

## CHALLENGES FACING THE ORGANIC MILK INDUSTRY

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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.