Milk Producers Council

DATE: March 15, 2013 PAGES: 5
TO: Directors & Members FROM: Rob Vandenheuvel, General Manager

MPC FRIDAY MARKET UPDATE

CHICAGO CHEDDAR CHEESE

<table>
<thead>
<tr>
<th>Block</th>
<th>Weekly Change</th>
<th>Weekly Average</th>
<th></th>
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<tbody>
<tr>
<td>Blocks</td>
<td>+$.0100</td>
<td>+$.0250</td>
<td>$1.6100</td>
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<tr>
<td>Barrels</td>
<td>+$.0100</td>
<td>+$.0295</td>
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CHICAGO AA BUTTER

<table>
<thead>
<tr>
<th>Dairy Market News</th>
<th>National Plants</th>
<th>Dairy Market News</th>
<th>National Plants</th>
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<tr>
<td>w/e 03/15/13</td>
<td>w/e 03/09/13</td>
<td>$5613</td>
<td>$6080</td>
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NON-FAT DRY MILK

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<tr>
<th>Calif. Plants</th>
<th>Nat’l Plants</th>
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<tbody>
<tr>
<td>$1.5159</td>
<td>6,966,964</td>
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<tr>
<td>$1.5304</td>
<td>16,442,542</td>
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MARKET COMMENTARY: (By Sarina Sharp, Daily Dairy Report, sarina@dailydairyreport.com)

Milk & Dairy Markets

Class III milk futures moved slightly lower this week, tempering last week’s double digit gains. Class IV futures were basically steady, and cheese futures moved lower. Butter futures were very strong as retailers stock up for Easter. Dairy product prices moved consistently higher at the CME spot trade this week. Butter led the way, up 2.5ȼ/lb. Cheddar blocks and barrels each added a penny. Grade A nonfat dry milk (NDM) moved up 0.25ȼ on Friday.

The dairy markets are in a fundamental tug of war. Heavy inventories and the approaching spring flush are bearish, particularly in the short term. But concerns about slowing production around the world, especially in New Zealand, argue for higher prices. This week, the bullish arguments gained momentum. New Zealand’s drought spread and now officially encompasses the entire North Island and parts of the South Island. The drought has garnered headlines, with articles noting farmer woes and the negative impact this will have on the economy in general. The drought has also spurred a massive increase in culling, as dairy producers try to conserve feed for their shrinking herds. For the season to date, dairy cow slaughter is 45% higher than the 5-year average. Slaughtered cows will not be replaced until next season. Producers are also concerned about conception rates, which could push the drought’s ill effects into next season.

In anticipation of lower production volumes, Fonterra has reduced the amount of product offered in next week’s Global Dairy Trade auction. This will likely support prices at the auction. Dairy Market News noted a 10% increase in butter and skim milk powder (SMP) prices in Oceania from two weeks ago. Whole milk powder (WMP) prices were up 14% to the highest level since May 2011, and Cheddar was slightly higher. Prices were steady to 3.8% higher in Europe, according to Dairy Market News. There too, WMP showed the strongest gains.

Chinese demand for WMP is voracious, and New Zealand has supplied nearly all of Chinese WMP imports. With New Zealand production waning, other producers will likely shift more production to WMP, leaving the United States with increased opportunities to export SMP and nonfat dry milk (NDM) powder.

The California Weighted Average Price for NDM in the week ended March 8 was $1.5159/lb., down 1.29ȼ from the previous week. Sales volume was much lower than the very strong sales the week before. Dairy Market News dry product prices were mostly lower. The National Dairy Products Sales Report (NDPSR) showed lower prices for all products, and with lower Dairy Market News prices, NDPSR prices will likely continue to move lower over the next few weeks.
Weekly dairy cow slaughter was 63,178 head, which is lower than recent weeks but still 3.3% higher than the same week in 2012. Year to date slaughter is 5.3% higher than last year. Slaughter in Region 9, which includes California, is up 4% year to date compared to 2012.

Falling cattle weights, regional beef shortages and unused slaughterhouse capacity have led to stronger beef prices even as the futures collapsed. The comprehensive beef cutout, which provides a weighted average price for all beef cuts, neared $200/cwt., a level where it has traditionally struggled. Indeed, retailers are hesitant to stock up on beef at these prices when they can feature pork or poultry at much lower values. But despite the higher prices, beef exports have been very strong of late. Lean beef prices have been leading comprehensive beef prices higher, and this is supporting dairy cow prices. The high price of cow beef will continue to encourage heavy dairy cow slaughter rates.

USDA’s National Agricultural Statistics Service (NASS) will issue the February Milk Production report next Tuesday, but due to the sequester, NASS will not release any other Milk Production reports until the new federal fiscal year begins in October. NASS will also cut the July Cattle report, which reports mid-year dairy cow and heifer inventories. NASS says it reviewed its costs and determined what to cut based on user criteria. Other agricultural industries outside of dairy and beef will feel little to no effect from the cuts. Most vital NASS reports, including Mushrooms, Honey and Catfish Feed Deliveries, will be issued as usual.

**Grain and Hay Markets**

Grain prices moved higher this week, while soybean prices moved sharply lower. Wheat prices continued to gain on more talk of wheat substitution for ethanol and feed use. This also supported corn prices as it emphasized tight corn supplies. Grain prices were also supported by very strong wheat export sales and stronger than expected corn sales.

The corn market was in the headlines this week as Renewable Identification Number (RIN) prices surged to record highs. A RIN is the code assigned to each gallon of ethanol that is blended into the fuel supply. When refiners blend more ethanol than the Renewable Fuel Standard (RFS) requires, they can hold the RIN for later use, or sell it. Refiners are limited in the percentage of ethanol they can blend into each gallon of gasoline to prevent engine damage, so as gasoline demand falls, the demand for ethanol falls with it. Ethanol production has stagnated at relatively low levels, as gasoline demand is lower than it was several years ago. Meanwhile, the RFS mandate has moved higher, to 13.8 billion gallons. At the current pace, refiners cannot blend enough ethanol to meet the mandate, and there are not enough unused RINs to meet the mandate. So the spike in RIN prices does not suggest that ethanol and corn prices will move higher. In fact, it reveals soft demand for ethanol.

The National Oilseed Processors Association reported that soybean processors crushed 136.32 million bushels of soybeans in February. The crush was smaller than expected, and because much of the recent rally was based on reports of processors’ vigorous demand for soybeans, prices fell precipitously in the wake of the report. Weekly export sales were unimpressive, which also pressured the soybean complex.

**FRED DOUMA’S PRICE PROJECTIONS…**

<table>
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<tr>
<th>March 15 Est:</th>
<th>Quota cwt. $17.99</th>
<th>Overbase cwt. $16.30</th>
<th>Cls. 4a cwt. $17.99</th>
<th>Cls. 4b cwt. $14.87</th>
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</thead>
<tbody>
<tr>
<td>Last Week:</td>
<td>Quota cwt. $17.98</td>
<td>Overbase cwt. $16.29</td>
<td>Cls. 4a cwt. $18.01</td>
<td>Cls. 4b cwt. $14.83</td>
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THE “ANTI-AB 31” PROPAGANDA CONTINUES IN SACRAMENTO: (By Rob Vandenheuvel) As dairy farmer organizations and processors continue to stake out their positions in Sacramento over AB 31, the Dairy Institute of California – representing the State’s cheese manufacturers – has put out more material in their attempts to derail the legislation. This week, the Dairy Institute published another one-page flyer titled, “E=mc² is easier” (http://www.dairyinstitute.org/pdf/Dairy-Einstein%20Onlnine%20Handout.pdf). The flyer claims that, “Once a month, experts at the California Department of Food and Agriculture use this complex formula to set the price of milk used to make cheese. AB 31 transfers this monthly responsibility to the California Legislature — the first time in state history that the Legislature would set prices for milk or any other commodity.”

As a reminder, AB 31, introduced by Assemblyman Richard Pan (D-Lodi) would provide specific guidance to the California Department of Food and Agriculture that would result in California’s Class 4b monthly price more closely following the Federal Milk Marketing Order (FMMO) Class III price – which is used throughout the rest of the country as a benchmark price for milk sold to cheese manufacturers. The bill also provides a small-business exemption that would actually reduce the Class 4b price from its current level on the first 100,000 pounds of milk a cheese manufacturer purchases each month.

To understand why AB 31 is needed for our industry, we have to first understand the basics of how milk is priced in California. These basics are conveniently left out of material put out by the Dairy Institute and their cheese manufacturing clients. **CDFA is empowered by THE CALIFORNIA LEGISLATURE to establish minimum prices for milk produced and sold in California.** That’s right…it is the California Assembly and State Senate that has given that responsibility to CDFA. However, CDFA was not given a “blank check” in that role as price-setters. And giving an agency a responsibility certainly does NOT mean that the California Legislature forfeits the right to revisit the law and consider additions/subtractions/clarifications along the way.

The Legislature has included provisions in the California Food and Agricultural Code that describe the responsibilities of CDFA in establishing those prices. Those responsibilities include:

- **Section 61805(d):** “The purposes of this chapter are to…Enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions, bring about and maintain a reasonable amount of stability and prosperity in the production of market milk, and provide means for carrying on essential educational activities.” (emphasis added)

- **Section 62062:** “Each stabilization and marketing plan shall contain provisions whereby the director establishes minimum prices to be paid by handlers to producers for market milk in the various classes. The director shall establish the prices by designating them in the plan, or by adopting methods or formulas in the plan whereby the prices can be determined, or any combination of the foregoing… If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products.” (excerpt, emphasis added)

- **Section 62062(a):** “In establishing the prices, the director shall take into consideration any relevant economic factors, including, but not limited to…The reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those class prices, in relation to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. In determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment.” (emphasis added)

So while the California Legislature empowered CDFA with great authority in establishing minimum prices for milk produced and sold in California, it is clear from the reading of the law that the Legislature intended that CDFA:

- Facilitate “stability and prosperity” for those who are producing milk in California;
- Maintain prices that are in a “reasonable and sound economic relationship” with what comparable milk is
sold for around the country; and

- Consider the dairy farmers’ income from the sale of milk in relation to what it costs to produce that milk, including a “cost of management” and a “reasonable return on necessary capital investment.”

Shown here is a chart demonstrating the difference between the monthly California Class 4b price and the Federal Order Class III price for the past 10 years.

Considering this chart with the Legislative guidelines listed above, does this information demonstrate “stability and prosperity” in the production of milk? Does it demonstrate a “reasonable and sound economic relationship” with prices that are paid for comparable milk around the country? Do I even need to answer those questions?

AB 31 proposes that the California legislature take another look at the California Food and Agricultural Code to ensure that significant gaps like we’ve seen since 2010 don’t continue to happen. The Dairy Institute can call it unprecedented if they like, but it’s also unprecedented to have California’s cheese manufacturers enjoying the benefit of a State-sponsored discount to the tune of $2.00 per hundredweight! (Which, as we’ve discussed in previous issues of this newsletter, equates to a discount of more than $750 million since 2010!)

So what is the actual financial impact of AB 31? That is something we never see mentioned in detail in the Dairy Institute’s flyers. The reality is that under AB 31, our cheese manufacturers will continue to enjoy a regulated discount relative to the FMMO Class III price that drives the value of milk sold to cheese plants around the country. Take a look at the chart below comparing the actual difference between the California Class 4b price and the FMMO Class III price, and what that difference would have been under AB 31.
Of course the first question that comes to mind is, “Why doesn’t AB 31 go further to close the gap between the California Class 4b price and the FMMO Class III price?” I agree. California dairy families deserve the same or higher prices than those received for milk around the country. Our costs certainly justify that. But recognizing that AB 31 is still a step in the right direction, the next question that comes to mind is, “How on earth can the Dairy Institute make claims – with a straight face – that AB 31 will devastate California cheese manufacturers and drive them out of state?!?”

The answer is simple: We have spoiled the California cheese manufacturers with the lowest-cost milk in the country, and they will work tirelessly to defend the continuation of that steep discount, regardless of the devastation it creates on your dairy farm. That should motivate each and every dairy in the State to do everything you can to help AB 31 get approved by the Legislature. Every dairy in California should make plans to travel to Sacramento whenever the Assembly Agriculture Committee hearing is scheduled. While that schedule has not been released yet, it is our hope that a hearing on AB 31 will be held sometime during the month of April. So keep an eye on this newsletter for the official date once it’s announced.

If you have any questions, please don’t hesitate to contact MPC at (909) 628-6028.

CDFA DENIES MPC’S REQUEST TO SHARE THE TRANSPORTATION SUBSIDY COSTS WITH CONSUMERS (By Rob Vandenheuvel) Last week, we wrote about a letter sent by MPC to CDFA requesting that CDFA allow us to share the cost of the transportation allowance program 50-50 between dairy farmers and the marketplace (www.milkproducerscouncil.org/030713mpcproposal.pdf). The concept was simple: The transportation allowance program is currently 100% funded by money in the dairymen’s revenue pool. More than $34 million was removed from dairy farmer revenue last year in order to pay for the transportation allowance program, which is designed to ensure that Class 1, 2 and 3 processors in major urban areas receive the milk they need, regardless of how much milk is in the vicinity of the plant.

This week, MPC received a response to our request. Did CDFA comment on the merits of our request? No. Instead, the letter (which is at http://goo.gl/WNT4W) simply denied the request because “the proposed amendment falls outside of the call of the April 4, 2013 hearing.” This is the bureaucratic method of dodging the issue. Who sets the “call of the hearing”? CDFA. Is there anything preventing CDFA from modifying the call of the hearing in order to consider a relevant, related proposal? Absolutely not.

The fact of the matter is that it’s just simpler for CDFA to take the $34 million (or possibly more if modifications are made to the transportation allowance rates in the upcoming hearing) out of the California dairy farmer revenues. Our state has overseen the decimation of our dairy farming sector. Dairies are auctioning off their herds or moving out of state at a record pace. In order to provide a reliable milk supply for the Class 1, 2 and 3 plants in urban areas like Los Angeles and the Bay Area, transportation allowances are used to subsidize the hauling costs associated with supplying those markets. And who is CDFA content to put 100% of those costs on? Dairy farmers.

Whether CDFA wants to admit it or not, it’s time to change our policy of constantly eroding the dairy farmers’ revenue, and engage in an equitable cost-share between producers and the market in order to cover the costs associated with the transportation allowance program. MPC’s alternative proposal would do just that, and MPC will continue to fight for this justified policy change.