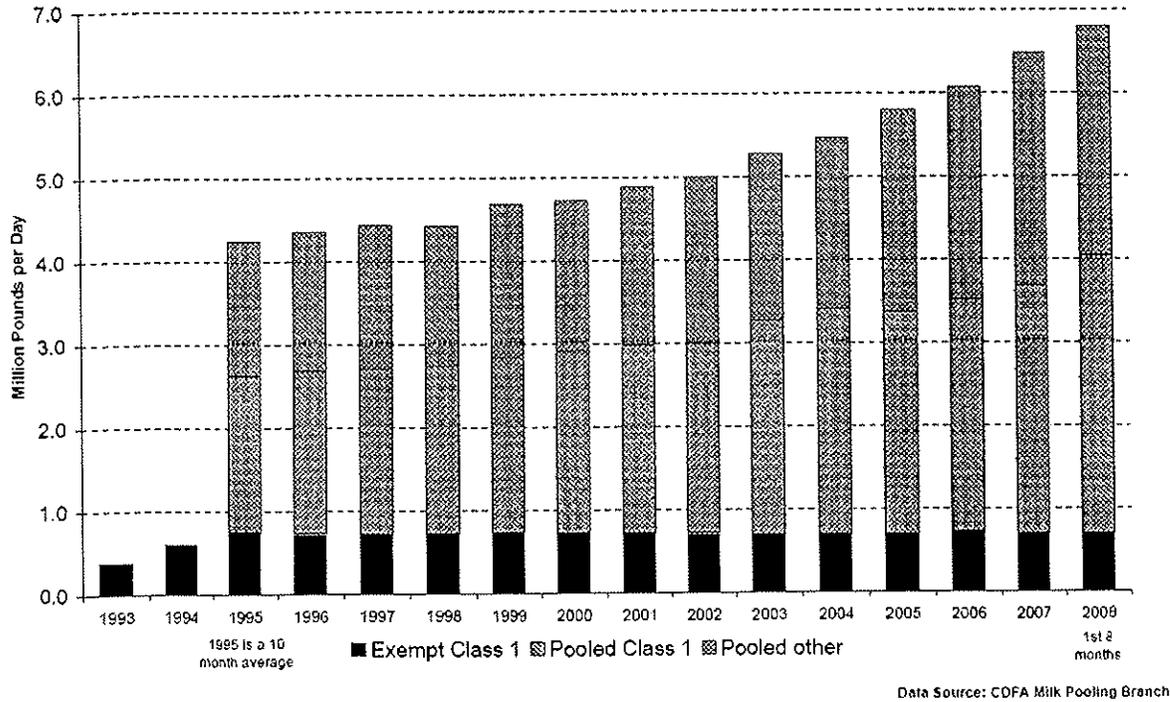
Regulatory Treatment of Producer Handlers in California

In California, producer handlers are often referred to as producer distributors or PDs. The terms are used interchangeably and refer to the same type of operation under California’s pricing and pooling system. There are two types of producer handler exemptions in California. The first type is known as a Type 66 or “Exempt Producer Handler.” These operations do not have to pool their own-farm production, provided they meet the qualifying requirements: 1) milk production and sales both must average less than 500 gallons per day, 2) 95% of both production and sales must be disposed to resale/wholesale outlets (other than handlers), and 3) no more than 5% of Class 1 sales can be from outside sources. Only two Type 66 producer handlers are currently operating, and the average monthly combined volume of both is 129,000 pounds. This group will not be the focus of my testimony. For the remainder of my testimony, the term “PD” will refer to the second type of producer handler as described below.

The second type of producer handler in California is the Type 70 or “Option Exempt Producer Handler.” These handlers operate with a soft cap and can deduct the volume of their exempt milk production from their Class 1 pool obligation. On their non-exempt milk production and on any milk purchased from other producers, the Type 70 PDs must account to the pool in the same manner as fully regulated handlers. Thus, the exemption is analogous to the one contained in Proposal 17, except that the entire ^{exemption} production is applied to the plant’s Class 1 usage. Currently, there are five Type 70 PDs operating in California. For the September 2007 through August 2008 period, the five Type 70 PDs had a combined exemption of around 21.2 million pounds per month and their pooled Class 1 volume was an additional 100.1 million pounds per month. They also utilized another 83.3 million pounds per month that was pooled in other classes. The accompanying graph (Figure 1) shows the Type 70 PDs’ average daily exempt production, pooled Class 1 milk volume, and other pooled milk volume by year since 1995. What is striking about this graph is that it shows a clear upward trend in total PD Class 1 milk volumes.

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Figure 1. Milk Processed by Type 70 Exempt Producer Handlers, Annual Averages, January 1995 – August 2008.



History of Producer-Distributor Exemption in California

California’s producer handler exemption was not born amid policy deliberations by agricultural marketing specialists, but was the result of the political compromise that was needed to pass the enabling legislation for the Gonsalves Milk Pooling Act in 1967. This compromise, which established statewide milk pooling in California also led to our unique method of dividing producer revenues according each producer’s quota, base and overbase milk production. Under the pooling legislation and regulations, each producer was assigned a production base derived from their historical milk output. Any production above a producer’s base was termed “overbase.” Each producer was originally allocated quota volumes equal to some percentage of their production base in proportion to their historic milk shipments to Class 1 uses. Quota milk received a higher price than base and overbase milk and was highly desired by producers under the new pricing system. This system of prices was adopted in lieu of uniform pool prices in order to gain legislative support from producers in Southern California who traditionally had a large share of the Class 1 market.

It was anticipated that growth in Class 1 sales over time would allow the issuance of new quota that would be allocated first to those producers with relatively low quota holdings

in proportion to their base. In this way, it was expected that all producers would eventually be "equalized" with respect to their quota holdings. Over time, quota began to be traded among dairymen, providing a second way for producers (including PDs) to increase their quota holdings.

Under the Act, PDs who did not meet the criteria for exempt plants (Type 66) were given the option to deduct the volume of their original allocated quota from their Class 1 pool obligation, or they could receive the quota price from the milk for their quota production, but would receive no exemption in calculating their handler obligation to the pool. This choice or option was a one-time offer for the Type 70 PDs and no new PDs could use this exemption after the pooling plan was enacted.

In 1978, following legislative changes, amendments were made to the Pooling Plan (the regulations governing milk pooling in California), which allowed Type 70 PDs to increase their exemption to equal their original quota plus any additional quota purchased prior to 1978. They also received an additional daily exemption of 150 pounds of fat and 375 pounds solids not fat, provided they had not transferred production base and pool quota after February 9, 1977. These changes to the PD exemption were part of larger legislative and regulatory amendments that were instigated by producers to equalize each producer's quota holdings at 90% of their historic production base. The broader changes were important to producer leadership and they were willing to accept the PD exemption increases as the price for getting their desired changes in the quota regulations enacted.

By the early 1990s, producers needed to change the way in which prices for base, overbase and quota milk were determined to relieve tensions over pool revenue distributions that were developing between quota holders and non-quota holders. In 1993, producers crafted a quota reform bill that they viewed as "must pass" legislation, essential for the continued viability of the pooling program. Once again, because producers needed to move the legislation, they were willing to accept legislative amendments offered by the PDs, who threatened to derail the quota reform bill if it did not contain their amendments. As a result of the legislation, the PD exemption was expanded to cover all original quota and all quota subsequently purchased, plus the additional daily exemptions of 150 pounds of fat and 375 pounds solids not fat that were allowed as a result of the 1978 amendments. The ability of PDs to continue purchasing new exempt quota was eventually terminated by legislation, effective March 1, 1995. The point that I believe is important from this history is that once the soft cap exemption was established in California, it became an attractive target for economic rent-seeking behavior on the part of the PDs. By opportunistically holding "must-pass" dairy legislation hostage to their amendments, PDs were able to increase their exemption, and the regulators charged with overseeing the proper administration and functioning of the state order had little say in the matter.

California Producer Handler Raw Product Cost Advantage

On exempt milk, the milk cost advantage PDs receive is calculated as the Class 1 price less the Quota price. If the PD did not have a plant, he would receive the quota for all the

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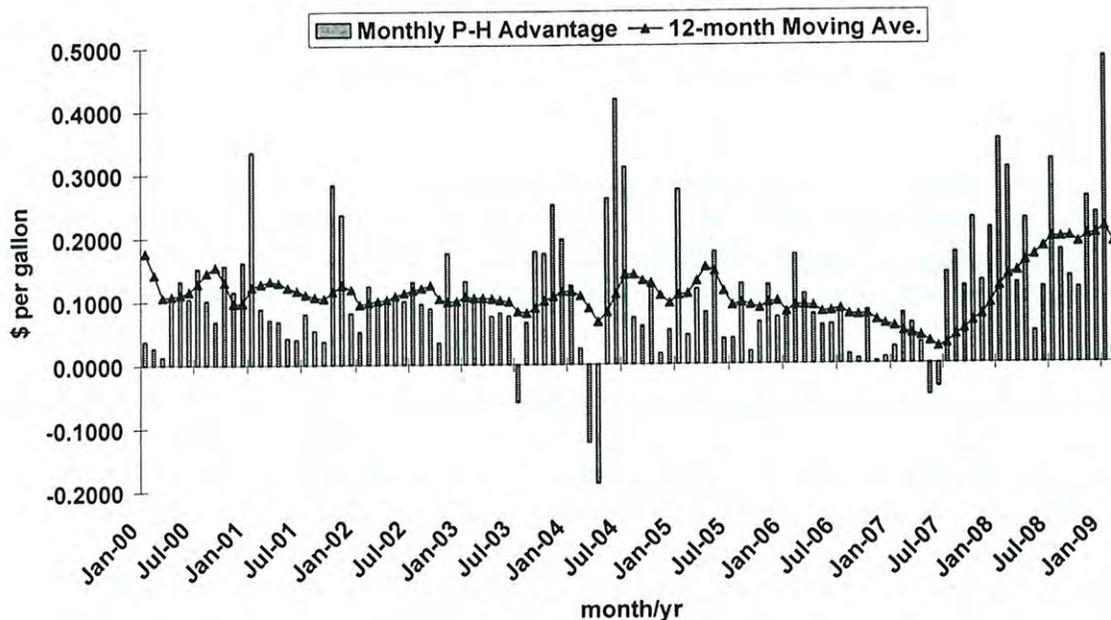
exempt milk he shipped to a regulated handler. Therefore, the PD's opportunity cost on exempt milk is the quota price. Put another way, the transfer price between the farm side of the operation and the plant is assumed to be the quota price. In reality, integrated firms will establish transfer prices to maximize the profits of the entire integrated operation, not just each component operation. If greater profits can be made in total by accepting a lower price at the farm, the PD will do it. So the actual cost advantage to the PD may well be greater than I have calculated here.

Using California price data from the California Department of Food and Agriculture (CDFA), I calculated the advantage for California milk testing 3.5% fat and 8.7% solids not fat on a per hundredweight basis by subtracting the quota price per hundredweight from the Class 1 price. The P-D ^{regulated}raw product cost advantage on a per gallon basis was calculated by dividing the advantage per hundredweight by the number of whole milk gallons in a hundredweight of milk. On a month to month basis, the value of this cost advantage varies greatly due to changes in the relationship between the Class 1 price and the pool quota price.

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Figure 2. California Producer Handler Cost Advantage Utilizing Exempt Milk

California Type 70 P-H Raw Product Cost Advantage for Whole Milk by Month, 2000-2009



Source: Dairy Institute Staff Calculations from CDFA Price Data

For the January 2000 through March 2009 period, the cost advantage on milk covered by the exemption averaged 11.3 cents per gallon. For the most recent 12 month period, it averaged 17.7 cents per gallon. Competition for fluid milk sales is intense in California and business often moves from one milk supplier to another based on price differences of a few hundredths of a cent per gallon. In this competitive environment, having a raw product cost advantage of more than a dime per gallon is a tremendous advantage for the PDs and a formidable challenge for fully regulated suppliers of fluid milk. The accompanying graph (Figure 2) shows the PD cost advantage by month as well as the 12-month moving average of that advantage. During September 2007 – August 2008 period, the exempt portion of the PDs Class 1 sales accounted for about 17.5% of their total Class 1 sales.

Impact of the Producer Handler Competitive Advantage in the California Market

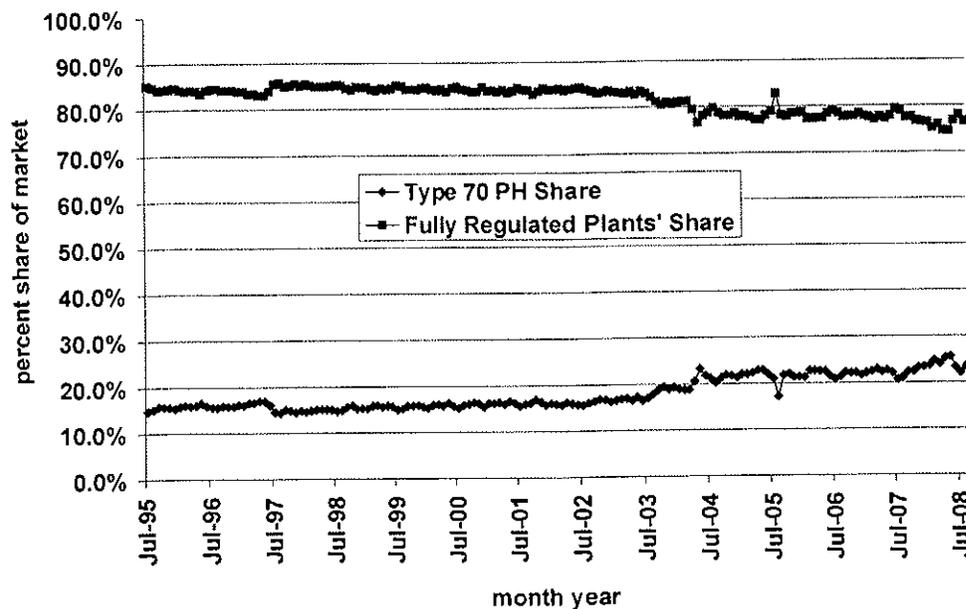
In the marketplace, not all customers are created equal with regard to the profits they generate for the businesses that supply them. Customers that sell high volumes and which are served at a relatively low cost per unit are usually the most profitable for a Class 1 supplier. It is these accounts: club stores, mass merchandisers, and large grocery stores that the California PDs have aggressively and successfully pursued. When going after these types of accounts, producer handlers have made full use of their exemption. As an illustration, several years ago one of our member companies acquired a large piece of grocery-chain business that could not be adequately served from its existing processing facilities, so they put that business up for bid using an online auction. Three processors that were fairly well positioned to serve the account bid on the business. Two were fully regulated processors and the third was a PD. After the auction, a representative of the company that put the business up for bid contacted me, noting that the bid submitted by the PD was significantly below the bid of the other competitors. Given that California has a law prohibiting sales below cost, the representative wanted to know if the bid was legitimate. When I informed him of the magnitude of the PD cost advantage, he was surprised, but was no longer concerned that the bid might be below cost. The account was awarded to the PD, even though one of the regulated processors was more favorably located to serve the business. The PD's low milk price was the determining factor.

One of the axiom's of competition in the California market is that, all other things being equal, to acquire business you need to bid lower than your competitor, but to retain business, you only need match your competitors bid. With regard to PDs, their soft-cap exemption can be characterized as a "moveable feast" or "the gift that keeps on giving." The California PD can pick and choose when to use its exemption. When it wishes to acquire business it can use its exempt volume to bid aggressively and undercut fully regulated competitors whose raw product cost cannot be lower than the Class 1 price. Later, the PD can simply match the regulated competitor's price by utilizing its non-exempt volume to retain the account. Its exempt volume is then free to be used to aggressively bid the next account it wishes to acquire.

As a result of the cost advantages from their exemption, producer handlers have grown their share of Class 1 sales at the expense of fully regulated competitors over time. Using data contained in CDFA's Hearing Exhibit from its October 2008 Class 1 pricing hearing, I was able to compare the Type 70 PDs' share of California-sourced Class 1 milk, with the share of non-PDs over the July 1995 to August 2008 period. As the accompanying graph illustrates (Figure 3), the PDs' share has increased and the fully-regulated processors' share has declined. The trend is unambiguous. For example, in July 1995 the PDs' share of the market was 14.8% and the non-PD share was 85.2%. By August 2008, the PDs' share had grown to 23.4% and the non-PD share was 76.6%.

Figure 3.

Share of California-Sourced Class 1 Market by Type of Operation, July 1995-August 2008

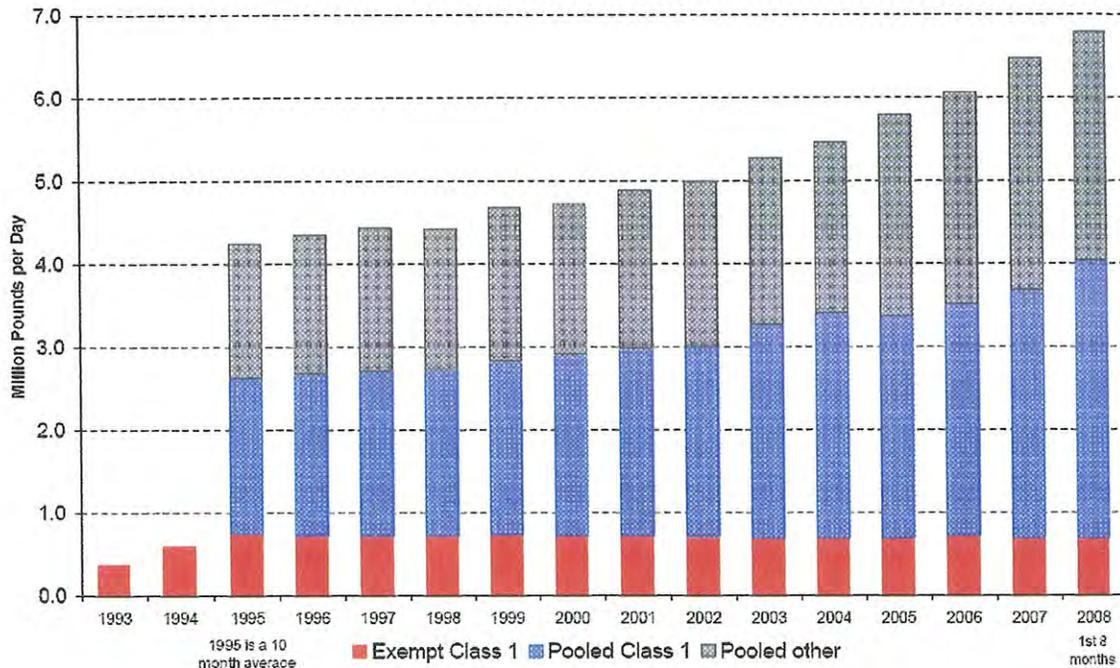


Source: Dairy Institute calculations form CDFA Milk Pooling Branch data.

Summary

The operation of the soft-cap producer handler exemption in California has significantly advantaged producer handlers to a great degree. In California, it cannot be argued that this has worked to the advantage of producers, and it has certainly worked to the disadvantage of fully-regulated Class 1 processors. It has created a dilemma for policy makers in the state, who struggle to reconcile the goal of providing equal prices to handlers competing in a marketplace with the legislatively mandated producer-handler exemptions. It is my sincere hope that the Secretary will find the California experience useful in formulating effective policy with regard to producer handlers in Federal Orders.

Figure 1. *Milk Processed by Type 70 Exempt Producer Handlers, Annual Averages, January 1995 – August 2008.*



Data Source: CDFA Milk Pooling Branch

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