



AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
<http://ageconsearch.umn.edu>
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Agricultural Outlook Forum

Presented: February 17, 2006

CHALLENGES FACING THE ORGANIC MILK INDUSTRY

Caragh McLaughlin
White Wave Foods

CHALLENGES FACING THE ORGANIC MILK INDUSTRY

Caragh McLaughlin
Senior Brand Manager, Horizon Organic
WhiteWave Foods Company

The organic milk category has experienced incredible growth over the past decade, reaching roughly a half Billion dollars in retail sales in 2005. Exploding growth rates present a number of challenges to a relatively young industry. In 2005 alone, there were several key issues facing the industry: an industry-wide shortage of raw organic milk supply, challenges to the rules governed by the NOSB, an emerging debate over the reasons why consumers buy organic milk and dairy products, and a perception that larger companies entering the industry want to weaken the integrity of the organic label. So the questions become: how do you accurately forecast demand far enough out to ensure that you're growing supply fast enough to keep up? Is the regulatory environment able to handle the challenges inherent in a much larger and more competitive industry? Can bigger companies enter the organic space without experiencing backlash from industry insiders?

Why do people buy organic foods and beverages? There's been a shift in how consumers think about food and their diet and their overall health and well-being over the past 20 years. 75% of Americans believe that diet is a better influence on their health than medicine. We're no longer looking for that "magic pill" to solve all of our problems. More specifically related to organic, over 60% of consumers believe that lowering their exposure to potentially harmful chemicals will lead to better health.

In fact, consumers choose organic foods because they believe that organics are healthier for them and their families. Health and Nutrition is the predominant reason people purchase organic foods. For organic dairy, the concerns about added chemicals in foods are the key purchase drivers. The order of these specific concerns change every few years as the media reports on new studies, but the top three reasons people buy organic dairy are consistently their concerns about how growth hormones, antibiotics and pesticides are going to affect their health.

Overall, the organic food/beverage category is growing at an extremely strong pace. Demand for organic products is tripling every 4-5 years.

Within organic, Dairy is one of the largest & fastest growing segments, growing at roughly a 25% compound annual growth rate. And within Organic Dairy, milk is the largest segment. If you use IRI data for the Grocery channel as a proxy for the industry, organic milk sales will have doubled in less than 3 years! Somewhat surprisingly, the growth curve has actually become more steep a couple of times in the past 2 years. The first, shorter growth spurt occurred in the summer of 2004 when conventional milk prices increased dramatically, shrinking the price gap between organic and conventional. The second time was late last summer through the fall.

According to the 2005 Whole Foods Market Organic Trend Tracker, nearly two thirds of Americans claim to have tried organic foods and beverages. This was an 11-point jump from 2004. 27% say they are consuming more organic foods than they did one year ago and 10% consume organic foods several

times per week (up 3 points from 2004). According to IRI's household panel data, organic dairy is in the refrigerators of over 4% of US households.

I'm sure you've noticed more and more organic products in your own grocery shopping trips. Most food categories grow in the low single digits annually. So grocers take notice when a category is growing at these rates. As of mid-January, organic milk is now sold in the vast majority of grocery stores (the stores that represent 89% ACV). All Wal-Mart Supercenters carry organic milk and most Club stores carry some organic food items.

What does all this demand growth and increased availability mean? Well, it means we've got an imbalance between demand and supply right now. Over the past year even the media has expressed interest in the topic, reporting on the spike in demand. In a nutshell, it takes three years to transition land to organic and one year to transition cows to organic. So, if you aren't accurately forecasting demand three years out, you may not have enough supply when you need it. That's what has happened to the organic milk industry. Recall those two "growth spurts" in the sales growth graph? That's the difference between having enough supply and not having enough supply. This is a significant challenge that the organic dairy industry faces.

You might ask, what is different about organic milk supply vs. conventional milk supply? In many respects, the challenges of being a dairyman are the same whether you farm organically or not. We're all affected by rising energy costs and bad weather, for example. And so are organic and conventional farmers. Feed costs are the major production cost – so when feed prices go up, it's harder to make money. And, organic dairies have spring flush, too.

But there are many differences between organic dairy farming and conventional dairy farming outside of just the regulations. First and foremost, the pay price for organic milk is not linked to the conventional milk market. We pay our processors and producers a premium for producing in accordance with the National Organic Program. We sign contracts with each farm or co-op that includes what we will pay them for their milk and for how long. Usually these contracts are longer-term, multi-year agreements. And the price is based on many factors, but it's a market-driven price. I often joke that our business is a perfect case study for an Econ 101 course.

There's also no commodities market for organic feed. And organic feed costs are significantly higher than conventional feed. Remember the growth rates for organic foods overall? Well, one of the fastest growing categories is organic meats – beef and poultry. And unfortunately for us, those animals eat much of the same food as organic dairy cows eat. With the 3-year transition period for land, it's going to take a while for the organic feed world to catch up with demand, so prices are at an all time high.

In addition, we've had some new entrants into the category in the past 18 months. I'm sure some of you have seen new private label organic brands in your grocery stores recently. Safeway has launched a multi-category organic line called "O" that they're promoting fairly heavily. Plus, Stonyfield Farms expanded from yogurt to organic milk in late 2004. So there are now a higher number of manufacturers competing for the organic milk supply that exists, driving up the price we have to pay to maintain our supply.

This may lead you to wonder what we are doing about this... We currently partner with over 325 family farms across the country who supply us with over 80% of our milk supply. We are actively helping farmers convert from conventional dairy farming to organic. In fact, right now we have 179 family farms in transition to organic. In addition, we operate two farms of our own: one in Idaho and one in

Maryland. Owning two of our own farms gives us a unique ability to understand the challenges of operating an organic dairy and what our farmer partners are facing in the market.

In 2005, the organic milk industry also faced some significant regulatory challenges. First, a bit of background for those of you who don't live in the organic regulations every day. The Organic Foods Production Act (OFPA) was created in 1990 by Congress and it established the original framework for organic standards. It required the development of the National Organic Program which includes the National Organic Standards (or "the Rules") which went into effect on October 21, 2002.

The basic regulations of organic agriculture are: 3 years to transition land to organic and 1 year to transition milking animals. This means that the land or animal has to be managed organically for that amount of time before it can be certified organic. Ruminants must be on pasture. Organic products must be produced without harmful pesticides, growth hormones, antibiotics, genetic engineering or irradiation. The organic certification is, therefore, based on the process not on the product. There are a limited number of synthetics allowed by the Rules and they are all on a list approved by the NOSB (think about things like vitamins or minerals that can't be certified organic but must be added to certain products to be legal for sale). The farms and processors are inspected regularly by third-party organic certifiers. And all organic farms must have an Organic Farm Systems Management Plan in place.

The National Organic Standards Board (NOSB) has the responsibility to advise the USDA on implementation of the organic regulations. It's made up of 15 volunteer members appointed by the Secretary of Agriculture.

One of the major regulatory challenges last year was the Harvey lawsuit. Arthur Harvey, an organic blueberry farmer and organic inspector, initially filed a lawsuit alleging that 9 provisions of the NOP Rules were inconsistent with OFPA. He lost the case but appealed on 7 counts. Last June, the US Court of Appeals agreed with Harvey on 2 of the counts.

The first of these concerned the use of synthetics such as pectin and carbon dioxide in organic food processing. This issue was quite contentious as it effectively would have removed the organic seal from entire categories of products like yogurt. The second count dealt with the whole herd transition issue of organic feed for dairy animals. Given the high prices of organic feed, this issue raised a lot of concerns about the cost of transitioning to organic for family farms. The industry was concerned that these additional costs would dissuade a lot of farmers from transitioning.

The Organic Trade Association led a process that brought the organic community together to find a mutually agreeable resolution. But it was also decided that only a Congressional amendment of OFPA would reverse the effects of the Court decision. So, in October, the House and Senate Agriculture Appropriations Conference added the OTA language to the agriculture appropriations bill. By early November the House and Senate approved it and the President signed it into law.

One of the other hot button regulatory issues is the lack of clarity in the Rules about how much "access to pasture" cows should receive. Unlike the issues in the Harvey lawsuit, pasture is not mentioned in OFPA. Pasture is in the regulations in 4 places, but there are no specifics regarding time on pasture or amount of feed that should come from pasture. Specifically, pasture is defined in the regulations as land used for grazing and as a feed source. It is also required that pasture conditions must be maintained in a way to minimize the spread of disease or parasites. The contentious aspect of this is how much "access to pasture" cows should receive as part of livestock living conditions.

The NOSB has recommended a rule change to try to clarify what “access to pasture” means. Given that animal welfare is a primary tenet of organic food production and that climate is different across the country, the NOSB has recommended that the regulations should read “ruminant animals grazing pasture during the growing season” with some additional clarification around which animals are included and excluded from the requirement.

So where does the pasture debate stand now? In November, the USDA announced that it would publish an ANPR this month on pasture rule changes. The April NOSB meeting will include a pasture symposium with expert testimony on pasture-related issues such as animal health, consumer expectations and feasibility. After the public comment period and the symposium, the USDA will propose a new rule followed by another public comment period hopefully resulting in new, clear language to be incorporated into the rule.

The pasture questions have really been a proxy for a different challenge facing the organic milk industry: the Big vs. Small debate. This has been rather divisive, in fact. There is a faction within the organic community who, it appears, would like to keep organic small and niche. They have raised questions about who is allowed in and who is not, which essentially questions the integrity of the organic label. At Horizon Organic, it has always been our mission to expand organic agriculture thereby limiting the amount of added chemicals entering our environment and impacting the health of future generations. We believe that family farming is an important part of America’s heritage and rural economies and that organic farming is a very viable way for family farms to stay in business. We firmly believe that there is room in the organic community for companies and farms of all sizes as long as they comply with the organic standards and regulations. And that big companies should be applauded for making positive changes in their food production processes.

It’s interesting that some people have become so cynical that they actually believe that big companies see a successful, growing category, decide that they would like to participate in that high growth area, and would then enter it and try to ruin what made the category attractive in the first place.

In conclusion, the organic milk industry presents a fascinating case study of the challenges inherent in a high growth arena. As the industry moves forward, we can only hope that the key players go back to what helped make the industry successful in the first place: compete vigorously for consumers dollars in the marketplace, but choose to work together for the greater good rather than pick each other apart and threaten the trust that consumers now have in the organic seal. If we collectively are able to convince more farmers to convert to organic, then we will accomplish our collective mission – to expand the market for organic agricultural products and prevent the use of added chemicals in food production creating a healthier world for all of us.



Challenges Facing the Organic Milk Industry

Caragh McLaughlin
Senior Brand Manager,
Horizon Organic

Consumers and Organic

Interest in organic is growing because more & more consumers are taking a closer look at how their food choices impact their health

- 75% of Americans believe diet is a better influence on health than medicine
- More than 60% of consumers believe lowering their exposure to potentially harmful chemicals will lead to better health

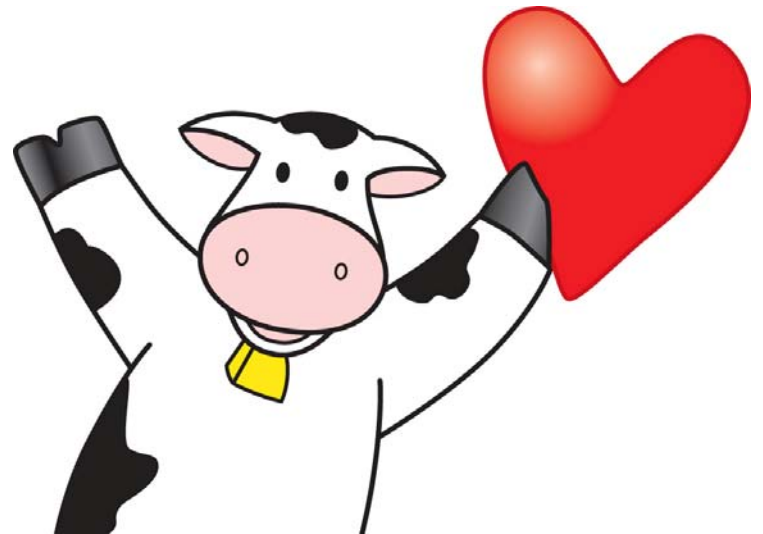


Consumers and Organic

Consumers buy organic foods because they believe they are healthier for them and their families

Top Reasons Consumers Purchase Organic Foods

Health/Nutrition	66%
Taste	38%
Food Safety	30%
Environment	26%



Consumers and Organic

Consumers buy organic dairy products because they are concerned about the affect on their health of added growth hormones, antibiotics and dangerous pesticides

Top Reasons For Purchasing Organic Milk

Concerned about growth hormones	76%
Concerned about antibiotics	73%
Concerned about pesticides	68%

Produced WITHOUT the use of
ANTIBIOTICS, added GROWTH HORMONES
or DANGEROUS PESTICIDES

Consumers and Organic

Demand for organic products more than tripled from 1996 to 2002, and is forecast to triple again by 2007

<u>1996</u>	<u>2002</u>	<u>2007</u>
\$3.6B	\$11.6B	\$30.7B



Consumers and Organic

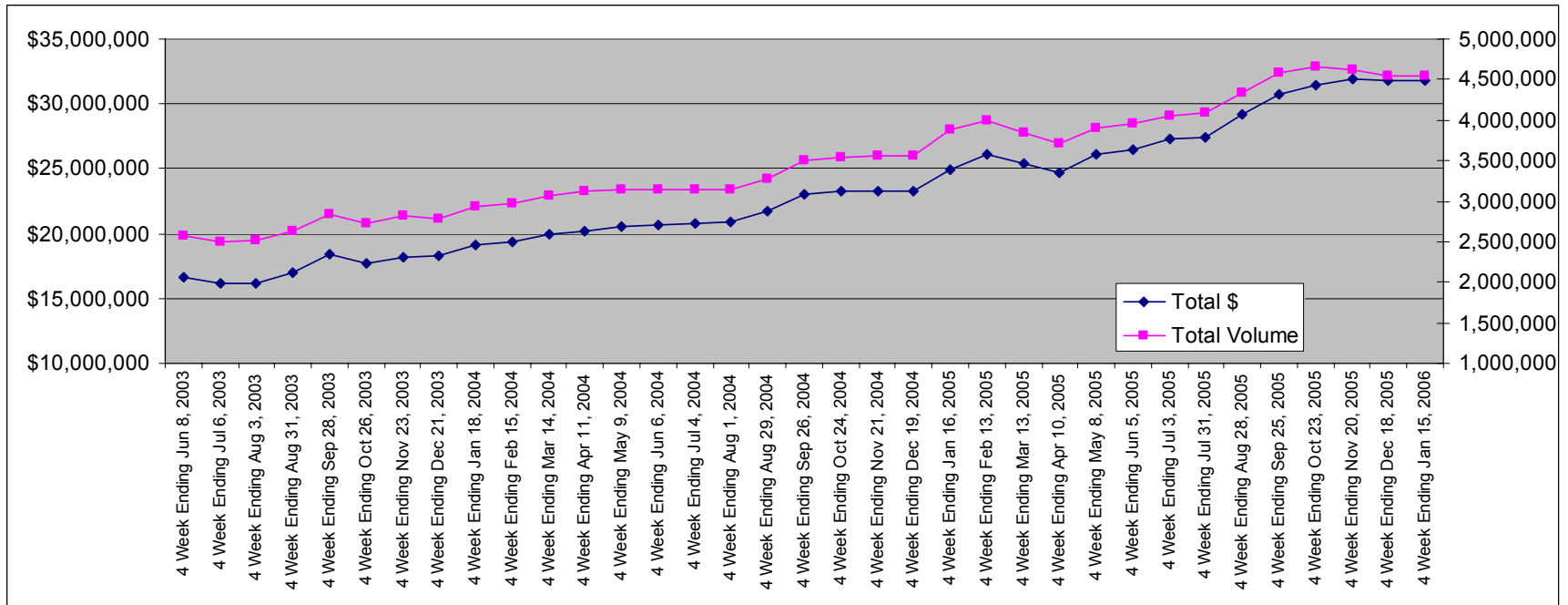
Organic dairy is one of the largest and fastest growing organic segments

	<u>2002</u>	<u>2007</u>	<u>5yr-CAGR</u>
Produce	\$6.0B	\$12.2B	+15.4%
Dairy	\$1.7B	\$5.4B	+25.7%
Bakery & Cereal	\$1.0B	\$3.2B	+25.5%



Organic Milk Growth

Organic milk is the largest segment within the organic dairy category.
On track to double in size within a 3 year timeframe.



Consumers and Organic

65% of Americans say they have tried organic foods and beverages

- 10% claim they eat organic several times per week
- IRI reports organic dairy in 4.4% of households



Retailers and Organic

- As more consumers become interested in organic, a broader base of retailers are considering organic in their product mix
- Organic milk has 89% ACV in traditional grocery stores, and roughly 70% of grocery stores carry some organic dairy or juice
- 100% of Wal-Mart Supercenters carry organic milk
- Most club stores carry some organic food items

Supply Dynamics

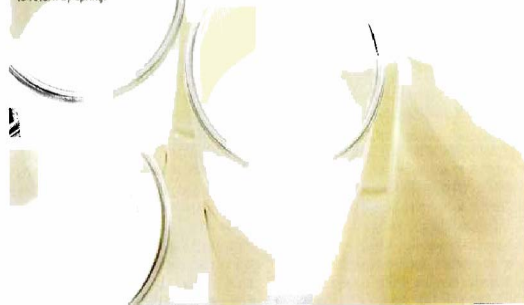


SN

Supermarket News

SUPPLY & DEMAND

Adequate supplies of organic milk are expected to return by spring.



OF GABLES AND GALLONS: ORGANIC SUPPLY RUNNING SHORT

By CHRISTINE BLANK

DON'T HAVE AN ORGANIC COW, but there's a bit of a supply problem with milk.

While grocers have not yet run out of product, deliveries have been cut back after demand began to seriously outstrip supply late last year.

"There is record demand and record sales," said Eric Newman, vice president of sales for Organic Valley, the organic dairy co-op in LaFarge, Wis. "We're disappointing a lot of people."

The company has a moratorium on bringing on new customers until this spring, while current customers are receiving less than ordered. Organic Valley has asked unprofitable customers to "temporarily de-list" their products.

While retailers are running short from time to time, the situation has not reached the point where consumers have complained, nor have they been forced to raise prices.

Giant Eagle, Pittsburgh, has experienced periodic shortages because of high demand.

"We are currently experiencing approximately 50% growth [over last year] in the organic milk category," said Brian Frey, spokesman for the chain.

However, the chain has been "very successful in maintaining product availability to satisfy our customer demand," Frey added. The chain expects the shortage to last through the first quarter.

Lund Food Holdings, Edina, Minn., has likewise seen increased demand for organic milk. While the stores aren't getting as much as they need, there have been no price increases or complaints from shoppers, said Bea James, the retailer's senior whole health manager.

James believes the reason for the surge in demand for organic dairy over the past year — one of the top growth items in Lunds and Byerly's stores — is the fact that mothers believe organic milk is more healthful than regular milk for their children.

"Many people are concerned that the growth hormones [in conventional milk] are contributing to children developing too quickly, and a resistance to antibiotics because of overexposure in the milk. Organic cows are never given antibiotics or growth hormones, and are given organic feed," James said.

Meanwhile, suppliers expect the shortage to last through this spring — more milk will likely be ready around May — and they're taking short-term measures to fill customer orders.

Another major supplier, Horizon Organic Dairy, Longmont, Colo., is temporarily switching all its Horizon Organic and The Organic Cow of Vermont organic milk to gallons only, instead of providing both half gallons and gallons.

"While the organic milk category is currently growing

"Many people are concerned that the growth hormones [in conventional milk] are contributing to children developing too quickly, and a resistance to antibiotics because of overexposure in the milk."

— Bea James senior whole health manager, Lund Food Holdings

at 27%, our brands have outpaced the category, growing at 37%," said Ramona Kent, senior vice president of sales for White Wave Foods, which operates Horizon, in a letter to trade customers.

The "unprecedented" demand, coupled with the industry's constrained supply of raw milk, has led to service levels below the company's expectations, Kent added.

The shortage is not surprising, since studies have been highlighting growth in organic dairy that outpaces most other organic categories. Organic dairy sales jumped 20% in 2003 to \$1.4 billion, the latest year for which figures are available, according to the Organic Trade Association, Greenfield, Mass. OTA believes the category probably grew even faster in 2004.

Still, demand last year and early this year was higher than even the organic suppliers predicted. In Organic Valley's case, the co-op had forecast that its sales would grow 20% in 2004; instead, sales jumped 34%. While Organic Valley had increased supply by 30% last year, that still left it unable to fill all of its orders.

Even though suppliers are bringing new organic dairy farmers on board, there is a mandatory, one-year transition period before conventional dairy farmers can commence organic operations. Some new organic dairy suppliers have come online, however. One such company, Aurora Organic Dairy, Boulder, Colo., began selling private-label organic milk to supermarket chains last year.

"It's a good time for someone like us

Continued on Page 40



Regional and national brands are emerging to fill demand.

SUPPLY & DEMAND

High Demand ... High Expectations, Too

Like any person, place or thing, demand brings greater scrutiny. Organic milk is no exception.

Last December, the U.S. Food and Drug Administration said tests showed perchlorate, a rocket fuel chemical, in samples of conventional lettuce, and in conventional and organic milk. Retailers said they haven't heard of any consumer concerns over the finding. The Organic Trade Association has been quick to point out that the chemical was found in both conventional and organic samples.

Meanwhile, Aurora Organic Dairy recently came under fire by the Cornucopia Institute, a farm policy research group, for confining its dairy herds in "an industrial setting," without access to pasture. Cornucopia asked the U.S. Department of Agriculture's Agriculture Marketing Service to investigate Aurora in January, saying it isn't following USDA's national organic rule, which requires livestock to have a certain amount of outdoor access to pasture.



The federal rule only provides exemptions to the outdoor access in cases of bad weather, poor animal health, and certain "stages of production" of dairy herds. Mark Retzlaff, the dairy's president, disputed Cornucopia's claims, saying the company's entire dairy herd is outside 365 days a year, and has access to 30,000 acres of dry land pasture. Raising the issue in this manner

doesn't help the image of organic agriculture, typically associated with humane treatment of animals and improving the environment, Retzlaff complained. "It paints a bad picture for the entire industry," he said.

USDA has asked the National Organic Standards Board to clarify the definition of "access to pasture" for the organic industry. — CHRISTINE BLANK

Continued From Page 39

to come in because there's a general shortage. We added milk to the market," said Clark Driftmier, Aurora's senior vice president of marketing.

This year, the dairy will complete the organic transition on a 3,400-head farm in Texas, adding it to a 3,500-head farm in Colorado already in operation.

As more supermarket chains add private-label organic dairy lines, Aurora may have trouble meeting demand as well, officials told WH.

"Milk is the No. 1 private-label item in terms of dollars. As organic grows and matures, more and more retailers are looking for [this milk]," Driftmier said.

Indeed, private-label milk was the top category by dollar volume, racking up \$6.5 billion in sales last year, according to the Private Label Manufacturers Association's annual yearbook. It

dwarfs the next highest category, fresh bread and rolls, which brought in only \$2.4 billion during the same period. Private-label milk was also tops in unit volume, with 2.8 billion sold. The FLMA report does not break out organic's take of the category.

Meanwhile, some manufacturers are banking on brand name power to propel sales of organic milk.

Stonyfield Farm in Londonderry, N.H., long involved in the organic yogurt business, just entered the organic milk market with its Stonyfield Farm Organic Milk slowly rolling out in half gallons to supermarkets and natural food outlets in the Northeast and Midwest.

"It's really a quiet launch. We have to wait until the second half of the year because there is such limited distribution right now," said Cathleen Toomey, the company's spokeswoman. Distribution is slower than expected because Stonyfield is "trying to get enough organic milk," Toomey said.

THE PRESS-ENTERPRISE

GOING NATURAL: SUPPLIERS STRUGGLE TO KEEP UP



CHANGING THE FACE OF DAIRY

Demand outpaces supply as shoppers ask, 'Got organic milk?'

BY KAREN ROBINSON-JACOBS
THE DALLAS MORNING NEWS

The nation's organic milk producers have stumbled into a problem that most companies only dream about: Their product is too popular.

As diet-conscious consumers step up their purchases of healthier food items, organic milk suppliers are grappling with the first shortages since organic products made their way out of natural-food stores and into mainstream supermarkets.

Some stores have been getting only 70 percent to 80 percent of their regular orders.

"There is a tight supply for organic milk," said Caragh McLaughlin, senior brand manager for Horizon Organic, a unit of Dean Foods, the nation's largest dairy producer. "Last summer demand started

moving up. And over the winter it's gone crazy. ... And part of that was unanticipated by any of us."

The shortage has begun to ease after peaking in January and February, experts say, as the onset of spring gives cows access to more grass and organic feed. But the industry still is debating how to boost capacity while remaining true to the organic philosophy.

"We're working close together with ... (suppliers) to keep this from happening again," said Jake Fontenot, national grocery buyer for Austin-based Whole Foods Market Inc., which posted signs at many of its markets to alert consumers to the problem.

About 70 percent of the chain's milk sales are organic, he said.

Kristi Estes, spokeswoman for Wild Oats, a Colorado-based retailer that has four Henry's Marketplace locations in the Inland Empire, said demand for organic milk has increased 20 percent in the past year, twice as fast as the growth in demand for conventional milk.

Estes said sales are split 50-50 between the conventional and organic varieties although in Henry's California markets a half gallon of organic milk is priced more

SEE ORGANIC/18



CARRIE ROSEMA/THE PRESS-ENTERPRISE
Organic milk at Trader Joe's represents more than a third of its milk sales.

THE RULES

For milk to be certified organic, it must meet these criteria:

- **BOVINE GROWTH HORMONES** cannot be given to the cows.
- **COWS MUST HAVE ACCESS** to pasture land.
- **MOST ANTIBIOTICS** cannot be used.
- **FEED** and the land used to grow that feed must be free of any synthetic herbicide, fungicide, pesticide or petroleum-based fertilizer for at least three years.

ORGANIC: Shoppers pay more

CONTINUED FROM E1
than \$1 higher.

Pat St. John, spokeswoman for Trader Joe's, said organic milk represents more than a third of that market chain's milk sales. She said organic milk was sold only in quarts and half gallons until two years ago when the gallon size was introduced and subsequently became the most popular size among shoppers.

Organic milk represents a fast-growing — and trend-defying — segment of the \$10.2 billion milk market, where conventional milk sales have been flat to declining in recent years.

Organic sales at health-food and conventional stores grew more than 15 percent last year to \$834 million, according to ACNielsen LabelTrends, which tracks consumer spending in natural food and conventional stores.

Still, it remains a niche product at mainstream grocers such as Albertsons, where spokeswoman Walt Rubel estimated organics' share at 2 percent of milk sales.

Many consumers are drawn to organic milk in part because of what it lacks: organic cows must be free of any bovine growth hormones and most antibiotics. Also their feed and the land used to grow that feed must be free of any synthetic herbicide, fungicide, pesticide or petroleum-based fertilizer for at least three years.

Other consumers buy organic to support small family farms, a large component of the organic dairy industry.

Although their ranks still are small, increasing numbers of dairy farmers are being drawn to organic because of the increased consumer demand, and the higher premium shoppers are willing to pay for organic milk.

Horizon has signed up 95 farms to make the three-year transition from traditional farming to organic. Ten of those farms will begin supplying milk to Horizon in the next few months, a spokeswoman said.

On Monday, the Organic Valley Family of Farms, the nation's largest cooperative of organic farmers, announced the



THE ASSOCIATED PRESS

Federal rules require that organic dairy cows be given access to pasture.

launch of "Texas Pastures," which it described as the first organic milk to be both produced and bottled in Texas.

The milk will come from three organic dairy farms in the Sulphur Springs region and will be bottled at Southwest Dairies in Tyler, Texas.

The farms in the Texas group range from 40 cows to about 240. That's small by traditional dairy farming standards but mid-sized in the organic world. The cooperative says its cows are mostly grass-fed at pasture, as opposed to eating trucked-in organic feed.

The seemingly arcane question of grass vs. feed ultimately could have a big impact on organic milk supplies over the next several years.

Federal rules require that organic dairy cows be given "access to pasture." But they do not specify what "access" means.

Prodded earlier this year by a nonprofit farm-policy group, the U.S. Department of Agriculture is expected to follow an advisory group's recommendation that could require cows certified as organic to spend more time grazing.

That kind of change could limit organic-milk supplies until more farms get their pasture access up to standard.

Katherine DiMatteo, executive director of the Organic Trade Association, an industry trade group, says it could take five years for supply and demand to balance out, depending on pricing, availability of feed, and any changes or clarifications that might be approved.

Reporter Leslie Berkman contributed to the story.

The Dallas Morning News

Market moover

Firms ruminate on ways to keep up with demand for organic milk

By KAREN ROBINSON-JACOBS
Staff Writer

The nation's organic milk producers — including a subsidiary of Dallas-based Dean Foods Co. — have stumbled into a problem that most companies only dream about: Their product is *too* popular.

As diet-conscious consumers step up their purchases of healthier foods, organic milk suppliers are grappling with the first shortages since organic products made their way out of natural-food stores and into mainstream supermarkets.

Some stores have been getting only 70 percent to 80 percent of their regular orders.

"There is a tight supply for organic milk," said Caragh McLaughlin, senior brand manager for Horizon Organic, a unit of Dean Foods, the nation's largest dairy producer. "Last summer demand started moving up. And over the winter it's gone crazy. ... And part of that was unanticipated by any of us."

The shortage has begun to ease after peaking in January and February, experts say, as spring gives cows access to more grass and organic feed. But the industry is still debating how to boost capacity while remaining true to the organic philosophy.

"We're working close together with ... [suppliers] to keep this from happening again," said Jake Fontenot, national grocery buyer for Austin-based Whole Foods Market Inc., which posted signs at many of its markets to alert consumers to the problem.

About 70 percent of the chain's milk sales are organic, he said.

Organic milk represents a fast-growing — and trend-defying — segment of the \$10.2 billion milk market, where conventional milk sales have been flat or declined in recent years.

Organic sales at health-food and conventional stores grew more than 15 percent last year to \$634 million, according to A.C. Nielsen LabelTrends, which tracks consumer spending in natu-



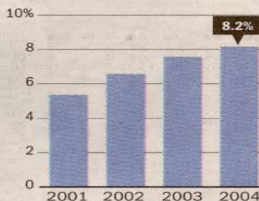
THE RULES

For milk to be certified organic, it must meet these criteria:

- No bovine growth hormones can be given to the cows.
- Most antibiotics cannot be used.
- Cows' feed and the land used to grow that feed must be free of any synthetic herbicide, fungicide, pesticide or petroleum-based fertilizer for at least three years.

GREENER PASTURES

Organic milk sales as a percentage of total milk sales:



NOTE: Figures represent sales at U.S. food and drug mass merchandisers excluding Wal-Mart Stores Inc.
SOURCE: A.C. Nielsen LabelTrends

LAURIE JOSEPH/Staff Artist

NATALIE CAUDILL/Staff Photographer

See **ORGANIC** Page 11D

Organic milk is cool item in dairy sections

Continued from Page 1D

ral food and conventional stores.

Still, it remains a niche product at mainstream grocers such as Albertsons, where spokesman Walt Rubel estimated organics' share at 2 percent of milk sales.

Consumer appeal

Many consumers are drawn to organic milk in part because of what it lacks: Organic cows must be free of any bovine growth hormones and most antibiotics. Also, their feed and the land used to grow that feed must be free of any synthetic herbicide, fungicide, pesticide or petroleum-based fertilizer for at least three years.

Other consumers buy organic to support small family farms, a large component of the organic dairy industry.

Although their ranks are still small, increasing numbers of dairy farmers are being drawn to organic because of the increased consumer demand and the higher premium shoppers are willing to pay for organic milk.

At a Kroger store in Garland, a half-gallon carton of Horizon 2 percent milk sold recently for \$2.47, nearly 50 cents more than the store brand's 2 percent milk, which sold for \$1.99.

Increasing supply

Horizon has signed up 95 farms to make the three-year transition from traditional farming to organic. Ten of those farms will begin supplying milk to Horizon in the next few months, a spokeswoman said.

On Monday, the Organic Valley Family of Farms, the nation's largest cooperative of organic farmers, announced the launch of Texas Pastures, which it described as the first organic milk to be produced and bottled in Texas.

The milk will come from three organic dairy farms in the Sulphur Springs area and will be bottled at Southwest Dairies in Tyler.

The farms in the Texas group range from 40 cows to about 240. That's small by traditional dairy farming standards but mid-size in the organic world. The cooperative says its cows are mostly grassed at pasture, as opposed to eating trucked-in organic feed.

The seemingly arcane question of grass vs. feed ultimately could have a big impact on organic milk supplies over the next several years.

Federal rules require that organic dairy cows be given "access to pasture." But they do not specify what "access" means.

More grazing time

Prodded earlier this year by a non-profit farm-policy group, the U.S. Department of Agriculture is expected to follow an advisory group's recommendation that could require cows certified as organic to spend more time grazing.

That kind of change could limit organic-milk supplies until more farms get their pasture access up to standard.

"Whenever there are changes that have to be made to your farm plan, it generally affects output," said Katherine DiMatteo, executive director of the Organic Trade Association, an industry trade group.

She said it could take five years for supply and demand to balance out, depending on several factors including pricing, availability of feed, and any changes or clarifications that might be approved.

In the meantime, she said, consumers could see tight supplies again next year if demand continues to rise and retailers — sticking with this year's game plan — decline to boost prices.

"It was anticipated that organic milk would grow rapidly, and that's a good thing," said Ms. DiMatteo. "What was not anticipated was that the supply chain was not going to be able to keep up."

E-mail krobenson@dallasnews.com

Organic Milk Supply Overview

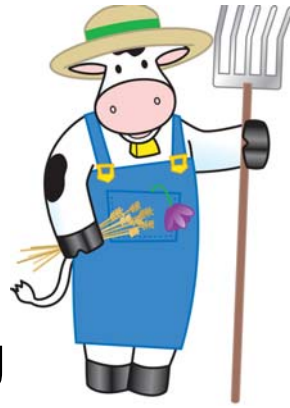
In some respects we're not that different than conventional milk

- Organic farmers are affected by increases in energy costs
- When feed costs go up, it's harder for farmers to make money, so they feed less high quality proteins, etc.
- We have spring flush, too

In some respects, we're very different from conventional farmers:

- Cost of raw milk supply rising due to increased competition and increased cost of production on the farms

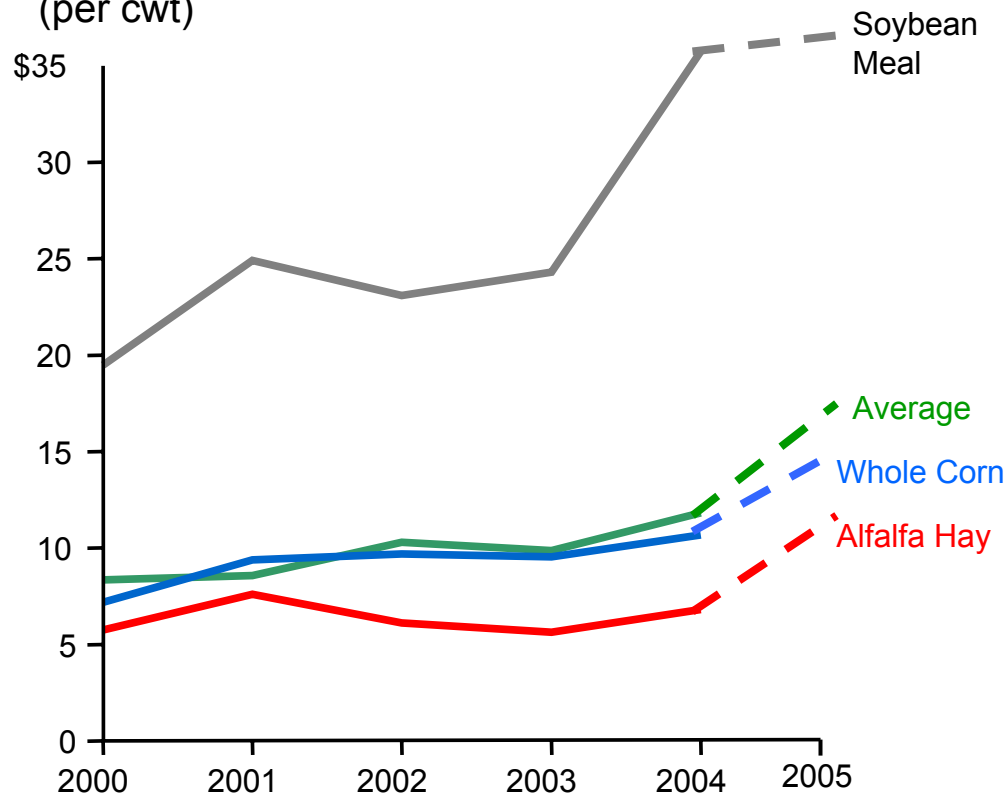
Organic vs. Conventional



- We pay processors / producers a premium for producing in accordance with the National Organic Program
- Organic milk prices are not linked to conventional milk market
 - USDA establishes the minimum price paid for conventional milk
 - Market dynamics set the price, not the government
 - Organic farmers paid a flat rate; usually multi-year contracts
- Organic feed costs significantly higher than conventional

Organic Feed Costs at all time high

Organic feed price
(per cwt)



Market drivers:



- › Organic Poultry
- › Investment to convert land

Organic Feed Costs are high

Contributing to ...

- A slowdown in amount of land converting to Organic
- Higher price of raw milk

Combined with ...

- Competitive demand for supply
- Added challenges from regulation changes



Ongoing Efforts to Improve our Supply

- Partner with 325+ family farmers
 - From 12 to 2000+ cows
 - Helping to transition ~179 farms to organic (adding more continually)



MAZY Acres Farm



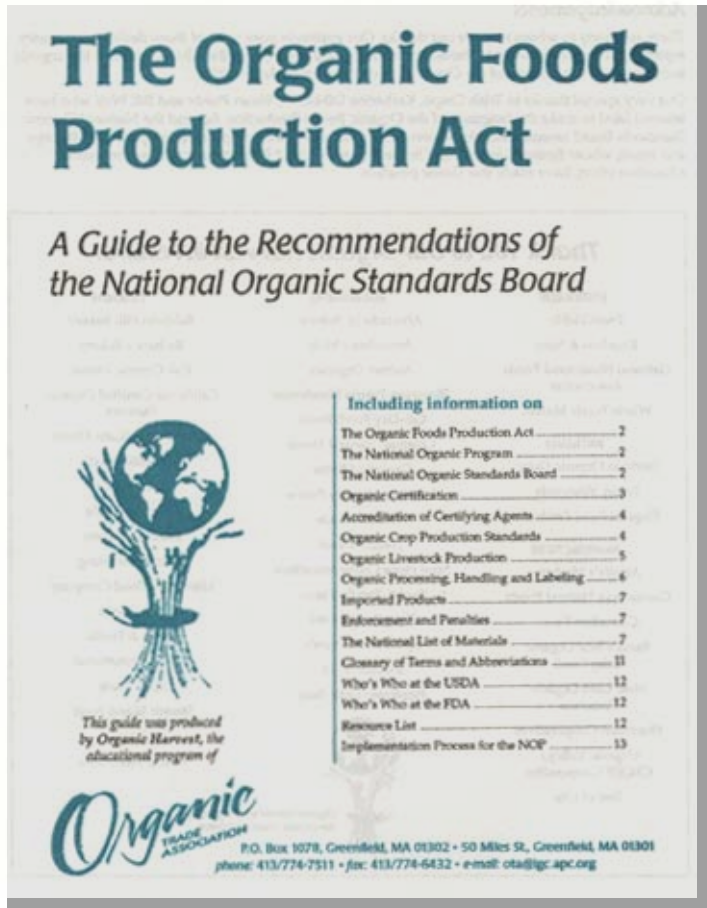
(Paul) Idaho Farm

- Own & operate two dairy farms:
 - Idaho in 1994 → ~4,500 milking cows
 - Maryland in 1997 → 600 milking cows

Regulatory Issues

- Arthur Harvey Lawsuit
- Pasture Issues

The Law



- The Organic Foods Production Act (OFPA)
- Created by Congress in 1990, as part of the US Farm Bill, it established the framework for organic standards and required a national organic program
- OFPA can only be changed by Congress
- 1990 to 2000 saw development of a comprehensive set of organic rules & procedures

The Regulations



- The National Organic Standards, under USDA's National Organic Program (NOP), are the regulations which implement OFPA, the law
- The NOP regulations, also called the Rules, went into full effect on October 21, 2002

The Regulations of Organic Agriculture

- 3 years of organic farming practices before the land and its crops can be certified organic
- 1 year of organic farming practices before the milk cow or goat and its products can be certified organic
- Ruminants must be on pasture
- Produced without harmful pesticides, growth hormones, antibiotics, genetic engineering, irradiation
- Certification based on process, not product
- All synthetics used must be approved by the NOSB
- Regular inspections
- Organic Farm Systems Management Plan

The Public Process—National Organic Standards Board (NOSB)

- A 15 member board of volunteers, appointed by the Secretary of Agriculture, whose responsibility is to advise the USDA on materials and implementation of the organic regulations

The Harvey Conflict—the Issue

- Arthur Harvey, a producer and handler of organic blueberries and other crops, (and an organic inspector employed by USDA-accredited certifiers) initially filed a lawsuit alleging that nine provisions of the NOP Final Rule are inconsistent with OFPA. He lost the case
- Arthur Harvey appealed the Court's decision, focusing on 7 of the original 9 counts
- In June 2005, the U.S. Court of Appeals for the First Circuit agreed with Harvey on two of the seven counts, with a third needing clarification

The Harvey Conflict—the Verdict

- **Count 3 (synthetics):** The Regulations established a thorough and transparent process, exercised over 12 years by the NOSB, for reviewing and approving certain synthetic materials necessary for processing organic food, such as pectin, carbon dioxide and baking powder. The Court found that OFPA specifically forbids the addition of synthetic ingredients in processing
- **Count 7 (whole herd transition):** The Regulations allowed dairy animals being “converted” to organic production to be fed 80% organic feed for the first 9 months. The Court found this to contravene OFPA, which requires dairy animals to be fed 100% organic feed during the 12 month transition

OTA Spearheads a Legislative Fix

- In the face of controversy and negative press, generated by the NGO's and activists that supported Harvey, the organic community, led by the Organic Trade Association, worked together towards a mutually agreeable resolution of the issue
- It was decided that only a Congressional amendment of OFPA would reverse the effects of the Court decision

Current Legislative Status

- October 26, 2005: The House and Senate Agriculture Appropriations Conference added the OTA language to the agriculture appropriations bill, as a manager's amendment
 - The language amended OFPA to reverse the consequences of the Court decision in the Harvey case
 - Language was also added to the bill that requested a USDA study on the effect of the court ruling on organic farmers, processors, and consumers
- October 28, 2005: The full House approved the language
- November 3, 2005: The full Senate approved the language
- Signed into law by the President
 - USDA will then amend the regulation

Pasture Requirements

- Pasture is not in the Organic Foods Production Act of 1990
- Pasture is required in the Regulations in 4 places
- Specifics as to days or time on pasture and amount of feed from grazing is not currently included in the Regulations



Pasture Requirements

Subpart A - Definitions

§ 205.2 Terms defined.

Pasture. Land used for livestock grazing that is managed to provide feed value and maintain or improve soil, water, and vegetative resources

§ 205.237 Livestock feed.

- (a) The producer of an organic livestock operation must provide livestock with a total feed ration composed of agricultural products, including pasture and forage, that are organically produced and, if applicable, organically handled

Pasture Requirements

§ 205.238 Livestock health care practice standard:

- (a) The producer must establish and maintain preventive livestock health care practices, including:
 - (1) Selection of species and types of livestock with regard to suitability for site-specific conditions and resistance to prevalent diseases and parasites;
 - (2) Provision of a feed ration sufficient to meet nutritional requirements, including vitamins, minerals, protein and/or amino acids, fatty acids, energy sources, and fiber (ruminants);
 - (3) Establishment of appropriate housing, pasture conditions, and sanitation practices to minimize the occurrence and spread of diseases and parasites;

§ 205.239 Livestock living conditions:

- (a) The producer of an organic livestock operation must establish and maintain livestock living conditions which accommodate the health and natural behavior of animals, including:
 - (1) Access to the outdoors, shade, shelter, exercise areas, fresh air, and direct sunlight suitable to the species, its stage of production, the climate, and the environment;
 - (2) **Access to pasture for ruminants**

Pasture: NOSB Recommended Rule Changes

Rule Change for §205.239(a) (1) and §205.239(b) (2):

The NOSB recommends a rule change to make the language in §205.239(a) (1) and §205.239(b) (2) consistent with the language in §205.237(a) (2). The language, therefore in §205.239(a)(1) would read “Access to outdoors, shade, shelter, exercise areas, fresh air, and direct sunlight suitable to the species its stage of life, the climate, and the environment.

Rule Change for §205.239(a) (2):

The NOSB recommends that §205.239(a) (2) be amended to read:

§205.239(a) (2) Ruminant animals grazing pasture during the growing season.

This includes all stages of life except:

a) birthing; b) dairy animals up to 6 months of age, and c) beef animals during the final finishing stage, not to exceed 120 days. Note: Lactation of dairy animals is not a stage of life under which animals may be denied pasture for grazing.

Organic Standards Clarification

- Pasture has been a contentious issue, used as a “rallying cry” in the big versus small debate in organic
- At the crux has been ambiguity in the regulations, specifically around pasture for milking cows
- The NOSB has attempted numerous times to clarify pasture. Most recently, they developed an aspirational guidance document. The guidance was meant to be aspirational only, in order to satisfy activists
- Horizon Organic has supported both the aspirational guidance and a Rule change that would clarify that lactation is not a stage of life during which a farm is exempt from pasturing their animals.

Organic Standards Clarification

- Pasture received further consideration at the NOSB meeting on Nov 16th
 - USDA announced it would publish an ANPR (Advanced notice of proposed rule making) in February followed by a 60-90 day comment period on pasture rule changes
 - USDA will hold a pasture symposium at April NOSB mtg w 2-4 panels with experts providing testimony on consumer expectations, animal health, feasibility
 - After 60 days, USDA will take all the above info plus NOSB recommendations and will synthesize into a new proposed rule (draft regulation language). Then after another 60 day public comment period, they will propose new language on pasture to be incorporated into the rule.
 - The goal is to provide clarity on pasture requirements for farms to be certified organic.

Conclusion

- Organic Dairy is a very dynamic industry
- With rapid growth, there are often unforeseen challenges to an industry
- Consumers are buying organic for health and well-being benefits
- Industry-wide supply constraints are not easy to resolve quickly
- Regulatory systems must be flexible to accommodate rapid change if necessary
- Big \neq Bad

