

Milk Producers Council

5370 SCHAEFER AVE. SUITE A - CHINO, CA 91710 - (909) 628-6018 - Fax (909) 591-7328

801 S. MOUNT VERNON AVENUE - BAKERSFIELD, CA 93306 - (661) 833-2549

E-mail: mpc@milkproducers.org

Website: www.MilkProducersCouncil.org

DATE: October 09, 2009
TO: DIRECTORS & MEMBERS

PAGES: 4
FROM: Rob Vandenheuvel

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE

Blocks +\$.0675 \$1.5025
Barrels +\$.0100 \$1.4300

CHICAGO AA BUTTER

Weekly Change +\$.0025 \$1.2375
Weekly Average -\$.0050 \$1.2380

NON-FAT DRY MILK

Week Ending 10/02 & 10/03

Calif. Plants \$.9580 9,868,657
NASS Plants \$1.0102 9,006,394

Weekly Average

Blocks +\$.0485 \$1.4670
Barrels +\$.0465 \$1.4280

DRY WHEY

WEST MSTLY AVG w/e 10/08/09 \$.3325
NASS w/e 10/03/09 \$.3018

John Kaczor is unavailable this week to provide commodity comments.

FRED DOUMA'S PRICE PROJECTIONS...

Oct 09 Est: Quota cwt. \$ 13.60 Overbase cwt. \$11.91 Cls. 4a cwt. \$11.29 Cls. 4b cwt. \$12.88
Last week: Quota cwt. \$ 13.43 Overbase cwt. \$11.73 Cls. 4a cwt. \$11.29 Cls. 4b cwt. \$12.46

THE DAIRY SAFETY NET: MEND IT, DON'T END IT: (By Geoffrey Vanden Heuvel) Dairy producers are in terrible shape right now. Clearly, the government's current dairy safety net is not working as it should. On September 21, National Milk Producers Federation put out a press release informing the rest of us that they are working on "sweeping changes" to the structure of the dairy industry as we know it. They are proposing eliminating the support price program and the MILC program and replacing it with a still undefined "revenue insurance" program, as well as essentially deregulating class II, III and IV in the federal order program and replacing that with a "competitive pay price" as the class I mover. In fairness to National Milk, we will let them flesh out their proposal before we make any substantive comments on it but the question for today is can the current program be fixed.

The Dairy Product Price Support Program (DPPSP) and the Federal Milk Marketing Order (FMMO) program are two major components of the government dairy safety net. Both are important, and policies guiding both need to be adjusted and coordinated to make them effective safety net tools.

The objective of the DPPSP is to clear the market of surplus products and provide "support" or a floor under milk prices. Clearly, as currently practiced, this system is not working adequately. USDA's Commodity Credit Corporation (CCC) is the entity that has the responsibility to actually purchase the surplus dairy products and it has not actually bought any cheese under the DPPSP for over 15 years. Why? Some folks will say it is because the packaging specifications that the CCC requires are expensive and out of date. But that is not the whole reason. A much larger factor is that the FMMO pricing formulas have a fixed make allowance embedded in them that virtually guarantees a profit margin for cheese plants as long as they sell their cheese for the average NASS cheese price. (The National Agriculture Statistics Service cheese price, which drives the milk pricing formulas, is determined by a survey of what the average price cheese plants sell their cheese for.) Because of the way the milk pricing formulas work, cheese plants make the same margin regardless of whether the cheese price is \$2 a pound, \$1.50 a pound or \$1.00 a pound. To protect that margin all they have to do is make sure that they are selling their cheese for the average market price. The cheese plants incentive is to make sure they get paid the NASS price for their cheese, as long as they do, the producers absorb all of the price risk. Cheese makers are clearly unwilling to take the risk of selling cheese to the CCC program and how can we blame them? The system does not penalize them for selling cheap cheese. This is a misplaced incentive. It can be fixed.

How could the existing system be fixed? First, the federal order class III and IV formulas should floor the product value portion of the formula at the support purchase price. If cheese makers decide to sell their cheese for a price below the CCC purchase price, they should bear the cost of that decision, not producers.

Second, the make allowance needs to be reconfigured and made variable. When cheese prices are low, cheese makers need to have a smaller make allowance. The make allowance should increase as cheese prices go up. This change would give cheese makers an incentive to move cheese prices up because they would have a financial stake in the outcome. It would also motivate them to push back production when cheese prices and therefore plant margins were low.

A third change needs to be the mix of products that the CCC purchases. Right now they only purchase butter, nonfat dry milk and cheddar cheese (although they have not really purchased cheese in many years). They could purchase other types of commodity dairy products. The support price should be raised to narrow the gap between the support price and the cash cost of production. As our experience of the last year has taught us, the support program really does act as the floor on milk prices. Producers are not able to quickly adjust the milk supply when the supply/demand balance gets out of whack. As bad as it has been, without the government involvement how low would prices have actually gotten. \$5 per cwt.????

What is the right level of support price? That is a good question. Up until 1977, the Secretary of Agriculture had the discretion to adjust it up or down based on his evaluation of what price was necessary to keep the dairy industry stable. The 1977 farm bill removed that discretion from the Secretary and mandated that the support price be 80% of parity. The practical impact of that policy was to raise the support price from \$8.26 per cwt in 1977 to \$13.49 per cwt in 1981. Clearly, that was too much. Since 1981 the support price has been reduced all the way down to \$9.90 per cwt (although it is really closer to \$9.00 in practice). The current farm bill has given the Secretary some discretion in setting the support price, which he used a couple of months ago to raise it temporarily. Should he extend that? Should it be higher? I would think something in the \$11.50 range would be more reasonable. Producers get the same price signal to reduce production when they are losing \$3 per cwt, as they do when they are losing \$5.50 per cwt. The wreckage and the long term damage is just less.

What about the Chicago Mercantile Exchange (CME)? There is a lot of criticism of the prominent role the CME plays in pricing milk. In concept there is nothing wrong with the CME. But as producers we need someone at the Exchange who is interested in keeping the price up. In a normal market the sellers should be interested in driving the price up and the buyers should be interested in driving the price down. But as I explained above, the sellers of cheddar cheese really don't care what they sell the cheese for as long as it is the "market" price, because the formula gives them a fixed make allowance regardless of what the market price is. This has led to a perverse situation where neither the sellers nor the buyers really care to drive the price up. Fixing the formula as I suggested above would help to address this, as would having our cooperatives either individually or collectively participating as buyers at the CME (instead of sellers, one of the biggest cheese sellers at the CME during the past six months was a major cooperative who shall remain unnamed).

We need to resist the calls to shut down the dairy industry's involvement with the CME. I have seen no competitive pay price proposal that offers a better outcome for producers than the I have outline above. The problem with a competitive pay price system (deregulation) is that in most of the county there is no competition for milk. Without competition, cheese plants will construct formulas, even without government regulation, that transfer all the price risk to producers. That is what happens in Idaho now. They have no regulation, but the results are the same.

In summary, remember that the dairy safety net functions at the bottom of the price cycle. We still need to add a program to manage our growth so that the range of the price cycles is reduced. But given the nature of the dairy industry (milk is very perishable and cows cannot be turned off and on like a light switch) having a safety net is very important. Clearly the safety net that has existed for decades in the dairy industry needs some repairs, but totally scrapping it is a very risky proposition and not necessary. Let's mend it, not end it.

TRANSFERABILITY OF “BASES” – A HOT TOPIC FOR THE DAIRY PRICE STABILIZATION PROGRAM: *(By Rob Vandenheuvel)* As the readers of this newsletter are well-aware, there is a growing debate throughout the country about what we can do to address the massive milk price volatility that has become commonplace in the dairy business. An idea gaining national support amongst producer groups is the Dairy Price Stabilization Program, or the DPSP. MPC has been promoting the DPSP for quite some time, and one recurring question that comes up is, “why doesn’t the program allow for full transferability of a dairy’s ‘base’?”

For those who may not be familiar with the DPSP, here’s a brief summary:

- The program would operate on a facility-by-facility basis and compare each quarter’s milk production to the same quarter in the previous year (i.e., your production during the 3rd quarter of 2009 would be compared to your production in the 3rd quarter of 2008).
- A dairy producer advisory board would be established to advise the Secretary of Agriculture on two variables in the program.
 - The first variable would be the “allowable year-over-year growth.” This figure – likely to be in the 1-3 percent range – would be the amount a facility could grow their quarterly production over their production in the same quarter last year without any fee being triggered by the program.
 - The second variable would be a “market access fee” that would be paid by any facility that exceeds its allowable year-over-year growth.
 - For each quarter, all the market access fees collected from the dairies that expand beyond their allowable growth will be distributed to the dairies that did not.
- This program really acts as a market allocation tool – an agreement amongst producers to allocate future market share. It would allow any dairy that wishes to expand their share of the market to do so, but they would have to budget for a market access fee that would be given to the rest of the dairies that held their production in line.

The program is designed to serve as a supply management program that avoids the pitfalls we’ve seen in other programs that have been tried, such as the quota system that operates in Canada. Two huge downfalls with the Canadian quota system are:

- There is a huge asset value that has been attached to their production quota. That quota trades around the equivalent of \$30,000 per cow, which is a tremendous amount of industry capital tied to the value of that quota, rather than being invested in the dairy operations.
- In addition to being an inefficient use of industry capital, the high asset value also creates a huge barrier to new entries that may be interested in getting into the industry.

The DPSP avoids these two major pitfalls by keeping the market access fee as low as possible (*Cornell University’s Program on Dairy Markets and Policy ran the program through their analytical model and determined that the market access fee will normally range from \$0.35 - \$1.00 per hundredweight*) and by greatly restricting the transfer of “bases.” Under the DPSP, the only two opportunities to transfer base are: (1) to combine two or more facilities that are under the same ownership; or (2) when a facility is taken over by a new operator. Of course, if that new operator increases their production beyond that facility’s allowable year-over-year growth, they will have to pay a market access fee just like any other dairy.

So why doesn’t the program allow bases to be fully transferable? The answer to that question lies in the way the program is structured. Under the DPSP, when a producer is determining whether or not to expand his share of the market, he will consider two things: (1) the market access fee that must be paid for the first year after the expansion; and (2) the amount of “dividend” (*his share of the market access fees paid*) that he will forfeit for the next year if he decides to expand. Those two factors combine to represent the full financial incentive the program creates.

If bases were able to be transferred under the DPSP, it could erode the amount of dividends that are available to the dairies that hold their production under their allowable growth. That is because every dollar that is transferred from a buyer of base to a seller represents one less dollar put into the market access fee “fund” to be distributed to dairies that hold their production.

If the program has fewer dividends available to distribute to producers that hold their production, the advisory board and the Secretary will likely need to increase the market access fee in order to maintain the same financial incentive (*since like I mentioned above, it is the market access fee plus the forfeited dividend that makes up the full financial incentive*)

Increasing the market access fee will increase the value of the base, since that value will obviously be attached to the current market access fee. As more and more base is transferred from producer-to-producer, the board will have to respond by continually increasing the market access fee. It's a snowball effect that could result in both the market access fee and the value of production base continually ratcheting higher. A higher market access fee (and subsequently a higher value attached to the base) could create the exact same pitfalls we see in the Canadian quota system.

Allowing base to be fully transferable runs the risk of restricting future production growth and keeping new entries out of the industry. As we structure the details of this program, we need to remember our ultimate goal: we want to allow our industry to continue growing, but to do so in a more strategic manner, which will get us out of the massive boom/bust cycles we've gotten ourselves in.

ONE MORE WEEK TO SIGN UP FOR CWT HERD RETIREMENT PROGRAM: (*By Rob Vandenheuvel*) Last week, Cooperatives Working Together (CWT) announced their 3rd herd retirement program of 2009. As with the program that was just recently completed, the maximum bid they will accept is \$5.25 per hundredweight. The deadline for submitting your bid is a week from today (October 15th). For more information, you can visit CWT's website at www.cwt.coop.

ALLIANCE OF WESTERN MILK PRODUCERS PETITIONS FOR A MILK PRICE INCREASE; MPC SENDS A LETTER SUPPORTING THE PETITION: (*By Rob Vandenheuvel*) This past Monday, the Alliance of Western Milk Producers (representing CDI and DFA's Western Area Council) sent a petition to the California Department of Food and Agriculture requesting a hearing to consider increasing the Class 1 (fluid), 2 (yogurt, cream, etc.) and 3 (frozen products) minimum milk prices. As many of you will recall, CDFA reduced the prices of these three classes on January 1st, citing a surplus of milk in California and concerns with interstate competition. The price reduction for Class 1 was \$0.35 per hundredweight, while the reduction for Classes 2 and 3 was \$0.26 per hundredweight.

In the Alliance's petition, they are requesting an increase in the Class 1 price of \$0.50 per hundredweight and an increase in the Class 2 and 3 prices of \$0.26 per hundredweight. Assuming 15 percent Class 1 utilization in the California pool and a combined 10 percent utilization for Classes 2 and 3, this increase – if granted by CDFA – would raise the overall pool price for producers by about \$0.10 per hundredweight. The full petition by the Alliance can be found at: http://www.cdfa.ca.gov/dairy/pdf/hearings/2009/Class1petition_2009.pdf.

MPC recognizes that a price increase of \$0.10 per hundredweight obviously won't close the gap we're currently facing, but a lot has changed in the past year since we held that hearing and the facts simply don't support maintaining that price reduction. We are supporting the Alliance's hearing petition and have sent a letter to CDFA asking them to grant the hearing and to schedule it immediately so that producers can receive the price relief as soon as possible. The MPC letter can be found at: www.milkproducerscouncil.org/100509mpcletter.pdf.

MPC MONTHLY BOARD MEETING NEXT TUESDAY – ALL MPC MEMBERS INVITED TO ATTEND: (*By Rob Vandenheuvel*) Next Tuesday, the MPC board will be holding our regular monthly board meeting. This month, our meeting will be held at our office in Chino. All MPC members or prospective members are urged to join us at the meeting. Lunch will be provided, so please give Debi a call (909-628-6018) if you'd like to join us.