

Milk Producers Council

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CHICAGO MERCANTILE EXCHANGE

Blocks +\$.0025 \$1.7025
Barrels -\$.0200 \$1.4400

CHICAGO AA BUTTER

Weekly Change -\$.1250 \$1.3250
Weekly Average -\$.0435 \$1.3945

NON-FAT DRY MILK

Week Ending 12/11 & 12/12

Calif. Plants \$1.2750 13,453,438
NASS Plants \$1.2756 16,297,418

Weekly Average

Blocks +\$.0005 \$1.7005
Barrels -\$.0040 \$1.4560

DRY WHEY

WEST MSTLY AVG w/e 12/17/09 \$.3950
NASS w/e 12/12/09 \$.3634

CHEESE MARKET COMMENTS: Forty five loads of block cheese traded on the CME this week; prices held steady through Thursday and rose by \$.0025 per lb on Friday when barrels **lost** two cents. While this week's results don't settle anything, it does suggest that the answer to the question about whether block prices are too high or barrel prices too low may be "neither." The price spread is now at \$.2625 per lb, and it has now been above \$.20 per lb for thirteen straight trading days. Call it the Big Spread, because it is now a record. *Dairy Market News (DMN)* notes that manufacturers are responding by reducing barrel production generally and by shifting production from barrels to blocks where they can. The CME prices are gradually being reflected in the sales prices reported to NASS which make up the federal order Class III price. Over the past five weeks that price spread has gone from a **plus** \$.007 per lb to a **negative** \$.107 per lb. DMN finds that buyers continue to assess their future needs, while trying to keep inventories from growing. Looking ahead, it doesn't look like shortages of cheese will occur, but competition among cheese plants and between cheese plants and butter/powder plants should help to support cheese prices.

BUTTER MARKET COMMENTS: In a week with generally positive news about butter demand (retail sales brisk, restaurant sales improving, and some export demand looming), prices on CME's spot market dropped \$.125 per lb with few sales. It was "sentiment" that caused the price weakness, and possibly buyers' plans to minimize inventories at year end. DMN reports the export interest has reached the point where some plants are now producing butter containing 82% butterfat, which is the international standard. Short term, through December, lower sales of fluid milk should result in some extra raw milk being made available for churning – which is normal, and expected for this time of year. The balance between supply and demand for butter in the U.S. continues to be balanced.

POWDER MARKET COMMENTS: Prices for dry nonfat milk, buttermilk, and whole milk are steady to slightly higher this week. The two major price series for NFD milk shipped last week are now virtually even at about \$1.27 per lb on slightly higher volume, about \$.16 above where they were four weeks earlier. Dry whole milk continues to come in (small amounts) from Australia, according to DMN. Current production is edging up, reflecting the availability of more milk and higher prices. Reports that production of milk and skim milk powder in New Zealand is no more than expected may be helping to support current U.S. prices.

WHEY PRODUCTS MARKET COMMENTS: Prices are mostly higher and DMN reports the market to be firm for the full line of whey-based products, but buyers are said to again be comparing dairy protein prices to prices for plant proteins. Nonetheless, buyers appear to be anticipating less supply of the good stuff next year, which should help to support prices at least at their present levels. The West's "mostly" price rose by another full cent this week. Exports of whey products through October this year are steady to strong.

FRED DOUMA'S PRICE PROJECTIONS...

Dec 18 EST: Quota cwt. \$ 16.19 Overbase cwt. \$14.49 Cls. 4a cwt. \$14.66 Cls. 4b cwt. \$15.18
Last Week: Quota cwt. \$ 16.16 Overbase cwt. \$14.46 Cls. 4a cwt. \$14.47 Cls. 4b cwt. \$15.17

CDFA ANNOUNCES TEMPORARY INCREASE IN MILK PRICES: *(By J. Kaczor)* Based upon testimony and evidence reviewed at the hearing held on November 9th, Secretary Kawamura approved a recommendation by the hearing panel to implement increases in all classes of milk usage for a period of three months, beginning with milk marketed on January 1st. The estimated effect of the increases on pool prices is \$.155 per cwt over the three month period. In making the recommendation, the hearing panel considered a number of other proposals including permanent increases in price levels or permanent changes to some of the state's price formulas. Included among the latter were proposals by Milk Producers Council to use the NASS sales prices for nonfat dry milk instead of the California plant average prices in the Class 4a butter/powder price formula, and to establish a variable factor for whey prices which would have split the revenue from future increases in whey prices evenly between producers and manufacturers.

The written discussion of all proposals by the hearing panel, including those that would have decreased producer prices, appears to have fairly considered a wide number of factors which affect all segments of the industry. Lack of consensus on some and lack of adequate notice for others were reasons given for rejecting most of the proposals that were presented. While the decision does in fact increase producer prices by about \$0.15 per hundredweight for January-March 2010, MPC still feels this decision falls well short of what would be considered a fair result from that hearing.

USDA ANNOUNCES DECISION ON ONE-TIME DIRECT PAYMENTS TO PRODUCERS: *(By J. Kaczor)* USDA announced yesterday how the \$290 million authorized by Congress for loss assistance to milk producers will be distributed. It will be a one-time direct payment based upon the amount of milk produced in 2009, capped at 6-million lb "per dairy operation unit," and the expected payment rate was said to be about \$.32 per cwt. That sounds like it could mean per dairy location; clarification will be gotten from USDA's Farm Service Agency. The announcement did not say when the payments will be issued, although unofficial reports indicate that producers will begin receiving the payments by the end of the year. Calculations will be made by FSA, which has estimated that more than 95% of U.S. producers will receive the payment without having to fill out an application (since most producers have already been submitting their production data this year for the MILC program).

MANAGER'S COMMENT: *(By Rob Vandenheuvel)* After several months of waiting, producers have finally confirmed our suspicions – that once again, Congress has tailored its help towards the smaller producers. This decision, which caps the payment at 6 million pounds of annual production (which is about the equivalent of 275 cows) is certainly better than the 2.985 million pound cap in the MILC program, but is still heavily skewed towards the smaller dairies outside the Western United States.

With that said, our industry's recovery was never going to be based on this program. These payments are only a tiny band aid, trying to cover the gunshot wound producers have sustained in 2009. We need long-term stability in our industry, and that is why MPC continues to work so hard towards fundamental long-term changes in our industry, i.e., the Dairy Price Stabilization Program.

MILK PRODUCTION IN NOVEMBER CONTINUES RECENT DOWNWARD TREND: *(By J. Kaczor)* USDA's estimate of number of cows, production per cow, and total milk production for November, released today, indicates the amount of milk available for processing in the U.S. continues to decline. However, the decline in number of cows, compared to the previous month, has tapered off. There were 246,000 fewer dairy cows, **27 more lbs production per cow**, and 152 million lbs less milk in November, compared to a year earlier. Based upon the weekly reports of number of cows culled in November, it **appears** that little of CWT's latest herd retirement program was completed during the month. **California** had 70,000 fewer dairy cows, **20 lbs less milk per cow**, and 179 million lbs less milk in November, compared to last November, a decrease of 5.4%, which is about equal to the percentage decrease shown for October.

A LOOK BACK...A LOOK FORWARD, PART TWO: (By Rob Vandenheuvel) Last week, I republished an article by MPC President Syp Vander Dussen called, "My View on Milk Production Increases." The article had originally run in November 2008. While that was more than a year ago, I thought it would be valuable for our readers to get another chance to read segments from those articles, which still very much apply today.

As I promised in last week's issue, today I am including an article originally written by Geoffrey Vanden Heuvel for our November 21, 2008 issue. The article follows up on the comments that were published last week by Syp.

My reason for doing this is simple: As we wind down the most devastating financial year in the modern U.S. dairy industry, it's important that we reflect over where we were a year ago and where we are now. And most importantly, what do we want to accomplish going forward?

More Comment

By Geoffrey Vanden Heuvel

(Originally published in the November 21, 2008 MPC Friday Newsletter)

Syp Vander Dussen, in his outstanding articles last week, explained the "**magic of pooling**" concept. He wrote, *"If I produce one extra load of milk, which of course will go to powder (and possibly to the CCC), it will have a value of less than \$10 to the pool, but I will receive a blend value of approximately \$15.00 cwt for that load. But remember, the income to the pool bucket is about \$10.00! That \$5.00 loss is shared by all! Stated in again another way, it is in the best interest of every producer to produce as much milk as he can, always, because the lower value for that excess product is borne by everyone."*

What Syp is pointing out is the fatal flaw in our milk pricing regulation: **the price risk associated with increased production is not borne directly by the person making the production increase; it is transferred to the group at large.** Basic economics tells us that supply and demand for any product is kept in balance by each individual participant's calculation of risk versus reward. The "**magic of pooling**" transfers the risk to the entire group and the individual is left with the "reward." Because of this reality, it is perfectly rational for each individual producer to grow production indiscriminately, while at the same time it is obviously irrational for dairy farmers collectively to produce more milk than can be profitably marketed.

News Flash! Processors like this! At a recent milk price hearing [October 2008], the Dairy Institute made an impassioned argument that CDFRA must *reduce* class 1, 2 and 3 milk prices. They claim the cost of doing business in California is so high that California processors need cheap milk in order to expand. The Dairy Institute argues that cheap milk and unbounded growth is good for the California dairy industry because *"Producers who are among the lowest cost and most innovative are also most often those who wish to expand their operations. In many cases these are also younger dairymen, the future of our industry. If these younger, innovative and low-cost producers are unable to grow in California, they will likely move their operations to states where they will have the opportunity to grow. As a result, California will lose its most efficient producers, and the overall cost of production will rise relative to other states."*

It is obvious that the logic of processors is also corrupted by the "magic of pooling". They apparently believe that regardless of the price they pay for milk, dairy farmers will produce more than enough milk as long as there is a home for it and a truck willing to take it there. We must admit that our past history is full of evidence that this is true. But why do we, as dairy producers, do this? Is it a rational decision on our part to add production based on the prospect of an increased profitable demand for milk? Or is it simply due to the perverse incentives inherent to the "magic of pooling"?

So what have producers received in return for our "cheap milk" policy in California? Has this cheap milk led to innovation and value-added processing in the state? The fact that nearly one third of California's solids nonfat production is turned into powder would create real doubts about the effect of this policy in bringing about processor innovation. The truth is that California processors don't need cheap milk to spur the kind of innovation that we need to lead this state into the next generation; they need exposure to some competition. It is that

competition for a milk supply that would drive processors to innovate so that they would be able to out-pay their competitors and therefore attract more supply to their plant.

In a normal business relationship, buyers and sellers have an incentive to protect the financial health of the other party. If buyers are not profitable, then over time, they will no longer be able to buy. Conversely, if the sellers are not profitable, there will soon be no product to buy. In the dairy business, the “magic of pooling,” by design, separates buyers and sellers. It mutes market signals that would normally adjust supply and demand to enable a successful industry. Absent the “magic of pooling” processors would not be so confident that an ever-increasing milk supply would be available for the taking. They would be much more attentive to the financial needs of their producer suppliers. Conversely producers – absent the “magic of pooling” – would make production decisions based on real market demand as opposed to the muted signals emitted by the current system.

Because of pooling, California producers have paid little attention to milk marketing and maximum attention to lowering the costs of production. **But simply being a low-cost producer of a product does not constitute everything that is demanded of a successful business.** Finding and developing profitable markets for the products you produce is as much or more of the secret to success as having low production costs.

California processors on the other hand, including our manufacturing cooperative processors, have not had the incentive to work at profitably marketing milk. They have huge amounts of cheap milk coming their way year after year. Big make allowances have facilitated a milk disposal strategy as opposed to a milk marketing strategy. The result is a California processing sector that is woefully lacking in innovation. This situation is deadly for our industry. We need change.

What kind of change should we look at? While there are some who might argue that it is time to completely scrap the whole system and deregulate (New Zealand and Idaho have done this), in my opinion we do not need to go that far. We can maintain a regulated system, but there needs to be some type of growth management. New production must not be able to demand market share just by showing up; some type of buy-in needs to be created. Secondly, some space in the California system needs to be carved out to create competition for the manufacturers. A huge impediment to processor innovation and value-creation comes from the strictness of the California regulated system. There is only one way to buy Grade A milk in California and that is to pay the state established monthly minimum price. That price fluctuates wildly and that volatility kills processor incentive for market innovation.

Necessity is the mother of invention and the status quo is not sustainable. California has always been a place where we are not afraid to lead and innovate. We have had a great run with the existing system but a recalibration is necessary. **Our basic regulatory program needs to be retooled to create the proper incentives.** Producers and processors must both be exposed to some measure of risk, and flexibility and competition need to be introduced into our system. With the proper incentives there is no reason why our processors and producers cannot adjust and thrive in the future.

There are a number of ideas along these lines that have been suggested by Milk Producers Council over the past year. We have had difficulty getting the industry to engage. There seems to be a real reluctance on the part of the “establishment” to consider serious change. But it certainly is not too late. The California dairy industry has a lot going for it; what we need now is courage to face the future with our hopes and not our fears.

The California dairy industry has taken pride in being a national leader, and we’ve reached another defining moment. We must use our God-given minds to engage with each other and come up with concrete plans for the future of this industry. The status quo will simply force us to manage our decline as the nation’s premier milk producing state. The time for action is now.

MANAGER’S COMMENT: *(By Rob Vandenheuvel) This “call to action” was published more than a year ago. Since then, our industry has been dragged through financial devastation. But did that devastation result in any action by our state’s leaders? Have we been able to make fundamental changes, not only in California, but*

across the country? Unfortunately for producers, the answer is a resounding “no.”

In the past fifteen months since California milk prices began to collapse, Milk Producers Council has put several quality ideas on the table:

- *A proposal to get producers a larger share of the whey stream revenues;*
- *A proposal to inject real competition into our state’s powder market, giving our powder makers an incentive to get more value from the products they make (and in turn, more money for producers);*
- *A proposal to get more money from the market to pay for our transportation subsidy system, instead of having producers pay the entire **\$3 million per month** bill;*

*Unfortunately, our state’s producer leadership has not supported **any** of these proposals. Instead, our leaders have asked CDFA for two hearings in the past year:*

- *The first – October 2008 – asking for a six-month increase of about \$0.25 per hundredweight on producers’ checks (which actually resulted in a permanent decrease of about \$0.08 per hundredweight); and*
- *The second – November 2009 – asking for a permanent increase of about \$0.10 per hundredweight on producers’ checks (which resulted in a three-month increase of about \$0.15 per hundredweight).*

*The proposals I mentioned above that were made by MPC were presented at these two hearings. We got **no support** from any of the producer testimony at those hearings.*

The other major proposal put forth by MPC over the past year has been the Growth Management Plan, also known as the Dairy Price Stabilization Program. MPC has worked hard with other groups throughout the country to build support for the program. For almost three years, Syp Vander Dussen, Geoffrey Vanden Heuvel and I have traveled from coast-to-coast promoting the idea. We’ve also worked with House and Senate offices to develop legislative language for the program.

So what have the producer leaders in our state done? Sure, there have been meetings held and task forces established; but beyond that, our producer leadership has failed to provide any meaningful assistance in promoting the program.

If someone graded 2009 on what our industry’s leadership – both in California and nationally – has accomplished in response to the devastation producers faced, you would be hard-pressed to come up with a passing grade. We can only hope that 2010 brings about better results. You can be sure that MPC is not giving up.