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DATE: September 21, 2012 **PAGES: X**
TO: Directors & Members **FROM: John Kaczor**

MPC FRIDAY MARKET UPDATE

CHICAGO CHEDDAR CHEESE		
Blocks	*+$.1275*	$2.0000
Barrels	*+$.1325*	$1.9600
Weekly Average, Cheddar Cheese		
Blocks	*+$.1035*	$1.9490
Barrels	*+$.1075*	$1.9045

CHICAGO AA BUTTER		
Weekly Change	*+$.0400*	$1.8900
Weekly Average	*+$.0280*	$1.8700
DRY WHEY		
Dairy Market News	w/e 09/21/12	$.6013
National Plants	w/e 09/15/12	$.5853

NON-FAT DRY MILK		
Week Ending 9/14 & 9/15		
Calif. Plants	$1.3013	8,650,299
Nat'l Plants	$1.3809	12,820,303
Prior Week Ending 9/7 & 9/8		
Calif. Plants	*$1.2874*	*7,500,804*
Nat'l Plants	*$1.3622*	*15,515,911*

CHEESE MARKET COMMENTS: Retail and food service cheese demand is steady to strong, exports also are setting new records almost every month, and production this month should be at its low point for the year. Still, until very recently the strong upward movement in prices since May did not seem to have sufficient foundation to be supported, much less continue. This week's report on August milk production, 0.3% lower than last August, added support. Today's report on cheese in cold storage at the end of August, showing stocks of American and other natural cheeses each lower by about 19 million lbs from July, added more. Now we see more clearly a tightening between supply and demand. Higher imports are nibbling away at the supply side but exports, with the help of CWT's assistance to its members, is more than off-setting the foreign-born cheese. Per capita consumption continues to move upward in the U.S. This week, prices for both styles of cheese on the CME moved sharply higher; it was almost a "full Monty," with prices increasing for both every day except for blocks resting today after Thursday's $.05 per lb increase. After this week's increases, prices charged by manufacturers for shipments made last week are now $.10 per lb behind this week's averages and $.15 per lb behind today's closing prices. Class III milk and cheddar cheese futures were higher in October and November and lower from thereon. Speculators are concerned and not convinced but they merely make the market work.

Another Month of the "California Discount" on Milk Sold to California Cheese Manufacturers			
	August 2012	**Jan–Aug 2012**	**2010-Present**
CA Class 4b price	$16.57	$14.34	$14.66
F/O Class III price	$17.73	$16.23	$16.35
"California Discount"	($1.16)	($1.89)	($1.69)
The discount in August 2012 was narrowed by a CME block Cheddar price that was more than $0.03/lb above the USDA-reported Cheddar cheese price.			

BUTTER MARKET COMMENTS: Butter on the CME advanced $.04 more per lb this week in very light trading. The biggest move came on Thursday, $.0225 per lb, from an offer to sell; it sold. *Dairy Market News* says retail sales remain steady, and buyers are looking ahead to see where they may be towards end of the year holidays – and to try to stay ahead of possible higher prices when their options are fewer. Cream is seasonally available, but milk is not. Plants in California and other southwestern states would probably like more at the present time. Butter production is fairly steady, though heading lower; some manufacturers have enough volume to add to their stocks but many do not. Wednesday's report on August milk production got buyers' attention, and today's report on the amount of butterfat products in storage at the end of August, 34 million lbs lower than the month before, almost certainly reflects the direction of production during that month, as well as domestic sales strength. CME futures were mixed this week; sharp increases for October and November and no change or lower prices later. Signs of wanting to avoid a sharp turn-around from the current high and rising spot market.

POWDER MARKET COMMENTS: An apparent supply-driven shortage of nonfat dry milk is not being reflected in sales prices anywhere near where economic theories say should happen. This is the time of year, in most states, where butter and powder production takes back stage to all other milk uses. U.S. production is falling; U.S. demand, according to *DMN*, is steady. However, buyers are reported to continue to resist paying market-based prices. As much as they would like, there is no NFDM to import, only milk protein concentrate. Exports continue to do well. The weekly price averages for shipments of NFDM last week moved higher, but by less than this week's spot prices. Dairy America's skim milk powder continues to be the highest-priced powder being sold in the internet auction. Someone asked could there be something less than above-board happening because of the low volumes involved for that product in that secret market. How could that happen?

WHEY PRODUCTS MARKET COMMENTS: The market for dry whey remains in fairly good balance even with lower cheese production limiting the raw product source. Other users, mainly as ice cream makers, have reduced needs so regular users are back to the market. However, those without contracts apparently are not able to secure the volumes needed. Re-sales continue to be their best source. Exports through July are slightly lower than last year but the U.S. continues to be the leader in that category. The west's "mostly" price average moved up by $.0083 per lb this week, and remains slightly higher than the level in the central region. Domestic demand for WPC-34 remains strong and for exports very strong. *DMN* says manufacturers believe supplies will continue to dwindle and prices to increase as cheese production moves lower.

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FRED DOUMA'S PRICE PROJECTIONS…

Sep 21 Est:	**Quota cwt. $18.42**	**Overbase cwt. $16.72**	**Cls. 4a cwt. $16.64**	**Cls. 4b cwt. $17.48**
Last Week:	**Quota cwt. $18.22**	**Overbase cwt. $16.52**	**Cls. 4a cwt. $16.45**	**Cls. 4b cwt. $17.17**

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AN OPEN LETTER TO THE DAIRY ECONOMISTS AT THE CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE: *(By Geoffrey Vanden Heuvel, Vice-Chairman, Milk Producers Council)* The following open letter was sent to CDFA's Dairy Economists on September 21, 2012:

Dear Candace, Hyrum and Amber,

Secretary Karen Ross has indicated in recent communications to the California dairy industry that department economists (I presume that would be you) are monitoring the conditions in the marketplace, apparently with the implication that if you see something that requires a course correction you will point that out to her. Since she is relying on you for this information I would like to share a few observations with you.

First I wonder from what point you are doing the monitoring. Some distance upstream from the Niagara Falls there is a sign on the river bank that marks the "point of no return." What this sign indicates is that if someone falls into the river past this point, there is no way to rescue them because the current in the river is too strong. Once you pass that point you are going over the Falls. I wonder if you are not monitoring the current dairy crisis from below the falls. Looking up at producers breaking over the falls, thinking that when enough of them go broke then you can change course and address the problem. But if that is your vantage point, everyone that has passed the point of no return is going over also.

California dairy producer bankruptcies are occurring every week, but let me assure you that those producers that file for bankruptcy are a small percentage of the producers that are in dire financial straits. And when producers cannot pay their bills and essentially go broke, who gets hurt? Not just the dairyman and his family but also the feed suppliers, the hoof trimmers, the veterinarians, the breeders, the soap suppliers and hundreds of other people in the allied industries. In essence the entire infrastructure of the California dairy industry begins to crumble right along with the bankrupt dairymen. This is why we have a regulated industry to begin with, to prevent this type of damage from occurring.

So the department, at your direction, has been maintaining a policy of looking at the milk supply and plant capacity and deciding, in essence, that the California dairy farmers economic well-being is not as important as protecting a handful of relatively small cheese plants processing a relatively small volume of California's milk who don't do much with their whey stream. The fact that everywhere else in the country similarly situated cheese plants do pay the higher regulated federal price seems to be ignored by you. You also ignore the fact that these small cheese plants are not making commodity cheeses. In the process, large cheese plants in California with operations in other parts of the country where they all pay federal order class III prices plus premiums, are allowed to buy milk in California at steeply discounted prices. How do you expect California dairy farmers to compete with dairy farmers in the rest of the country when our prices are so severely discounted?

Secretary Ross has now sent copies of the 2007 Mc Kinsey report to all of California's dairy families. This report goes into some detail (see page 21-22 of part 2) in observing that discounting California's cheese milk to obtain market share is not a strategy that will work in the future. This was written in 2007 and yet you continue to pursue this cheap milk policy despite having the full discretion and I would say responsibility to change course.

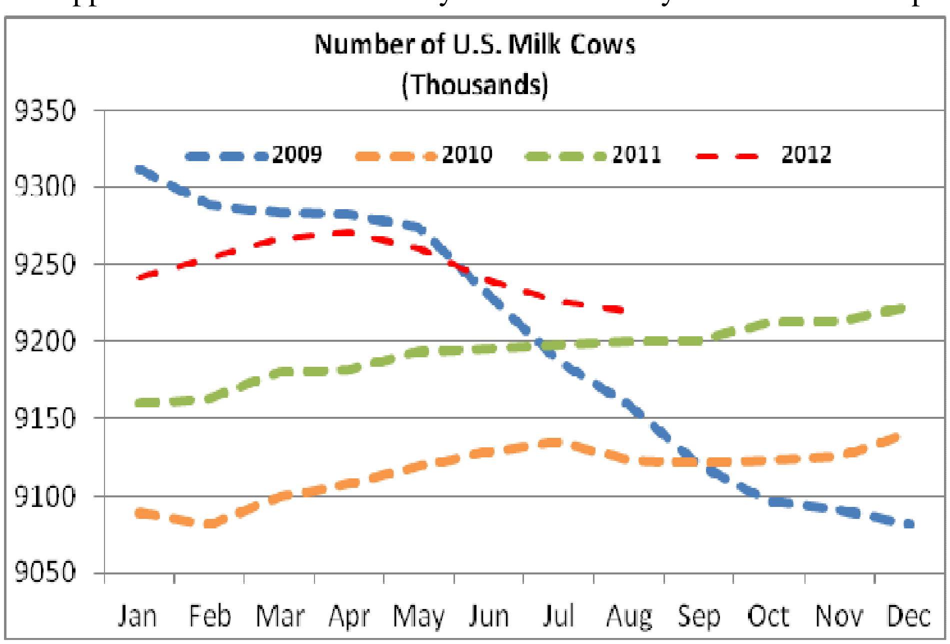
There is nothing fundamentally wrong with the California system. What is wrong is the way the California system is being administered. Secretary Ross has the tools she needs to bring California's regulated price into a reasonable relationship with the milk prices received by dairy farmers everywhere else in this country. She simply refuses to do it, apparently because you as her economists don't recommend it. The tragedy is that the California producer sector and with it the allied industries are being permanently damaged, not by market forces, (if we were paid a comparable price with what producers are paid in the rest of the country and still were failing that would be different), but by your policies. I beg you to find the courage to change course.

Sincerely,

Geoffrey Vanden Heuvel
J&D Star Dairy
Chino, CA

Geoffrey Vanden Heuvel has been a dairy farmer in Chino, California since 1979. He currently serves as Vice-Chairman of Milk Producers Council

AUGUST MILK PRODUCTION DROPS BELOW YEAR EARLIER: *(by J. Kaczor)* Based on this week's NASS report on August milk production it appears that most of the heavy increase in dairy cow culls from April through August this year were replaced. From April 28th through September 1st, more than 1,007,000 dairy cows were sent to slaughter but the number of milk cows over that period fell only by 51,000. Based on anecdotal reports a sizable percentage of the culls may have been related to producers who made significant cut backs or who terminated production. If that is so, it means other producers either maintained or increased the size of their herds, despite what appeared to be a looming "nobody wins" financial outlook for U.S. dairy producers for the rest of the year.

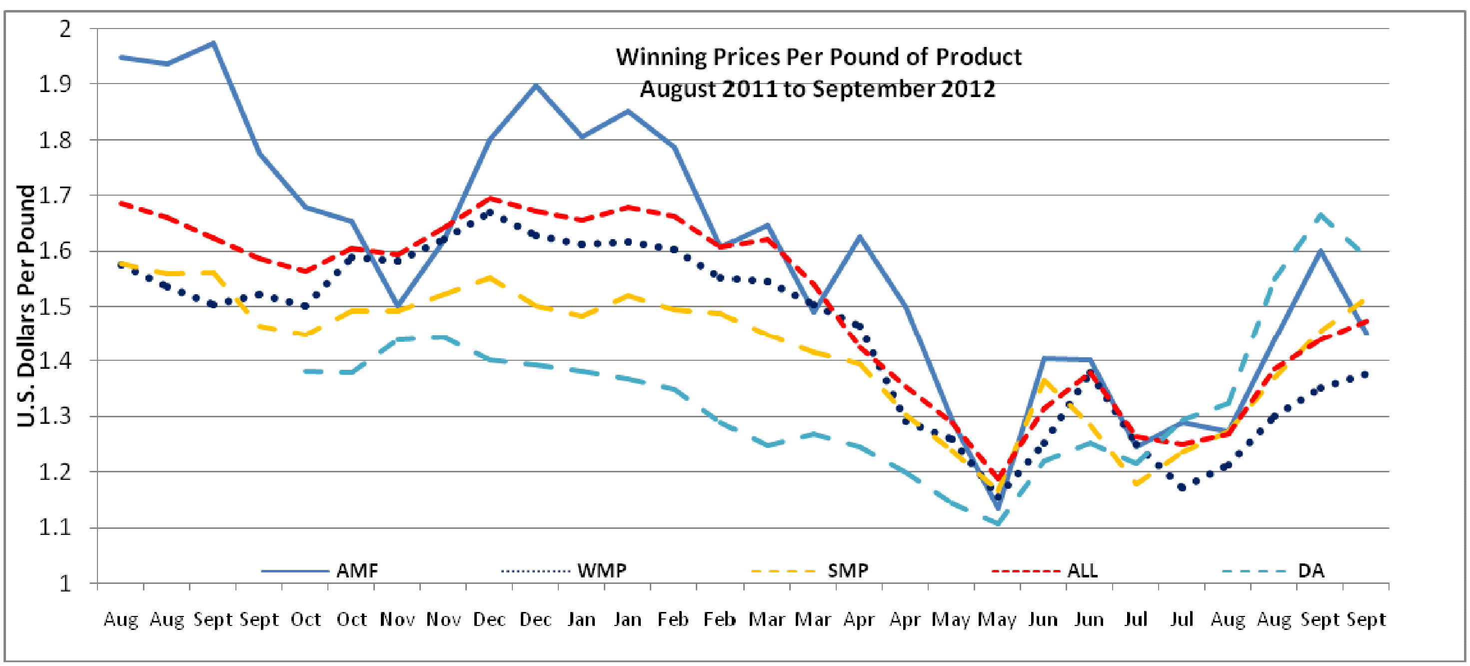


NASS, comparing August to July, reports there were 6,000 fewer milk cows, average production per cow was 1,776 lbs for the month, 21 lbs lower than July, and milk production per day was 6.4 million lbs lower. Compared to last August there were 20,000 more milk cows, production per cow was 9 lbs lower, and total milk production was 45 million lbs lower, a decrease of 0.3%. The decrease in production per cow from July was surprisingly small, considering the effects of the drought on feed costs, the continuing heat wave, and the many reports of negative gross profits for producers.

The chart shown above compares this year's number of monthly milk cows to the numbers for the past three years. The rate of decline from April's high continues to decrease. The monthly decreases, respectively, since then (in thousands) are 11, 21, 13, and 6. Considering the current strong upward movement in dairy product prices, far less heat, feed acreage, demand, and prices in a state of flux, and in some areas that had little or none, a bit of rain, it would not be surprising for the decline in number of milk cows to at least flatten out for the balance of the year.

The milk production report for August serves as one more reminder that averages can sometimes mislead. The biggest surprise in this month's report is the changes in production per cow. While the average change for the 23 top milk producing states was small – 10 lbs per cow less than last August and 20 lbs less than in July, only eight states showed decreases from a year ago – six of them in the West, led by California's astounding drop of 125 lbs per lb. The other western states with lower PPC ranging from -10 lbs to -55 lbs were Arizona, New Mexico, Oregon, Utah, and Washington. California had 2,000 fewer cows than in July (still 10,000 more than last August) and total milk production, because of "various weather, financial and feeding factors," was 203 million lbs less than a year ago, a decrease of 5.8%. Idaho's PPC was +10 lbs for the month but milk production was off by 0.2%. Fourteen of the top 23 states had either no change or higher production than last August. All nine states considered to be in the Midwest showed production increases over last August, seven of them with more milk cows than last August.

GLOBALDAIRYTRADE AUCTION: NET SMALL GAIN ON ALL VOLUME: *(by J. Kaczor)* There were fewer bidders in this week's auction than in the previous session but a few more winners for a bit less total volume. The weighted average winning price for all products in all contracts this week was $1.474 per lb, up $.034 per lb from the winning price recorded on September 4th. Total volume sold was about 3 million lbs lower than the record set last time. The chart below records the changes over the past Fourteen months in prices for the three major volume products that were sold.



This chart reaches back to August 2011 which is the beginning of Fonterra's fiscal year. However, it is not clear how or when they record these sales. The bright red broken line records the weighted average price for all products sold in the auctions. As such, it is a good indicator for Fonterra of the overall changes in total revenue generated from auction to auction because Fonterra's products comprise virtually all of the volume offered and sold. The average price has now moved upward for the fourth straight time. Prices for other products in this auction: cheddar cheese, -$.002 per lb; milk protein concentrate-70, -$.100 per lb; rennet casein, +$.146 per lb; buttermilk powder, -$.028 per lb.

A few comments for clarification. Neither Arla Foods nor Murray Goulburn offered products in this auction and Dairy America again offered only regular skim milk powder, and only in contract #1 (for delivery in October). Through mid-June the volume DA has offered in contract #1 was generally less than one million lbs per auction. Next, as has been noted before, the price for skim milk powder includes and is influenced by the prices received by others for their skim milk powder, which in the case of this auction was little. And, for a fifth straight auction, Fonterra's SMP winning prices are higher than their winning prices for whole milk powder.

Regarding questions about what percentage of Fonterra's production is being offered in these auctions, the good people at New Zealand's major commodity exchange did some research and offered the following interesting and important information. By comparing New Zealand exports of anhydrous milkfat, skim milk powder, and whole milk powder in the 12 months ending this past June to the volumes of these products forecast to be offered by Fonterra via GlobalDairyTrade over the next twelve months NZX concludes the following estimated percentages of New Zealand's three major products will be sold via the auction: anhydrous milkfat, 64%; whole milk powder, 50%, skim milk powder, 45%. Reasonable assumptions were made in calculating these percentages. Verification of the numbers was obtained, courtesy of NZX. That should satisfy most skeptics, including this writer, about the relevance of the auctions. But still, what is going on with what those upside down SMP and WMP prices?