Milk Producers Council

5370 SCHAEFER AVE. SUITE A - CHINO, CA 91710 - (909) 628-6018 - Fax (909) 591-7328
E-mail: mpc@milkproducers.org Website: www.MilkProducersCouncil.org

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TO: DIRECTORS & MEMBERS **FROM: John Kaczor**

MPC FRIDAY MARKET UPDATE – SPECIAL EXTENDED EDITION

CHICAGO MERCANTILE EXCHANGE

Blocks	*- $.1350*	$1.1750
Barrels	*- $.0900*	$1.1800

Weekly Average

Blocks	*-$.0863*	$1.2200
Barrels	*- $.0718*	$1.2045

CHICAGO AA BUTTER

Weekly Change	*+$.0475*	$1.1500
Weekly Average	*+$.0315*	$1.1340

DRY WHEY

WEST MSTLY AVG	w/e 02/27/09	$.1613
NASS	w/e 02/21/09	$.1591

NON-FAT DRY MILK
Week Ending 2/20 & 2/21

Calif. Plants	$.8030	17,078,021
NASS Plants	$.8141	24,709,041

CHEESE MARKET COMMENTS: The five straight weeks of price increases on the CME for block cheddar ended this week, and both blocks and barrels fell by substantial amounts. *Dairy Market News* says that once prices reached the $1.30 per lb level, plants wanted to unload product. One commentator was hoping that cheese prices may start to trade in a tight range, but that could be risky considering that today's closing price is only pennies above the support price. Everyone seems to be looking for an angle. Amid the uncertainty, it looks like retail sales are picking up, supported by low prices and ad features. Nothing has really changed since last week or the week before, regarding the outlook for dairy: low prices, high costs, disbelief about how bad it has gotten in such a short period of time. But change is in the air: over the first 37 days of this year, 71,000 more dairy cows were culled than in the same period a year ago. The key question is how many of them will be replaced. February's milk production report could help indicate if milk production will merely even out or drop below a year earlier.

BUTTER MARKET COMMENTS: Small price increases every day this week on the CME. Production is reported to be as expected, some ice cream operations may be getting an early start on stocking their warehouses, and retail sales are reported to be pretty good. Offsetting that, food service buying continues to lag. Market fundamentals do not seem to support the price increases, as butter was still being sold to the CCC for $1.05 per lb, well below today's close on the CME, and don't forget that big jump in the amount of butter in storage that was reported just last week.

POWDER MARKET COMMENTS: Demand for nonfat dry milk is slow; export interest is low; sales to the CCC by California plants last week represented 60% of total sales. Internationally, Europe increased the amount offered to subsidize exports of butter, cheese, and skim milk powder, and Fonterra continues to lease warehouse space for storage. In the West, nfdm continues to sell for as little as $.77 per lb, 3 cents below support. There is some hope for some powder to be used by cheese plants, but current milk and cheese prices are still far too low for that to happen. There is now about 184 million lbs of product in CCC warehouses in California, but that is sold and payment is on the way, while **Fonterra is sitting on unsold product, is having to find places to put it, is paying 7.5% interest on the stockpile, and is worried about how low Europe will go on prices**. Is that a clear enough picture for what lies ahead?

WHEY MARKET COMMENTS: DMN reports that the market for dry whey is showing a "firming undertone," and the average of the West's "mostly" price has again edged up. DMN reports that many plants seem not to be concerned about the level of their inventories. There are even reports that interest from international buyers is evident. All that is good news, but comes from such a deep, deep pit it is difficult to find solace in those reports. The market for whey protein concentrate remains stuck where it has been for several weeks as buyers continue to push back on prices, which have had a nice run up over the past two months.

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FRED DOUMA'S PRICE PROJECTIONS…

Feb 27 Final:	**Quota cwt. $ 11.32**	**Overbase cwt.**	**$ 9.63**	**Cls. 4a cwt.**	**$ 9.40**	**Cls. 4b cwt.**	**$10.11**
Last Week:	**Quota cwt. $ 11.36**	**Overbase cwt.**	**$ 9.66**	**Cls. 4a cwt.**	**$ 9.40**	**Cls. 4b cwt.**	**$10.20**

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A CLOSER LOOK AT THE GROWTH MANAGEMENT PLAN: *(By Rob Vandenheuvel)* Last week, I wrote in this newsletter that the Growth Management Plan (GMP) had received substantial support at a dairy industry forum hosted by Western United Dairymen on Thursday, February 19th. This week, I'd like to delve a little deeper into the actual details of the GMP. While the GMP is nothing new for the regular readers of our newsletter, **the current economic condition of the dairy industry warrants a fresh look at this simple and achievable policy proposal.** *As a reminder, the presentation made by Dr. Chuck Nicholson from Cornell University on their analysis of the GMP can be found at http://www.milkproducerscouncil.org/021909gmp.pdf.*

First and foremost, what is the Growth Management Plan (GMP)?

The GMP is a proposal that would create a national program that fundamentally changes the inherent incentives in the U.S. dairy industry that promote constant production growth regardless of the market's ability to absorb that growth.

Why should we be considering a Growth Management Plan?

Dairymen are no different from any other businessmen – they respond to incentives. What incentives currently exist in the highly-regulated dairy industry? The incentive to grow, grow, grow. Every morning, dairymen across the country wake up with one question in mind – how do I get the most amount of milk into my tank? There is little or no thought about the market demand for the milk you are producing.

While this type of produce, produce, produce mentality makes a lot of sense to individual dairymen, it makes absolutely no sense to the dairy industry as a whole. Producers need to realign the incentives in our industry and the GMP would do this. The proposal would create a real, tangible, financial incentive for dairy producers to watch and manage the amount of milk that goes into their tanks.

How does the GMP work?

First off, the program must be both national and mandatory. It would be mandatory in the sense that every dairy in the U.S. would have to participate in the program, although the decision about whether to grow or not would rest solely on the individual dairymen. There is nothing in the GMP that prevents growth by a producer.

The GMP would allow for a pre-announced level of annual growth (something in the 1.5-3% range) and for producers that wanted to growth beyond that annual growth, a market access fee would have to be paid *(Cornell modeling estimates the market access fee would range between $0.35 - $1.50 per cwt, depending on the market conditions)*. **It's important to note that the market access fee would be applied to all your production, not just the amount that a dairyman produces beyond the allowable growth.**

The program would operate on a facility-by-facility basis and milk production would be measured on a quarterly basis. Each quarter's production would be compared to that same quarter in the prior year.

For dairies that choose to grow beyond the "allowable growth" and pay the market access fee, their fees would be collected and redistributed back to the producers who held their production to below the allowable annual growth. Once it is determined that a dairy has expanded beyond the "allowable growth," that dairy will have the market access fee deducted from their milk check in the following quarter. That facility's higher level of production then becomes the new benchmark on which the next year's production will be

compared to.

The market access fee will continue to be deducted from the producers' milk check until that facility has a quarter that falls within the allowable growth when compared to the prior year. So for a dairy that chooses to expand, that dairy would need to budget for the market access fee during the first year of the expansion, at which point that new production is part of the dairy's benchmark production level.

So essentially, the program allows any dairy to increase their production if they so choose, but it requires that they pay their fellow dairymen who are holding their production in line, which in turn allows the market to absorb the increased production. **The program is not aimed at stunting growth**, since in normal times we need some level of growth to allow the industry to keep up with population growth. What the industry needs is **smarter growth**.

Since the production is measured on a quarterly basis, the following examples demonstrate how the money would be collected.

Example #1: Under the GMP, an allowable growth of 3% is announced, and producers that choose to grow beyond that 3% must pay a market access fee of $0.75 per cwt on all their milk.

In 2008, a dairy is milking 500 cows and produces 2,700,000 lbs during 1st quarter of 2009. A year later, in the 1st quarter of 2009, that dairy decides to expand his herd to 800 cows, ending the quarter with a total production of 4,300,000 lbs during that quarter – a 60% increase year-over-year. That facility would then have to pay the market access fee of $0.75 on all their milk in the following quarter (which would total about $32,250 in market access fees for that quarter). Their fees would be pooled with the other market access fees and redistributed back to those producers who kept their production below the allowable growth.

Example #2: Same market access fee, same allowable growth. Same dairy – milks 500 cows, and produces 2,700,000 lbs in the 1st quarter of 2008. However, the dairyman decides that he would prefer to hold his production and get his share of the market access fees rather than expanding. That dairy makes sure that his production does not exceed 2,780,000 lbs for that quarter (2,700,000 plus 3% allowable growth), and for that production management, not only does the dairyman not have to pay the market access fee, but he is entitled to his pro-rata share of the market access fees that are paid for that quarter. The Cornell University model shows that the "refunds" could be **$0.39 - $0.61 per cwt on all your milk**, depending on market conditions. So the value of that production management could be worth $10,000 - $17,000 in "refunds" for that quarter, according to the Cornell University modeling.

Simple? Yes. Effective? The best people to ask would be the producers themselves. **Would you pay more attention to how much milk you produce if you knew there was a financial incentive if you held your production in line?**

Who would participate?

The program would have to be national and everyone would have to participate. That doesn't mean that everyone has to stay below the allowable year-over-year growth. **Anyone can grow under this program; they simply have to "buy" that market share by paying a market access fee. That fee compensates their fellow dairymen who are holding their production in line to allow the market to absorb your new production.**

What would the "Market Access Fee" be?

Cornell University modeled several scenarios. Under "normal" circumstances, a market access fee of $0.30 - $0.50 per cwt would likely stimulate enough response from producers to keep our supply and demand in better balance. However, this industry seems to be a magnet for "abnormal" economic conditions. For

instance, this industry has been subjected to a "feed price shock" over the past two years, with a rapid escalation in the price of feed commodities. Cornell University modeled how the GMP might work under this type of "shock," and found that it would continue to stabilize the milk price, but would require a higher market access fee (from $0.74 - $1.50 per cwt) to stimulate enough of a production response to bring the milk price to a profitable and stable level.

The Cornell University model envisioned the program operating like the Federal Reserve. The Secretary of Agriculture could be responsible for making periodic adjustments to the allowable growth and the market access fee to better respond to the current economic conditions.

How would this program affect the type of growth that occurs in this country?

The GMP would certainly change the way dairymen throughout the U.S. think about growth. The market access fee could be budgeted on a one-time expansion (i.e., a dairymen expands his herd, budgets to pay the market access fee in the first year he expands and that expansion then becomes part of his benchmark production).

However, the GMP would have a huge impact on small, incremental growth. For instance, let's assume you started 2008 milking 1,000 cows, and by the end of the year, you were milking 1,050. You've expanded your production by 5%. Did you intend to expand 5%? Maybe; maybe not. You could have easily dried some cows up early, sent next week's cull cows to beef this week, and kept your herd around 1,000 cows, but you didn't. Why not? It goes back to the produce, produce, produce incentives that are inherent to the regulated dairy industry. If you don't have a reason to manage your production, why would you? And while those few extra cows in the supply chain may not seem like much, multiply that incremental growth by the 50,000+ dairymen in the U.S., and you can see how we often wind up with a supply that's a percentage point or two above market demand.

The GMP would give these dairies a tangible, financial incentive to watch and manage their production, keeping that "incidental growth" in check, and keeping our supply in better balance with market demand.

Why does the program apply the market access fee to all of that facility's milk? Why not just apply the market access fee to the production that exceeds the allowable growth?

A two-tiered milk pricing approach like this is used in the base programs implemented last year by the large California cooperatives. While a program like this could possibly work, the GMP was designed the way it is for a couple reasons:

(1) In order to get the kind of production response the GMP expects, the market access fee must be a significant financial consideration for the dairy. By applying the fee to the facility's entire production, that "significant financial consideration" is created. If the market access fee were only applied to the "overproduction," it would need to be much larger (perhaps $4 - $5 per cwt, or maybe even larger) to get the same production discipline from producers. A fee this large would be a tremendous barrier to any growth or new entries into the industry. This is the same problem we see with strict production quotas in places like Canada and Europe – it completely stunts new, innovative minds from getting involved in the industry.
(2) This is why the GMP makes a point of never creating an asset-value for the "production base" in the program. If a dairy shuts down, that "base" dies with the operation. This doesn't prevent new production – all someone has to do to start a new facility is pay the market access fee during the quarters they are growing.

In other words: Under the GMP, "base" is earned – never bought or sold.

Would the Growth Management Plan have prevented the wreck we are currently experiencing?

The intent of the GMP is to minimize the "cyclical" volatility that our industry has. While this "cyclical" volatility has been with the industry for many years, it has continued to get worse, with longer and deeper financial wrecks (i.e., 2009 is worse than 2006, which was worse than 2003, etc.). Cornell University's model shows that by implementing the GMP, we could minimize this cyclical volatility. If you recall, in 2007 the Cornell model predicted that without the Growth Management Plan, we were destined for a wreck in the dairy industry in 2009, before we ever experienced the dramatic rise in exports followed by the rapid collapse. The cyclical volatility alone was going to make 2009 a devastating year for the industry.

What we are experiencing in 2009 is a double-whammy – not only was the industry destined to be on the losing end of the "cyclical" volatility this year, but at the same time we are dealing with a collapse of the global economy, drying up a chunk of the export market we have relied on in the past couple years, and rapidly driving our milk price to government support levels. And while the GMP could not have forecasted or prevented the sudden loss in demand, Cornell University modeling has demonstrated that it could still be utilized to dramatically shorten the amount of time we experience these low prices.

We've all been in meetings or heard folks say, "If everyone could just cut back 3-5%, we could get out of this wreck." Up until now, that concept has been a pipe dream. How can you enforce it? However, if we were able to utilize the GMP during these times to actually reduce supply, we can dramatically shorten the wreck.

In the case of a "demand shock" where a sudden, but temporary demand loss occurs, the GMP could require dairies to pay the market access fee unless they reduced their quarterly production by a set percentage. Not everyone would cut back their production, but enough would to get a real market response.

Cornell University modeled the current economic wreck, and found that if we could set a 5% reduction, and dairies that choose not to reduce by 5% would pay a $1.00 per cwt market access fee, we could take about $3 per cwt off the "bottom" of this wreck, and we could **shorten the length of the wreck by almost a year**.

Again, this is not why the GMP was conceived, but once the infrastructure is in place, we have a tool that can be efficiently used to get the reductions in supply that we need.

Most of the California co-ops have already implemented base plans, and we still saw our milk prices collapse over the past months. Why would a national Growth Management Plan be any better?

First and foremost, California does not operate in isolation. We are part of a national industry. Even though California is the largest dairy state in the nation, it is implausible to think that we could "balance" the supply and demand for the entire country *(although, as an aside – can you imagine how large our "oversupply" would be if our coops <u>hadn't</u> implemented their base plans a year ago?).*

Secondly, the base plans implemented in California were designed to address a local problem – a lack of adequate plant capacity. These bases were simply aimed at identifying the individual dairymen who had expanded most recently, and were therefore asked to pay the increased costs of marketing "excess" milk that the cooperatives had to sell. These cooperatives were implementing a base to balance their own supply and demand, which makes sense for the coop. But that does nothing to change the fundamental grow, grow, grow incentives in the rest of the country.

Would this program affect our ability to compete in the global markets?

The impact on U.S. imports and exports are important and were not fully analyzed in the work Cornell University did in terms of its impact on the import/export of specific products. Additional exploration by Cornell University or others is certainly warranted to see exactly what impacts this program might have on imports and exports.

However, it is arguable that imports would not be greatly affected under the moderate price increases the GMP would create, since the U.S. still has pretty significant barriers to imports for products other than casein and milk protein concentrates. The impact on export markets is likely a larger topic to explore, although the impacts will be product-specific.

On the other hand, there may be some benefits to U.S. exporters interested in longer-term supply arrangements that arise from more stable product prices, even if average prices are a bit higher. **Analyzing the impact on specific export markets would be an important part of further examination as this program moves forward in the public-vetting process.**

So what's the next step?

Ultimately, the Growth Management Plan would have to be approved by Congress. Federal legislation is the only way to implement a national program like this.

The time to act is now. Dairy producers throughout the U.S. are looking for a long-term solution to this devastating milk price volatility. And given the incredibly short memories that the dairy industry tends to have, we all know that the window of opportunity to have this discussion on a national scale will close at some point in the near future.

But first and foremost, we need to at least get our own state on board with the idea. There was tremendous producer support for the GMP at the industry forum hosted by Western United Dairymen last week, and that support needs to be translated into phone calls and conversations with your coop and trade association leadership. If we expect to build a coalition of support for moving the GMP forward on a national scale, we must first all be on the same page here in California. **The success or failure of this program falls entirely on the industry leadership that represents you in your trade associations and cooperatives.** So please, call your coop board members. Call your trade association leadership. Let's move this process forward. That's not to say that we can't continue to examine and fine-tune the program, but we need to move the process forward and have this serious policy discussion while we've got the whole industry's attention.

Got a question or comment about the GMP? We'd love to hear from you. Please send it to gmp@milkproducers.org. It's important that we have a real industry discussion on this program, and in a future issue, we can explore some of the questions/comments we receive from our readers.

And as a final reminder, you can find the presentation by Cornell University's Dr. Chuck Nicholson on the Growth Management Plan at http://www.milkproducerscouncil.org/021909gmp.pdf.

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