DATE: September 6, 2013
TO: Directors & Members
FROM: Rob Vandenheuvel, General Manager

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MPC FRIDAY MARKET UPDATE

CHICAGO CHEDDAR CHEESE

| Blocks     | Weekly Change | $1.8100 | $1.8000 |
| Blocks     | Weekly Change | $1.8100 | $1.8000 |
| Barrels    | Weekly Average | +$.0275 | $1.8100 |
| Barrels    | Weekly Average | +$.0300 | $1.8000 |

Weekly Average, Cheddar Cheese

| Blocks     | Daily Market News w/e 09/06/13 | $1.7894 |
| Barrels    | National Plants w/e 08/31/13 | $1.7781 |

CHICAGO AA BUTTER

| Weekly Change | $1.4300 |
| Weekly Average | +$.0073 |

NON-FAT DRY MILK

| Calif. Plants | Nat’l Plants |
| $1.7594       | $1.7585     |
| 6,510,667     | 4,568,958   |

Dry Whey

| Dairy Market News w/e 09/06/13 | $0.5763 |
| National Plants w/e 08/31/13 | $0.5740 |

FRED DOUMA’S PRICE PROJECTIONS...

Sept 6 Est: Quota cwt. $19.27 Overbase cwt. $17.58 Cls. 4a cwt. $18.89 Cls. 4b cwt. $16.67

Last Week: Quota cwt. $19.19 Overbase cwt. $17.49 Cls. 4a cwt. $16.49 Cls. 4b cwt. $16.49

MARKET COMMENTARY: (By Sarina Sharp, Daily Dairy Report, sarina@dailydairyreport.com)

Milk & Dairy Markets

CME spot Cheddar prices gained ground in the latter half of this week, reaching highs not seen since May. Blocks rose 2.75¢ and settled at $1.81/lb. Barrels added 3¢, closing at $1.80. Class III futures rallied Friday after the cheese trade, but the strength was short-lived. Contracts ended in the red and well off their highs. The Friday afternoon weakness reveals a lack of conviction in the cheese market rally. The absence of trades at the CME further suggests that recent gains are somewhat tenuous.

Spot butter rallied on Friday, adding a penny. However, this was not enough to overcome early week losses, and butter closed 0.75¢ lower than last week at $1.43/lb. Grade A nonfat dry milk (NDM) was bid 1.5¢ higher, while the Extra Grade NDM market was untested. Class IV futures were mostly higher than last week.

USDA reported dairy products production this week as well as U.S. export sales for July. Please see the table on the next page for a detailed data comparison. July cheese production totaled 910 million lbs., up 3% from the prior year. Butter production was 0.5% higher than last year, while NDM/SMP production fell 4.9% short of a year ago.

These production figures show that cheese processors pulled milk away from driers despite the strength in milk powder prices in July. This is partly due to strong milk production in Midwestern orders with heavy cheese production. But it was also the case in California. July milk...
production in the Golden State was 3.5% lower than a year ago, but cheese production increased by 1.6%. Meanwhile, California NDM production was 34.4% lower than last year. Some of the decline is due to a shift of capacity from NDM to SMP. However, much of the drop means that driers operated below capacity while cheese vats were full.

Cheese processors may have increased production in order to build inventories in anticipation of the opportunity to sell it for higher prices later in the year. Indeed, prices have risen since July. However, to the extent that cheese production displaced milk powder production and lowered Class IV utilization, it represents a lower return to dairy producers. USDA announced the August Class III milk price at $17.91, well below the August Class IV price of $19.07. Similarly, California’s August 4a milk price, based on the butter and milk powder price, is $18.70, much higher than the 4b price of $16.32. All four classes of milk were higher in August than July.

U.S. dairy product exports remained strong in July. Exports of all dairy products exceeded the volumes sold the year before. July butter exports more than doubled relative to last year to the highest monthly volume since 2008. They were 12% greater than June. Cheese and milk powder exports also increased in July relative to June. Sales of whey and ice cream retreated when compared to the prior month. U.S. dairy products remain underpriced relative to the global market, suggesting that strength in dairy product exports will continue for the foreseeable future.
Dairy product prices at the Global Dairy Trade auction were mixed. The Price Index fell 1.1%. Cheddar led the way downward; the average winning price dropped 3.2%. Milk protein concentrate, SMP and WMP prices also settled lower. Butter, anhydrous milkfat, and buttermilk powder prices increased.

The Class III milk futures curve projects lower milk prices in the months to come. There will likely be more milk around next year as lower feed costs encourage production increases in the U.S. and Europe, and this could pressure prices. The absence of adverse weather could also foster a rebound in milk production in Oceania and Europe.

But there are reasons to be optimistic. European production has been slower to bounce back than was expected. Both Europe and New Zealand have plenty of room to rebuild stocks before they feel pressure to flood the export market with supplies, and this may take months. Global demand for dairy products remains firm, and major cooperatives in Europe and Oceania expect prices to remain high, as evidenced by their pay-price forecasts.

**Grain and Hay Markets**

It is corn silage season in the heart of the country, and dairy producers there are eagerly anticipating much lower prices for grain, silage and haylage. However, while every dairy producer should see some decline in feed costs this fall, regional disparities remain. Silage prices throughout the West remain near the sky high levels of last year. Hay prices have shown little inclination to retreat. Dairy producers in California are stuck paying enough for corn silage to compete with a variety of high value crops for farmland. Futures currently promise $16-$17 milk for next year. For many producers that may be enough, but it will be tougher for those who face only a marginal decline in feed costs.

Dry weather in the Corn Belt pushed soybean futures up this week. They settled a dime higher. But with the corn harvest underway, the weather had little effect on corn prices. December corn futures closed 13.75¢ lower, at $4.68 ¼. Corn prices appear comfortable in a range from $4.50 to $5.00, and with reports of record high yields in the South, they are drifting lower. The dry weather may continue to support soybean prices, but they have had difficulty rallying with enthusiasm while corn prices weaken further.

The International Grains Council expects Brazilian soybean area to increase 5% this year to a record high 29 million hectares. Spring in southern Brazil has been colder than normal, which has delayed corn planting. This could shift even more acreage from corn to soybeans. Increased soybean production in Brazil would be welcomed to satisfy Chinese import demand, which remains strong.

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**A LOOK AT CALIFORNIA POOLING AND THE UPCOMING CDFA HEARING, PART TWO: (By Rob Vandenheuvel)**

Last week, we took a look at California’s pooling system, and how changes to one or more of the five class prices impacts not only the Overbase prices paid to dairy farmers, but also the relationship each plant has with the pool. If you missed that article, you can find it on our website at: [http://www.milkproducerscouncil.org/083013pooling.htm](http://www.milkproducerscouncil.org/083013pooling.htm).

This week, I want to take a look at another side of this, an issue that regularly comes up in California Department of Food and Agriculture (CDFA) hearings, but is often completely misunderstood. Over the past couple years, California dairy farmers have made the plea to CDFA that our Class 4b price (for milk sold to California’s cheese
manufacturers) should be in closer alignment with the Federal Order Class III price (the benchmark price for milk sold to cheese manufacturers throughout the country). Those who oppose our efforts to close this gap have always pointed to the differences between the California state pricing system and the Federal Milk Marketing Orders (FMMO), claiming that those differences justify what has become a massive and expensive discount for California-produced milk (plenty of data on that point in last week’s article).

Rather than try to explain the arguments on the differences between the California and FMMO systems, take a look at this paragraph below from the July 20, 2012 hearing panel report, discussing this very issue:

“One key difference between the California and federal order systems is the ability in federal orders to ‘escape’ regulated minimum prices by paying a lower price for milk than the announced class prices for manufacturing milk (milk used to manufacture cultured and frozen dairy products, butter, dry milk powders, cheese, and whey products). In federal orders, manufacturing plants may voluntarily elect to de-pool or decouple their milk from the minimum pricing regulations so that they are not required to pay the minimum class price established by the federal order.”

Oh, if only it were that simple... There are a couple different dynamics that are going on here, and all-too-often those dynamics get glossed over when trying to simplify the differences between California’s state order and the FMMOs. So let’s take a look at what those differences really are with regard to milk pooling and minimum prices.

**Why Do Some Plants Choose to Operate Outside Pool?**
In both California and FMMO, each non-fluid milk handler (which can be a cooperative or an individual plant) has the opportunity to decide whether or not to operate as part of their respective “pooling plan.” In California, that decision is a 12-month decision (in other words, once a handler decides to join or leave the pooling plan, they are locked into that decision for 12 months). In the FMMO’s around the country, the rules vary, with some allowing for the decision to be made monthly while others are more restrictive (there seems to be a general movement in recent years to go the more restrictive path).

So why would a plant decide to operate outside the pooling plan? There are a couple primary reasons (and you’ll be surprised to know that neither is driven by an obligation to pay minimum prices, as is often incorrectly argued).

First, there are certain requirements that come with being part of the pooling plan. A plant may decide it is not in their interest to fulfill those requirements, for any of a number of reasons. In this case, the plant is not jumping in-and-out of the pool; rather, it is a long term decision to operate independently of the pool.

Second, there are economic forces that can drive plants into and out of the pool. Those forces are directly tied to the issues I discussed in last week’s newsletter. Remember the discussion last week about pool withdrawals and pool contributions? If you are a cheese manufacturer buying Class III milk in a FMMO, you are likely to receive a payment from the FMMO because the Class III price is often below the announced blend price (remember, the blend price includes higher valued Class I sales, which are required to be part of the pool). But there may be some months where the opposite is true – when the Class III price rises quickly and is actually above the announced blend price. In months like that, those plants would not receive a payment, but would instead be liable for a pool contribution. In order to escape this obligation, a plant may decide to opt out of the pool temporarily.

FMMOs recognize this is happening, and some have taken steps to limit it. Those limitations include time restrictions for rejoining the pool or limitations on how much milk can be brought back into the pool in subsequent months.

Notice that neither of these two reasons to “de-pool” are driven by a requirement to pay the announced minimum price.
The Payment of Announced Minimum Prices

In California, a manufacturer purchasing Grade A milk is obligated to pay at least the announcement minimum class price for that milk, depending on how the milk is used (Grade B, or “manufacturing milk,” contains no such requirement, but is a small portion of the milk produced in the State). In FMMOs, there is no such requirement. As we discussed, CDFA has used this fact to justify the huge discount in our Class 4b price compared to the FMMO Class III price in recent years (average of $1.71 gap since 2010). However, the way excess milk is handled throughout the country in FMMOs really isn’t all that different from how we handle excess milk here in California.

To explain, let’s think about the different types of “demand” that exist for milk produced on the dairy.

There is a certain amount of milk that a plant needs to operate their business and meet the needs of their customers. That supply of milk must be on a consistent and reliable schedule and volume. All over California and throughout the country, dairymen and their cooperatives move milk around to ensure that each plant receives the milk they need. We all know that in California, the prices are based on the minimum prices announced each month by CDFA (they have to be if it is Grade A milk). But how are those prices established in FMMOs? Since there’s no legal obligation to pay the minimum prices, it’s based on contracts. Well the cooperatives who market most of the milk around the country could tell you that for a regular daily supply of milk to a plant, that price is based on the FMMO-announced prices each month, such as Class III, likely with premiums on top of that. After all, why in the world would a dairy farmer or cooperative agree to sell all the milk a plant needs for an extended period of time at anything less than the benchmark price used for that type of milk around the country?

Now having said that, there are times of the year when the amount of milk produced in a particular area exceeds the amount a milk contracted with the various processors in that area. This happens all over, both in California and throughout the country.

So what happens to that excess milk? In California, you all know what happens: calls are made to potential out-of-state customers, or to a nearby calf ranch in need of milk, and steps are taken to sell that milk through other channels, at a loss to the dairy farmer or cooperative (that’s an important note: it is the DAIRY FARMERS who suffer the cost of marketing surplus milk, not the processors, CDFA or the consuming public, which is why California cooperatives have taken steps to establish base programs in order to respond to supply/demand imbalances).

In the FMMOs, this same type of scenario happens. The balance between supply and demand – always difficult to maintain, but especially difficult given the biological and geological factors in the dairy industry – is in constant flux. Plants contract for the milk they need, and sometimes there is more milk than those contracts cover. Just as we do in California, producers and cooperatives in FMMO areas take steps to find a buyer for that milk, likely at a discount. The difference in FMMOs? Those potential buyers can include dairy manufacturing plants. In other words, a plant that has already contracted for the milk they need may be willing to take some additional milk at a discount.

So what’s really all that different? In both California and FMMOs, we try our best to maintain supply/demand balance, but inevitably fail from time to time. And in both California and FMMOs, we must take steps during those limited times to find alternative markets for our milk. Would it be easier – and less expensive – if California cooperatives could offer discounted milk to our local plants rather than the calf ranch or an out of state market? Perhaps. But why in the world does this justify a $1.71 per hundredweight discount on all (not just the “excess”) of California’s Class 4b milk supply?
To further illustrate the insanity of the current system, let’s do some simple math. First a couple assumptions for this exercise:

- Rough Estimate of Class 4b milk purchased/sold in California in 2012: 14 billion lbs.
- Average Class 4b price in 2012: $15.54/cwt
- Average Federal Order Class III price in 2012: $17.44/cwt

So let’s take an extreme example that in 2012, the top 5% of the milk sold all year to Class 4b plants was “surplus” milk that the plant only took out of the goodness of their heart, and if the Class 4b price were raised to the FMMO Class III price, they would no longer want to take that milk (a major assumption, but work with me).

Here is how the math would work:

- 95% of the milk (13.3 billion lbs) would get the higher Class 4b price (tied to the FMMO Class III price in this example):
  - 13.3 billion lbs X $17.44 per cwt = $2,319,520,000
- The other 5% of the milk (700 million lbs) would be “surplus” milk that cheese plants no longer wanted, and for the sake of argument, let’s make it easy and assume that milk had to be sold for zero net revenue (i.e., the cost of marketing/transporting the milk equaled the amount paid for the milk):
  - 700 million lbs X $0.00 per cwt = $0
- Total revenue for the 14 billion lbs = **$2,319,520,000**

Now compare this to selling the 14 billion at the CDFA-discounted price of $15.54 per hundredweight, which yields **$2,175,600,000**.

In this admittedly simple example, our dairy farmers would have been **$144 MILLION better off** getting paid the higher price on most of our milk and discounting the assumed 5% “surplus” (in this example, 700 million lbs or roughly 38 loads a day...like I said, it’s an extreme assumption), rather than having CDFA discount **ALL** of our Class 4b milk by $1.90 per hundredweight.

So as you can see, there is a lot of misunderstanding about the differences between California’s system and the FMMO system, and that has led to inappropriate conclusions, which in turn have led to unwarranted and devastating discounts in California’s milk prices. Our state’s cheese manufacturers – and CDFA – have taken the position that a significant discount between the California Class 4b price and the FMMO Class III price is warranted because of the opportunity in FMMOs to pay below regulated prices, despite any evidence that it actually happens on a meaningful scale. And to the extent it does happen, it is really no different than the way California dairymen/cooperatives handle their surplus milk, other than the fact that we lose our local plant as a possible market for that spot load or two of excess milk. So because we may have to occasionally seek out markets further away or of lesser value (which already may hurt our dairy farmers), CDFA chooses to discount **all** our Class 4b milk (which definitely hurts our dairy farmers). Logical? You be the judge.