



Class I Differential Testimony (Proposal Number 19)

Testimony Presented By:

Rob Vandenheuvel
Sr. Vice President, Member & Industry Relations
California Dairies, Inc.
2000 N. Plaza Drive
Visalia, CA 93291

This testimony is presented on behalf of California Dairies, Inc., hereafter CDI, and is submitted in support of Proposal Number 19.

My name is Rob Vandenheuvel, and I am Senior Vice President of Member and Industry Relations for CDI, headquartered at 2000 North Plaza Avenue, Visalia, CA 93291. CDI is a Capper-Volstead cooperative association qualified to market milk on Federal Milk Marketing Orders, hereafter Federal Orders, is a member of National Milk Producers Federation, hereafter National Milk, and fully supports Proposal Number 19. I serve on National Milk's Executive Committee, Economic Policy Committee, Federal Order Task Force, and Class I Working Group. Among my day-to-day responsibilities at CDI and specific to the issues relevant to this proposal are oversight of all ranch-to-plant movements of bulk raw milk, all plant-to-plant movements of bulk processed fluids, and all sales of bulk raw milk and bulk processed fluids.

CLASS I DIFFERENTIALS

By comparison to other regions of the country, California is fairly new to the issue of Class I differentials, as the California Federal Order began in November 2018. Included in that promulgation of a new California Order was the current Class I differential map that existed in its current form since the early 2000's. No updates to that differential map were requested during the course of the California Federal Order promulgation hearing, but the experience the past four years has revealed opportunities for updates and improvements that will be further described in this testimony.

Prior to entering the Federal Order system, California dairy farmers and milk handlers operated under a California State Order that used a different method to establish Class I prices. The California county-by-county Class I differential map developed in 2000 was therefore dormant until the implementation of the California Federal Order in November 2018.

While operating under that State Order, California experienced significant imports of bulk raw milk, with increased prevalence up to 2018. These long-distance movements of bulk raw milk into California-based bottling facilities were largely the result of financially beneficial milk price differences, made possible because of California's inability to regulate interstate commerce under the Commerce Clause of the U.S. Constitution. Therefore, milk originating outside of California could be marketed to California-based bottlers without the need for that milk to participate in the State-run milk pricing and pooling program. At the time, the savings associated with avoiding minimum California state milk prices and any pooling obligations that would

otherwise be required for purchases from a California-based farm or milk handler served as an offset against the additional cost associated with hauling milk from farms located out of state.

In the more than four years California has operated under the Federal Order system, interstate movements of raw milk have been greatly reduced. The regulatory gap that existed in the California State Order with respect to milk originating outside of California no longer exists. The limited volume of interstate milk movements into and out of California that remain are now driven by either temporary or long-term business-related issues, as opposed to a function of the milk pricing and pooling regulations. In light of these facts, CDI supports a general continuation of the current regional relationships between California and surrounding states. In other words, CDI supports Proposal Number 19 in part because it maintains a relatively consistent relationship between California's Class I differentials and those of surrounding states.

ECONOMIC MODELING: "A" TOOL, NOT "THE" TOOL

As for proposed updates to the Class I differentials, testimony has been provided by the authors of a University of Wisconsin, Madison report entitled, "Spatial Price Relationships in Class I Markets," using a model referred to as The U.S. Dairy Sector Simulator, or USDSS. This dynamic model has many variables taken into account as it generates county-by-county spatial relationship recommendations and should be a consideration when proposing an updated Class I differential map. However, it should not be the only consideration, as all models have limitations. For example, the USDSS does not and cannot take into account:

- Regional competitiveness at the farm level, an important consideration for USDA and for the industry when updating any element of the Federal Order program, including the Class I differential map.
- Pool stability and maintaining a robust incentive for handlers and farms to serve as available supply for the Class I market, another critical consideration.
- Limitations or cost drivers created by region-specific factors, such as geography (i.e., mountain ranges), chronic traffic congestion, and differences in regional cost structures and operational costs.

These comments are not intended to diminish the value of USDSS or any other model used to evaluate various proposals. Economic modeling can serve a critical purpose as a tool that should be a factor among other real-life considerations, as opposed to the sole and absolute tool, in crafting or evaluating a proposal. The proposed updates being considered in this hearing, including Proposal Number 19, are not conceived in a vacuum, but rather in the context of promoting stable marketing relationships for handlers and producers, based on real life data and experience. As such, the model results must be supplemented with considerations that are beyond the scope of the model.

Specific to regional competitiveness, while virtually no milk moves between California's primary milk supply region of the Central Valley¹ and the major Upper Midwest milksheds of Wisconsin, Minnesota and South Dakota, these regions have some functional similarities. First, both regions share a profile as large milk-producing regions with a vast majority of milk marketed to local non-Class I manufacturers and serving as a reserve supply for the relatively small portion of Class I bottlers in the region. In total, about 10 to 12 percent of California's milk production ends up in a Class I facility, but a majority of that Class I demand is from bottlers outside the Central Valley. While the Central Valley is home to approximately 90 percent of the total milk production in the State, only five of California's 20 current pool distributing plants are located in the area. The on-farm competitiveness of similar regions across the U.S. is not something the USDSS model is designed to solve for, but it is an important factor for USDA and the industry to consider. Dairies across the country participate in the same federal safety net programs, such as the Dairy Margin Coverage, Dairy-Revenue Protection and Livestock Gross Margin-Dairy programs, all of which rely on national – not regional – milk and dairy markets in triggering distributions or indemnities. Those same dairies compete for animal feed and other supplies sourced throughout the United States.

The current Class I differentials reflect the similarities between California's Central Valley and the Upper Midwest regions, as the Class I differentials in California's Central Valley range from \$1.60 to \$1.80 per hundredweight, while the current Class I differentials in Wisconsin, Minnesota and South Dakota range from \$1.65 to \$1.80 per hundredweight.

In light of these facts, Proposal Number 19 establishes updated Class I differentials in California's Central Valley ranging from \$2.50 to \$2.60 per hundredweight. Proposed Class I differentials in Wisconsin, Minnesota and South Dakota range from \$2.55 to \$3.00 per hundredweight. The gap is wider than exists today, but CDI supports Proposal 19 and believes it represents a reasonable relationship in Class I differentials between these two regions.

Pool stability is another critical consideration in structuring any update to Federal Orders, but is another variable that the USDSS is not designed to consider. In the more than four years that California has operated within the Federal Order program, our state's industry has received a graduate-level education on the farm level impacts of pooling and depooling large volumes of milk in any given month. While one might point to the COVID-19 pandemic as a contributing factor in driving volatile classified milk prices that contributed to significant depooling, California actually saw its lowest volume of pooled milk in July 2022, at 1.65 billion pounds of milk, followed by its highest volume of pooled milk in March 2023, at 2.84 billion pounds of milk. Comparing those volumes to USDA's Milk Production Report, July 2022 verified that less than half, or 47 percent, of all California milk production was associated with the Federal Order pool. That figure grew to 78 percent of all California milk production associating with the Federal Order pool in March 2023.

The decision of whether to pool or not to pool milk on a Federal Order can be driven by many things, including both price and non-price considerations. Specific to price considerations, one can reasonable claim that large and sustained gaps between the Class III and Class IV monthly milk prices are a major contributor to the swings we have seen in the volume of milk pooled on

¹ For purposes of this testimony, California's Central Valley is defined as Butte, Glenn, Fresno, Kern, Kings, Madera, Merced, San Joaquin, Sacramento, Stanislaus, Sutter and Tulare Counties. These counties collectively represent the most prominent milk shed within the State of California.

Federal Orders across the U.S. However, there is no doubt that specific policies related to Class I pricing can also have a meaningful impact on those pooling decisions. Elimination of the “higher of” Class I mover in 2019, as mandated in the 2018 Farm Bill, also known as the Agriculture Improvement Act of 2018, reduced the incentive to pool milk in certain months over the four-year history of that change. Previous testimony given at this hearing has demonstrated that Federal Orders across the U.S. saw nearly \$1 billion less pool revenue over the past four years as a direct result of that formula change. Likewise, a lack of updates to the Class I differential levels to recognize incremental increases in the cost of supplying Class I markets over the past two decades has also suppressed the pool revenues that could otherwise have been available as a further incentive for more farms and milk handlers to associate regularly with their respective Federal Order pool.

While there is no silver bullet that will incentivize more milk to associate with a Federal Order pool, other than a mandatory requirement to pool all Grade A milk handled, restoring the “higher of” Class I mover (Proposal Number 13) and updating the Class I differential map (Proposal Number 19) will help to increase the incentive by growing overall pool revenues. Not only does an increased incentive to pool milk help ensure that more farms and milk handlers are willing to supply Class I needs, but it also creates more stability at the producer level, as blended prices paid for milk produced across a Federal Order are more consistent from farm to farm.

The third consideration to supplement the USDSS model results are regional cost drivers that are not reasonably captured by a national model. California has undergone significant shifts in population centers and milksheds since 2000, which has meaningfully impacted the cost of hauling bulk milk generally, and the cost of supplying urban-centered Class I bottlers specifically. In 2001, the California Department of Food and Agriculture, or CDFA, reported that there were 295 dairy farms in Southern California, housing an estimated 266,672 cows (see *Attachment A*). That same report indicated that between the five milk-producing counties surrounding the Bay Area – Sonoma, Marin, Solano, Contra Costa and Santa Clara counties – there were 125 dairy farms in 2001, housing an estimated 42,031 cows. In 2017, the last such report published by CDFA, those numbers had fallen to 92 dairy farms in Southern California, housing an estimated 90,675 cows, and fallen to 87 dairy farms in the five counties surrounding the Bay Area, housing an estimated 37,928 cows (see *Attachment B*). Meanwhile, those respective regions also experienced population increases. The Southern California population centers of Los Angeles, Orange, San Bernardino, Riverside and San Diego counties grew from 18.43 million residents in the 2000 Census to 21.10 million residents in the 2020 Census, a 14.5 percent increase; and the Bay Area population centers of San Francisco, Contra Costa, Alameda and Santa Clara counties grew from 4.85 million residents in the 2000 Census to 5.66 million residents in the 2020 Census, a 16.6 percent increase (see *Attachment C*).

These two trends of a shrinking local milk supply and a shifting and growing population has resulted in the need for bulk raw milk to be sourced from further distances to meet the needs of milk bottlers located near the population centers. Extreme traffic congestion that is generally the rule, rather than the exception, in these metropolitan regions adds further complexity and cost that cannot be captured by current economic modeling.

In addition, while cooperatives, including CDI, previously operated manufacturing plants available for balancing purposes in Southern California, those plants have since been closed. The nearest cooperative-owned balancing plant to the urban population center of Los Angeles

County is CDI's butter and milk powder manufacturing facility in Tipton, California, roughly 150 miles – and over the Tehachapi Mountain Range – from the Southern California bottlers that need milk on a specific schedule in specific and varying quantities throughout the week. Further, there is only one primary path to travel between the milkshed in California's Central Valley and the urban centers of Southern California: Interstate 5, a highly travelled interstate highway with significant commuter and other business traffic in both directions crossing over the Tehachapi Mountains. Two alternative routes – one through the desert and one via the coast – are utilized only in emergency situations, as they are significantly longer routes. Taken together – the closure of nearby balancing assets in 2019 and the logistical challenges associated with navigating extreme traffic conditions – has simply increased the cost and complexity associated with serving those urban Class I markets – a dynamic that the USDSS model is simply not designed to capture.

THE NEW PROPOSED CLASS I DIFFERENTIALS

Proposal 19 includes the following updated Class I differentials in California:

County	State	Current Differential	Proposal Number 19
Alameda	CA	\$ 1.80	\$ 2.90
Alpine	CA	\$ 1.70	\$ 2.50
Amador	CA	\$ 1.70	\$ 2.50
Butte	CA	\$ 1.70	\$ 2.50
Calaveras	CA	\$ 1.70	\$ 2.50
Colusa	CA	\$ 1.70	\$ 2.50
Contra Costa	CA	\$ 1.80	\$ 2.90
Del Norte	CA	\$ 1.80	\$ 2.80
El Dorado	CA	\$ 1.70	\$ 2.50
Fresno	CA	\$ 1.60	\$ 2.50
Glenn	CA	\$ 1.70	\$ 2.50
Humboldt	CA	\$ 1.80	\$ 2.80
Imperial	CA	\$ 2.00	\$ 3.00
Inyo	CA	\$ 1.60	\$ 2.50
Kern	CA	\$ 1.80	\$ 2.60
Kings	CA	\$ 1.60	\$ 2.50
Lake	CA	\$ 1.80	\$ 2.80
Lassen	CA	\$ 1.70	\$ 2.50
Los Angeles	CA	\$ 2.10	\$ 3.00
Madera	CA	\$ 1.60	\$ 2.50
Marin	CA	\$ 1.80	\$ 2.90
Mariposa	CA	\$ 1.70	\$ 2.50
Mendocino	CA	\$ 1.80	\$ 2.80
Merced	CA	\$ 1.70	\$ 2.50
Modoc	CA	\$ 1.70	\$ 2.50
Mono	CA	\$ 1.60	\$ 2.50
Monterey	CA	\$ 1.80	\$ 2.90
Napa	CA	\$ 1.80	\$ 2.90
Nevada	CA	\$ 1.70	\$ 2.50

Orange	CA	\$ 2.10	\$ 3.00
Placer	CA	\$ 1.70	\$ 2.50
Plumas	CA	\$ 1.70	\$ 2.50
Riverside	CA	\$ 2.00	\$ 3.00
Sacramento	CA	\$ 1.70	\$ 2.50
San Benito	CA	\$ 1.80	\$ 2.90
San Bernardino	CA	\$ 1.80	\$ 3.00
San Diego	CA	\$ 2.10	\$ 3.00
San Francisco	CA	\$ 1.80	\$ 2.90
San Joaquin	CA	\$ 1.70	\$ 2.50
San Luis Obispo	CA	\$ 1.80	\$ 2.90
San Mateo	CA	\$ 1.80	\$ 2.90
Santa Barbara	CA	\$ 1.80	\$ 2.90
Santa Clara	CA	\$ 1.80	\$ 2.90
Santa Cruz	CA	\$ 1.80	\$ 2.90
Shasta	CA	\$ 1.70	\$ 2.50
Sierra	CA	\$ 1.70	\$ 2.50
Siskiyou	CA	\$ 1.80	\$ 2.50
Solano	CA	\$ 1.80	\$ 2.90
Sonoma	CA	\$ 1.80	\$ 2.90
Stanislaus	CA	\$ 1.70	\$ 2.50
Sutter	CA	\$ 1.70	\$ 2.50
Tehama	CA	\$ 1.70	\$ 2.50
Trinity	CA	\$ 1.80	\$ 2.80
Tulare	CA	\$ 1.60	\$ 2.50
Tuolumne	CA	\$ 1.70	\$ 2.50
Ventura	CA	\$ 1.80	\$ 3.00
Yolo	CA	\$ 1.70	\$ 2.50
Yuba	CA	\$ 1.70	\$ 2.50

In addition to an overall increase in Class I differentials for reasons stated earlier in this testimony, Proposal Number 19 also includes necessary adjustments to some of the county-by-county relationships. As previously alluded to in this testimony, there are generally three distinct regions of California, each with unique supply/demand dynamics. As mentioned earlier, the Central Valley makes up approximately 90 percent of the State's milk supply. Southern California, made up of counties south of the Tehachapi Mountain Range, has a limited and shrinking milk supply, representing less than five percent of the State's total supply, but is home to 10 of the 20 total pool distributing plants in the State. As such, bulk raw milk from the Central Valley is regularly exported to Southern California. Finally, the Bay Area is a region of extremely limited and shrinking milk supply, representing less than three percent of the State's total supply, and is home to five of the 20 total pool distributing plants in the State. As such, bulk raw milk from the Central Valley is also regularly exported to the Bay Area.

Proposal Number 19 incorporates a "slope" in the Class I differentials between the Central Valley and Southern California and between the Central Valley and the Bay Area at levels intended to incentivize dairies and milk handlers to serve the Class I needs in those urban regions.

Specific to Southern California, the current Class I differential map incorporates a \$0.30 per hundredweight slope between Kern and Los Angeles counties, with a significant volume of Kern County milk regularly supplying Los Angeles County Class I needs, as it is the nearest available milk other than local farms located in Southern California. Proposal Number 19 includes a \$0.40 per hundredweight slope between Kern and Los Angeles counties as a more appropriate slope. The average cost incurred by CDI in 2022 for delivering bulk milk from Kern County to Los Angeles County ranged from \$1.39 - \$1.50 per hundredweight. Meanwhile, the average cost incurred by CDI in 2022 for delivering bulk milk from those same farms in Kern County to the nearest local manufacturing plant in Tulare County was \$0.68 - \$0.81 per hundredweight. Simply put, the \$0.40 per hundredweight slope in Proposal 19 provides an additional pool draw for those farms and milk handlers that is needed to at least partially offset the incentive that otherwise exists to simply deliver all milk to the local manufacturing plant in the Central Valley.

Proposal 19 includes a \$0.50 per hundredweight slope between the remaining counties in the Central Valley and Los Angeles County. While that slope exists throughout the Central Valley north of Kern County, the slope is most important for Tulare and Kings Counties, as farms in those counties represent the next logical reserve milk supplies in the event Kern County milk is not sufficient to supply Class I needs in Southern California. This \$0.50 per hundredweight slope is consistent with the current spread between the differential levels in Tulare and Kings Counties and Los Angeles County.

The cost incurred by CDI in 2022 for delivering bulk milk from Tulare County to Los Angeles County ranged from \$1.68 - \$1.88 per hundredweight. Meanwhile, the average cost incurred by CDI in 2022 for delivering bulk milk from those same farms in Tulare County to the nearest local manufacturing plant in Tulare County was \$0.44 - \$0.54 per hundredweight. While that gap is more than the \$0.50 per hundredweight provided by the slope in the proposed differential map, it is consistent with the current slope for this reserve supply of milk available for Southern California Class I usage.

In addition, Proposal Number 19 includes some adjustments in the county-to-county relationships within the three distinct regions mentioned earlier in this testimony. Under the proposal, Class I bottlers in all counties in Southern California are subject to the same Class I differential, as they procure milk from a combination of locally-produced milk and milk produced in the Central Valley. They also participate in a common market without significant logistical advantages in any parts of Southern California. This updated structure promotes a competitive landscape for all bottlers and handlers.

Further, the proposal establishes a common Class I differential for most of the counties within the Central Valley, as the regions represent a collective milk shed. The one exception is Kern County, which Proposal Number 19 brings closer to, but not equal to, the differential levels in the other counties within the Central Valley.

Specific to the Bay Area, the current Class I differential map incorporates a \$0.10 per cwt slope between the coastal regions of San Francisco and the nearby milksheds of Sacramento, Stanislaus and San Joaquin Counties, an insufficient differential when looking at the cost of servicing that market and attracting a long-term milk supply. Proposal Number 19 includes a more appropriate \$0.40 per cwt slope between these same counties. The cost incurred by CDI

2022 for delivering bulk milk from San Joaquin County to Alameda County, which includes Class I utilization and borders the San Francisco Bay, ranged from \$1.08 - \$1.29 per hundredweight. Meanwhile, the average cost incurred by CDI in 2022 for delivering bulk milk from those same farms in San Joaquin County to the nearest local manufacturing plant in Stanislaus County was \$0.45 - \$0.65 per hundredweight. As with the earlier reference to Southern California, the \$0.40 per hundredweight slope proposed for the Bay Area would provide an additional pool draw to partially offset the incentive that otherwise exists to simply deliver all milk to the local manufacturing plant in the Central Valley.

CONCLUSION

For the reasons outlined in this testimony, which reach beyond a strict spatial analysis as conducted by the University of Wisconsin and incorporates additional broad-based policy considerations, CDI urges the Secretary to adopt Proposal Number 19.