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TO: Directors & Members **FROM: John Kaczor**

MPC FRIDAY MARKET UPDATE

CHICAGO CHEDDAR CHEESE		
Blocks	*+$.0800*	$1.6500
Barrels	*+$.0625*	$1.5325
Weekly Average, Cheddar Cheese		
Blocks	*+$.0955*	$1.6100
Barrels	*+$.0578*	$1.5238

CHICAGO AA BUTTER		
Weekly Change	*+$.0125*	$1.4000
Weekly Average	*+$.0121*	$1.3981
DRY WHEY		
Dairy Market News	w/e 06/01/12	$.4838
National Plants	w/e 05/26/12	$.5240

NON-FAT DRY MILK		
Week Ending 5/25 & 5/26		
Calif. Plants	$1.1302	21,155,940
Nat'l Plants	$1.1317	34,457,764
Prior Week Ending 5/18 & 5/19		
Calif. Plants	*$1.1440*	*20,970,560*
Nat'l Plants	*$1.1449*	*32,735,694*

CHEESE MARKET COMMENTS: For the third time this year block cheese prices on the CME have risen to above the $1.60 level, closing at $1.65 per lb today. Barrel prices have followed somewhat the same pattern, although at lower levels. Both styles received nice increases this week, but last week's unsustainable price spread of $.10 per lb between the two is now $.1175 per lb. Production continues to be fairly heavy but sales, including exports, also has been good, with some excess continuing to clear to inventories. Trading was light. All block price changes this week came from bids and all barrel price changes came from offers. That is as strange as the present price differential between them. Prices reported to AMS for shipments made two weeks ago reflected a price differential of about $.04 per lb, and is about $.03 per lb for last weeks' shipments, so the differential is obviously not a problem for most buyers and sellers – it may exist only at the margin – and should soon revert to a more normal difference. *Dairy Market News* says most manufacturers say their present inventories are not burdensome. They, along with their major buyers, are looking ahead for guidance on the direction of U.S. milk production towards the end of the year. Class III milk futures, showing skepticism about current prices, were marginally lower for the week, not reaching to the $16 per cwt level until October. Cheese futures also lost some value but still reflect premiums to the Spot prices, ranging from $.03 per lb to $.09 per lb through November.

BUTTER MARKET COMMENTS: The market's indifference shown last week to the report of the huge increase in the amount of butterfat products in cold storage at the end of March continued unabated this week as prices on the CME increased for a fourth straight week. There were relatively few trades again this week, and a good balance between bids and offers. The total increase over the last four weeks is not great -- $.08 per lb – but the apparent consensus viewpoint may be focused on the balance of the year, influenced by the expectation of a sizable cut back in milk production as producers adjust to what could be a protracted period of tight margins. Butter sales were reported to have been strong leading up to last weekend's holiday, but official numbers for May's production and usage are still several weeks away. Butter production appears to have passed its annual peak but *DMN* continues to hear that butter stocks are still increasing. Futures prices this week fell a bit lower for June through September, despite the increase in the spot prices, and rose thereafter. June's $1.42 is the low price for the year; November's $1.515 is the high.

POWDER MARKET COMMENTS: *DMN* heard this week that manufacturers of NFDM in the East and Central regions of the country see their inventories as coming into balance or at least closer to a better balance. Prices are reported to be higher in all regions. Part of the apparent increase in sales is attributed to increased usage by cheese plants, and likely continuing heavy exports. However, based on monthly production and weekly sales reports for California plants, it appears production of NFDM and skim milk powder over the first four months this year exceeded shipments by about 90 million lbs. Prices for fairly heavy shipments made last week slipped by about a penny per lb nationally and for California plants. More sales of grade A powder also occurred this week on the CME, eleven loads, and the price increased by another $.03 per lb, to $1.185 per lb. If there is a change of market sentiment, it could be attributed to the USDA/FAS report that China will be increasing its imports of SMP this year by about 110 million lbs, while reducing its imports of whole milk powder by about the same amount. Whatever the reason, it is certainly good to see signs that prices for the major U.S. dairy powder product may have reached a 52 week bottom. Increased usage of buttermilk powder is helping to stabilize prices and offers hope that stocks will continue to move lower.

WHEY PRODUCTS MARKET COMMENTS: The supply of dry whey appears to be in fairly good balance with its demand. Export sales continue to do well, although price pressure, mainly from Europe, may test the resolve of U.S. shippers. [Would there be a problem if they had managed their price or cost risk, as milk producers are continually being reminded to do?] Prices for last week's shipments lost about $.015 per lb and are now down to about where they were a year ago. "Mostly" prices for the central and western regions are averaging about $.05 per lb lower than the national sales price. *DMN* says dry whey production continues to be somewhat limited as fluid whey usage for higher concentrated products appears to continue to increase. The current supply of WPC-34 has increased to the point where prices have softened, making them more competitive with NFDM, and spot loads are readily available. Prices for the whey stream product garnering the greatest returns for manufacturers, dry lactose, have shifted lower, says *DMN*. Competition from European exporters was given as one reason for the weakening prices.

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FRED DOUMA'S PRICE PROJECTIONS…

June 01 Est:	**Quota cwt. $15.83**	**Overbase cwt. $14.14**	**Cls. 4a cwt. $13.37**	**Cls. 4b cwt. $14.84**
May '12 Final:	**Quota cwt. $15.44**	**Overbase cwt. $13.74**	**Cls. 4a cwt. $13.45**	**Cls. 4b cwt. $13.56**

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A QUICK LOOK AT APRIL USAGE OF MILK: *(by J. Kaczor)* The report on dairy product production in April was released by NASS at noon today. There was 3.2% more milk produced than last April and fluid milk sales (class 1 usage) were 4.1% lower than last April. Therefore, the additional volume of milk available for manufacturing uses in April from those sources, compared to a year ago, comes to about 713 million lbs. Compared to March, 502 million fewer lbs were produced in April but fluid milk sales were 297 million lbs lower than in March. Therefore, compared to a month ago, there was only about 205 million lbs less milk available for manufacturing uses.

Regardless of which comparison is used, it appears cheese manufacturers used a lower percentage of available milk in April than in March and butter and powder manufacturers used a higher percentage of the available milk. The saddest conclusion of all is that bottling plants were forced to use less than their share of the milk supply simply because, once again, fluid milk sales fell by far more than had been the normal case for oh so many years. Preliminary figures from federal order areas show class 1 usage in April to be 4.4% lower than last April. California reported class 1 sales down by 2.9% for the month. Only two out of the last thirty months have U.S. class 1 sales been higher than the year before, and one of those was February, helped by an extra day of sales.

For the record, cheese and butter production in April was lower than in March, by 44.5 million lbs and 5.8 million lbs, respectively. Nonfat dry milk production was 3.7 million lbs higher. Skim milk powder production was 5.5 million lbs higher. Whole milk powder production was 0.3 million lbs higher. Joining the others with lower production in April are yogurt, sour cream, and ice cream mixes. The combination of lower butter and cheese production during the month and an increase in month-end stocks of 18.9 million lbs of cheese and 45.6 million lbs of butterfat products does not look good. The reaction of cheese and butter sellers and buyers on the CME next week will be interesting. One hopes they will continue to contemplate the expected sharp drop off in milk production later this year instead of their current growing inventories.

DAIRY PRODUCERS UNITED AT CDFA HEARING…NOW WE WAIT: *(By Rob Vandenheuvel)* This week, CDFA conducted a two-day hearing considering proposals to modify the Class 4b (milk sold to cheese plants) minimum price formula. As readers of this newsletter are well aware, the proposals focused on modifying the formula, particularly how our formula accounts for the value of the whey stream that is generated during the cheese making process.

As a reminder, there were three proposals submitted for consideration. Two of those proposals – which were completely identical – were put forth by producer organizations:

1. On was from the "Coalition" (made up of California Dairies, Inc., Dairy Farmers of America, Land O'Lakes, Security Milk Producers Association, California Dairy Campaign, Milk Producers Council and Alliance of Western Milk Producers).
2. The other was from Western United Dairymen.

Those proposals would have brought our Class 4b price into much better alignment with the Federal Order Class III price, which is the benchmark price that drives the price of the milk being sold to cheese plants around the country.

The third proposal was put forth by Farmdale Creamery, a cheese manufacturer in San Bernardino, CA. That proposal would result in a decrease in our current Class 4b price.

California's dairy farmers were very well represented at this week's hearing. There were 34 witnesses that testified; of those witnesses, 7 were from producer organizations/cooperatives, 14 were actual dairy farmers and 1 was an attorney representing the Coalition of dairy groups. Of the remaining witnesses, 10 were cheese manufacturers or their representatives, 1 was a representative from Farm Credit West (who gave a sobering account of the current financial state of the California dairy producers) and 1 was from an energy company (who talked about some of the efforts to utilize the whey stream coming from cheese manufacturers as a source of alternative fuel).

Dairy producers and their representatives made a strong case that CDFA is mandated by law to establish our Class 4b price in a "reasonable and sound economic relationship" with what comparable milk is worth around the country (a mandate included in the California Food and Agricultural Code), and that the Federal Order Class III price is the appropriate benchmark to look at when making that comparison. While the witnesses testifying on behalf of California's cheese manufacturers did their best to minimize this strong legal argument, the hearing panel that was receiving the testimony got a clear message that not only is our current formula resulting in prices that are ***not*** in a reasonable relationship with what cheese plants are paying around the country, but that the current discounting of milk is having a direct impact on the ability/inability of our state's dairy farmers to have a reasonable opportunity to profitably operate, which the California Food and Agricultural Code clearly states as a goal of our pricing system.

Looking forward, we will be finding out the results of this hearing sometime in the next 52 days (which is around mid-July).

The testimony provided at the hearing by Milk Producers Council has been copied below:

Testimony of Rob Vandenheuvel *(General Manager, Milk Producers Council)*
California Department of Food and Agriculture Hearing on Class 4b Minimum Price Formula

Mr. Hearing Officer and Members of the Panel, my name is Rob Vandenheuvel and I am the General Manager of Milk Producers Council (MPC). MPC is a non-profit trade association with office locations in Ontario, Bakersfield and Turlock, California. We represent a voluntary membership of dairy families throughout Southern and Central California. My testimony today is based on positions adopted by the MPC Board of Directors.

Economics of the California Dairy Industry

The last several years have been extremely challenging for California dairy producers. The California Department of Food and Agriculture's (CDFA) own numbers tell a sobering story about the financial state of the California producers. As we can see from the figures in CDFA's exhibit, the average cost-of-production in California from 2007 – 2011 was $16.77 per hundredweight. Compare that to the average price paid for milk during that time period of $15.96 per hundredweight. To put that in perspective, a California dairyman working hard for the past five years to run an average-sized 1,000 cow dairy and provide for his family can reasonably expect, according to CDFA's own analysis, to realize a net loss of over $850,000 during that extended time frame.

While today's hearing focuses specifically on the structure of the Class 4b formula and achieving equity with the national prices paid for comparable milk, it is important to recognize that the decisions made by the Secretary in this area have a direct impact on the overall economics of the California dairy families. Forty percent of the milk produced and sold in California is going to cheese manufacturers, and the regulated minimum prices that must be paid have a direct impact on the ability/inability of our State's dairies to generate a reasonable return on their investment.

Producer Petitions

Before us today are two producer-sponsored proposals for modifying the Class 4b formula – one from a Coalition of dairy producer organizations and cooperatives and another from Western United Dairymen. As previous testimony has already shown, these two proposals are identical. Milk Producers Council was involved in the development of the proposed changes to the Class 4b formula and strongly supports them as the only proposed changes that would result in a California Class 4b price that more reasonably tracks with the national value of milk being sold to cheese manufacturers.

While CDFA staff has included analysis in its hearing exhibit about the impact of this proposal on a per-hundredweight basis, I have included in Attachment A of this testimony a breakdown of the actual financial impact this proposal would have on California's pooled revenues. As you will see in the attachment, the difference between this proposal – which brings our formula in closer alignment with the national value of milk being sold to cheese plants around the country – and the actual Class 4b formula we've had for the past several years is absolutely astounding. Since December 2007, when the Class 4b formula was changed from having a variable dry whey factor to having a static $0.25 per hundredweight dry whey factor, the difference between this proposal and the actual formula equates to more than $582 million. In just the past eight months since the last time the Class 4b formula was modified, the difference equates to more than $212 million.

While these numbers alone tell a sobering story, it should also be noted how the proposed changes would have impacted the relationship between the California Class 4b price and the announced Federal Order Class III price – which as I will discuss in a few minutes is the optimal benchmark price for milk being sold to cheese manufacturers around the country. Looking at that same period from December 2007 to the present, the proposed changes would have resulted in an average Class 4b price of $15.13 per hundredweight, a $0.74 per hundredweight increase over the actual Class 4b prices that were announced during that time ($14.39 per hundredweight). During that same period, the average announced Federal Order Class III price was $15.55 per hundredweight.

The reason for pointing this out is to demonstrate that while producers are proposing a revised Class 4b formula that will more fairly capture the value of whey solids, it is worth noting that over the past five years, even our proposed Class 4b formula would have resulted in a minimum price that is $0.42 per hundredweight below the Federal Order Class III price. That difference is primarily tied to the differences in how the two formulas account for the value of cheddar cheese (i.e., CME vs. NASS, differing make allowances and California's f.o.b. adjuster). I point this out not to endorse this difference but to recognize that even under the producer proposal, our State's cheese manufacturers would have enjoyed a regulated minimum price that is on average $0.42 per hundredweight below the Class III benchmark price for milk sold to cheese manufacturers around the country.

California Food and Agriculture Code
CDFA is bound by law to implement minimum prices for each of the five classes of milk per the legislative instructions included in Sections 62061 – 62079 of the California Food and Agricultural Code ("Code"). While these sections collectively include numerous things the Secretary must "consider" when establishing minimum prices, Section 62062 lays out the most direct mandate to the Secretary in determining the minimum price for each class of milk. While the section provides broad latitude in how the Secretary establishes the prices (i.e., directly designating the prices or establishing methods/formulas to result in the prices), the statute is clear that, *"If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products."* So regardless of the methods/formulas that are used, the ultimate Class 4b minimum price that is announced shall be "in a reasonable and sound economic relationship with the national value of manufactured milk products."

Other testimony in this hearing, particularly from Coalition partners Land O'Lakes and Dairy Farmers of America who operate in both California and Federal Order areas, will devote more time to explaining why the Federal Order Class III price is an appropriate benchmark for establishing the "national value of manufactured milk products." I understand there is also evidence being submitted into the hearing record about the pricing structure being utilized by a cheese processing company that operates in Idaho, a market that is not part of a state or federally-regulated system. Collectively, that additional testimony will make it abundantly clear that in the case of determining the national value of milk being sold to cheese manufacturers, the Federal Order Class III price is by far the best benchmark to use.

The next question is how to define a "reasonable and sound economic relationship." In conducting research for this hearing, I came across a letter CDFA wrote to John Rossi, Chairman of the "California Floor Price Committee" on August 25, 2010. In that correspondence, CDFA cited Section 62062 as a justification for denying a hearing request. As background, the California Floor Price Committee petitioned CDFA to hold a hearing to consider establishing a floor price of $14.50 per hundredweight for milk produced and sold in California. In CDFA's letter denying this hearing request, Kevin Masuhara – Director of CDFA's Division of Marketing Services – stated that, *"Establishing a floor price for a two year period would result in prices that are not in reasonable and sound economic relationship with the national value of manufactured milk products, as required by Section 62062 of the Food and Agricultural code."*

The clear message in the letter was that limiting the ability of California raw milk prices to move with the market while no such limitation exists in other areas of the country would violate the legislative mandate outlined in Section 62062 of the "Code." I submit to the hearing panel that this characterization can be equally applied to our current Class 4b formula, which includes provisions that narrowly limit the range of possible dry whey factors to between $0.25 - $0.65 per hundredweight. It is clear that our current Class 4b formula must be changed in order to allow the monthly announced price to consistently be in a reasonable and sound economic relationship with the national value of manufactured milk products, as required by Section 62062 of the Food and Agricultural Code.

Importance of Maintaining a "Reasonable and Sound Economic Relationship"
Much of the raw milk sold in the U.S. is priced using formulas that utilize the market value of dairy products. This includes not only the California and Federal Order pricing systems, but also the contracts that are entered into in unregulated areas like Idaho. That type of formula allows supply/demand signals to be sent to dairy farmers through changes in the market values of products such as cheddar cheese, butter, nonfat dry milk and dry whey.

With that amount of market value flexibility already built into the pricing structure, there is no logical reason to further discount California's regulated price significantly below national values for comparable milk. We've seen ample evidence – some of which will be included in testimony at this hearing – that the discounted regulated prices in California have not attracted significant additional investment in processing capacity in the State. At the same time, news reports indicate that proprietary dairy processing companies are choosing to make investments in other areas of the country where the expected cost of a milk supply is higher than California. The logical reason is that the business climate – whether you're a dairy farmer or a dairy processor – is very hostile in California. The dairy producer side of our industry cannot afford to continue discounting our milk prices in some misguided attempt to overcome the red tape that exists in California and attract additional processing investment. That issue is larger than simply the milk price.

Reasonable Expectation that CDFA Will Follow the Law

Sellers of raw milk in California – whether that is an independent dairy farmer or a producer-owned cooperative – rely on a belief that the government will follow the law, and because of that, have established long-term contractual relationships for milk based on state-announced minimum prices. That is a reasonable position to take when looking at the California Food and Ag Code which states that:

- A goal of the regulations is to enable the dairy industry, with the aide of the state, to develop and maintain satisfactory marketing conditions…and bring about and maintain a reasonable amount of stability and prosperity in the production of market milk (excerpt from Section 61805(d));
- CDFA shall establish prices that are in a reasonable and sound economic relationship with what comparable milk is worth around the country (paraphrase of Section 62062); and
- CDFA shall take into consideration that the reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those class prices, in relation to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. And that in determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment (Section 62062(b)).

Dairies and their cooperatives rely on CDFA to follow the Food and Agricultural Code when they establish contracts to sell their milk to manufacturers. They rely on the fact that the prices must be competitive with what milk is worth in other parts of the country. They rely on the fact that CDFA must consider producers cost of production, including a reasonable return on investment and a cost of management, when establishing prices.

Why would sellers of raw milk in California agree to long-term contractual relationships fundamentally based on CDFA-announced minimum prices if they thought those prices would be systematically discounted below the national prices for milk sold to comparable manufacturing facilities? Why would sellers of raw milk agree to contracts that can't be reasonably expected over the long term to cover dairy producers' costs? It's simple; they wouldn't.

Managing Supply/Demand is Role Best Played by the Industry, not CDFA

In a March 28, 2012 letter written to California Dairies, Inc. with regard to this hearing, CDFA Marketing Services Director Masuhara wrote that, *"The Department has the responsibility and mandate to establish minimum prices that will encourage California's milk production to be marketed in an orderly fashion. The Class 4a and Class 4b prices must be set at a level that will "clear" the market or will facilitate the balancing of the supply and demand for milk."* While this hearing structure does not allow for a dialogue with CDFA legal counsel, MPC would challenge the assertion that any such mandate exists. Where in the California Food and Agricultural Code is it stated that our manufactured class prices must be set at market-clearing prices? It is true that references in the Code list "orderly marketing" as something the Secretary must "consider" when establishing prices, no different than the requirement that CDFA "considers" producers cost of production and return on management/investment and the ability of the milk prices to cover those costs. But the only fundamental mandate that exists in the relevant sections of the Code is the mandate that the prices resulting from our classified pricing formulas be in a reasonable and sound economic relationship with the national value of manufactured milk products.

It's unrealistic to expect broad policies outlined by CDFA to be responsive enough to address supply/demand issues within the State. The ultimate responsibility for aligning our State's milk production with demand for that milk falls on the dairy producer sector, whether that's individual dairies that have contracts with their buyers, or producer-owned cooperatives. It's also worth noting that any financial cost that arises from a milk supply that exceeds local demand is borne directly by producers. The recent implementation of "base plans" by the state's major dairy cooperatives is clear evidence that the dairy producer sector of our industry is the only one that truly has the tools to affect regional supply/demand balance.

Basic Structure of the Class 4b Formula

A common theme in previous hearings on this issue has been that not all cheese manufacturers are created equal. Our State boasts a diverse collection of cheese manufacturers, from large-scale international companies to smaller-scale specialty manufacturers, and everything in between. These plants have all made individual business decisions about how to operate their plants.

The role of CDFA is to establish a minimum price for the milk these plants must purchase to run their operations. To accomplish this task, CDFA has established a Class 4b formula that is driven by the prices reported for commodity-grade cheddar cheese, being sold on the Chicago Mercantile Exchange in high-volume quantities (40,000 lb loads of Cheddar cheese blocks) and basic dried whey powder as reported by the U.S. Department of Agriculture. That's not to say that most of the cheese manufactured in California is cheddar cheese sold in high-volume quantities on the Chicago Mercantile Exchange. In fact, significantly more mozzarella cheese is being produced in California than cheddar cheese. But CDFA has chosen these basic commodity dairy products to serve as a surrogate for the purpose of establishing minimum prices for Class 4b milk.

Each individual manufacturing plant in California makes a business decision as to whether they can secure a milk supply at a price that allows them to process that milk into a product that can garner a profitable price in the marketplace. It's no different than the considerations that must be made by cheese manufacturers around the country – including those that operate in Federal Order areas that pay prices at/above Class III minimum prices.

The point is that the minimum price formulas established in California have not been designed to reflect the exact processes followed by each manufacturer, nor should they be. They are simply a tool used each month to establish a regulated minimum price for the various classes of milk sold to manufacturers, with the mandated standard that those prices must be in a reasonable and sound economic relationship with what prices are paid for comparable milk around the country.

Conclusion

In conclusion, for all the reasons stated above as well as the reasons outlined by previous/upcoming testimony given by fellow producer organizations/cooperatives, MPC is strongly supporting the identical petitions submitted by the Coalition and Western United Dairymen. That proposal is truly the only one being made today that will achieve the mandated standard of bringing our California Class 4b price into a reasonable and sound economic relationship with the national value of manufactured milk products. We strongly urge the Secretary to act quickly to implement this much needed change to our Class 4b formula.