

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

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FROM: John Kaczor

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE

Blocks	N.C.	\$1.2700
Barrels	+\$.0025	\$1.2500

Weekly Average

Blocks	-\$.0410	\$1.2700
Barrels	-\$.0351	\$1.2494

CHICAGO AA BUTTER

Weekly Change	+\$.0100	\$1.1800
Weekly Average	+\$.0025	\$1.1725

DRY WHEY

WEST MSTLY AVG	w/e 09/10/09	\$.3200
NASS	w/e 09/05/09	\$.2906

NON-FAT DRY MILK

Week Ending 9/04 & 9/05

Calif. Plants	\$.9451	9,481,478
NASS Plants	\$.9457	24,820,853

CHEESE MARKET COMMENTS: *Dairy Market News* (DMN) calls the cheese market weaker in the East, unsettled in the central region, and balanced in the West. Trading this week was moderately active on the CME. Prices for blocks were unchanged and barrels gained a quarter cent. The **current balance** of supply and sales in the West, if that is the case, may have come from the fact that less cheese was produced **per day** in July than in June, and less milk is now available to cheese plants than was the case in June and July and August. Overall cheese production should have at least leveled off since July and, if past years are an indication, Cheddar production (our price-setting product!) should be lower. Mozzarella production appears to be increasing, as expected, with schools back in session and weekend football finally here. Cheese exports in July were the highest so far this year, within 3 million lbs of last July. Looking ahead, Congress is working on legislation to provide an additional 350 million dollars to USDA to be used before the end of October to bolster milk prices. National Milk and several other producer organizations, including several in California, are pressing USDA to use that money to buy cheese for donation to schools and other U.S. food programs. Unfortunately, National Milk didn't lay it all on the line by not proposing that the money be used to buy Cheddar cheese only. It's hard to guess what effect on prices would result from a deep pockets buyer publicly committing to a major purchase of cheese, but one sure result would be more cheese production.

BUTTER MARKET COMMENTS: After three weeks without any price movement on the CME, butter added a penny today. Trading volume has been slow. Production of butter should level off after dropping for five months before the normal increase in the fall and winter months. Exports in July were very low, but DEIP approved bids for exports through November should bolster those volumes. All of the butterfat volume allocated thus far for DEIP subsidized exports was used up this week when 10 million lbs were approved, although a small amount may be still be in reserve for USDA to put up for bids. **Note:** In November a "window" will be opened to the real world wide value of butterfat - Fonterra intends to add anhydrous milkfat (AM) to the products offered on its monthly internet auction. Leading up to that auction, a lot of eyes will be focused on DMN's reports on international prices for AM and wondering about where the starting price for bidding will be. The production season "down under" should be well underway by then, giving Fonterra and its potential customers a good idea of how much product will be made available. This could be very interesting.

POWDER MARKET COMMENTS: Confusion and uncertainty continues to describe what nfdm buyers are dealing with. The two major price series for nfdm rose again last week and are now about even. Sales volume reported by California plants was very low for a second straight week, reflecting mostly commercial sales including subsidized exports. Powder exports in July were eighteen million lbs higher than June's exports, and within five million lbs of where they were last July. DEIP works, although new bids **by manufacturers** are expected to decrease in favor of sales to the CCC. The expected large volume offers to the CCC (at \$.92 per lb)

cannot be made later than 60 days after production, so the offers should begin soon. DMN passes on an interesting comment by someone in the East about current prices beginning to feel “real” instead of artificially supported. Well, at this point, it’s simply not possible to get a good read of “real” nfdm prices. As we all know, the value of virtually anything is what an informed seller accepts from an informed buyer. Does anyone know where those informed people can be found? Confounding the matter, there also are reports of people thinking an extension of the current support prices may happen, and some who even say another bump up in price levels could result if that \$350 million is not all used by USDA on cheese.

WHEY PRODUCTS COMMENTS: This is becoming easy; for dry whey the market is steady, prices are unchanged, inventories are level, plants are making a profit. However, exports of dry whey in July were lower than the same month a year ago. Whey protein concentrate prices continued to rise (steadily since last October, to \$.625 per lb), and WPC exports in July were slightly higher than last July.

FRED DOUMA’S PRICE PROJECTIONS...

Sept 11 Est:	Quota cwt. \$ 12.50	Overbase cwt. \$10.80	Cls. 4a cwt. \$10.78	Cls. 4b cwt. \$11.08
Last Week:	Quota cwt. \$ 12.46	Overbase cwt. \$10.76	Cls. 4a cwt. \$10.66	Cls. 4b cwt. \$11.08

MPC MOURNS THE LOSS OF A FORMER CEO: Milk Producers Council’s former General Manager, Frank Vicencia, passed away on September 9, 2009 at the age of 78 in Seal Beach, CA. He was appointed General Manager of MPC on January 7, 1964 and served in that position until 1967. Before his time at MPC he served in the US Army fighting in the Korean War and rose to the rank of Corporal. After leaving MPC, Frank became a Legislative Representative for Milk Producers Council, Southern California Rapid Transit District and California Thoroughbred Breeders Association. In 1974 he was elected to the California State Legislature where he served for six terms, the last two as Speaker Pro-Tem of the Assembly. MPC is grateful to Frank for all of the work he did for California Dairymen. Bob Feenstra, another former General Manager of Milk Producers Council, said of Frank, “In my 37 years with MPC all I could do with the State Legislature was because of Frank. He was my mentor. Frank and I learned all we knew behind the barn instead of a classroom. He will be missed and is truly loved and respected.” Some of the major projects Frank worked on were the Gonzales Milk Pooling Act and Equalization. Milk Producers Council would like to remember Frank for his years of service to MPC, the State of California, and the United States Army.

ARE DR. RICHARD SEXTON’S ARGUMENTS CREDIBLE? *(By Rob Vandenheuvel)* It’s been a more than a month since I’ve written in this newsletter with any detail about the Dairy Price Stabilization Plan. However, behind the scenes there has been much activity.

The U.S. dairy industry is in the midst of a national debate. Everyone – from producers to processors – recognizes that the growing milk price volatility that has become commonplace in our industry is extremely harmful. However, when it comes to potential solutions, there is a battle of ideas and ideologies circulating.

While the Dairy Price Stabilization Program (or DPSP) has been garnering more and more support amongst dairy producers, there has been an effort by some to discredit the idea. I’ve published several “Frequently Asked Questions” and responses in this newsletter in an effort to foster real debate over the issues that have been raised (these and more information can be found at www.milkproducerscouncil.org/gmp.htm). But recently, those opposing the DPSP have enlisted a new spokesman – Dr. Richard Sexton.

Who is Dr. Richard Sexton?

For those of you who have never heard of Dr. Sexton, he is a professor at the UC Davis Agricultural and Resource Economics Department. He has only recently (and by recently, I mean in the last several months) delved into the world of dairy policy, but he has made quite a stir, particularly in the area of supply management.

Dr. Sexton was hired several months ago by Western United Dairymen – a fellow dairy trade association in California. He was hired to examine the Dairy Price Stabilization Program and come up with a list of potential problems or issues that should be further explored. According to Dr. Sexton's own words, he was hired to be a "devil's advocate" (this according to MPC President Syp Vander Dussen who has been present for two of Dr. Sexton's presentations of his findings).

Fast-forward to now. Those opposing the DPSP have made Dr. Sexton their Expert of Choice. He is heralded as an expert in milk price volatility and supply management, and his list of "potential problems" with the DPSP is being sold as genuine "analysis" of the program.

So if Dr. Sexton is going to be a resource that our industry relies on in the area of milk price volatility and supply management, it is vital that the industry examine what Dr. Sexton adds to the debate. Let's take a look at what he says.

In the interest of space, you can read Dr. Sexton's "evaluation" of the DPSP (titled "*Evaluation of the Refundable Market Access Fee Proposal as a Supply Management Tool for the U.S. Dairy Industry*") here: <http://www.milkproducerscouncil.org/sexton.pdf>. For the purpose of this discussion, I've pulled some excerpts below and added responses from Milk Producers Council.

So are Dr. Sexton's Arguments Credible?

You be the judge.

Dr. Sexton: "A rule of thumb for the price elasticity of demand for raw milk is -0.5, meaning that a one percent increase in production will cause a two percent decrease in producer price, other factors constant."

- This "rule of thumb" that Dr. Sexton uses to define the movement of raw milk prices is a huge oversimplification. Unfortunately, the reader is left to make assumptions on its validity, since Dr. Sexton provides no citations to support this very general claim.

When looking at the price elasticity of milk, you have to look at the elasticity of various dairy products – most notably fluid milk, cheese, butter and powder. Even among these products, there is a vast difference in elasticity – ranging from fluid milk which economists argue is highly inelastic, to butter which economists argue is fairly elastic. Even within the cheese, there are different levels of elasticity for the different kinds of cheeses.

To generalize all these factors into one "elasticity" for raw milk is not particularly helpful. In addition, the claim that a one percent increase in production will cause a two percent decrease in producer price flies in the face of what we've seen in the past ten years. Over the past decade, we've seen producer prices range from roughly \$10 - \$20 per hundredweight. That's a 100 percent range in producer prices, with supply/demand imbalances of no more than 5 percent during that time. If Dr. Sexton's "rule of thumb" was accurate, a 5 percent drop in demand would only result in a 10 percent drop in producer price, which dairies across the U.S. could probably live with. Unfortunately, that hasn't been the case.

Dr. Sexton: “Volatility in the market has become more pronounced in recent years as the U.S. has become integrated into a world market for dairy products. The relevant market appears to be worldwide for various key intermediate dairy products, such as milk powder and whey, where prices in key producing and consuming regions (U.S., E.U., and Oceania) move in comparative lockstep – the ‘law of one price’ applies.”

- Again, this is a huge oversimplification of how the U.S. dairy industry interacts with the world market. To state that the U.S. price and the world price move in “lockstep” doesn’t seem to pan out in reality. Over the last ten years, there have been periods of time where the U.S. price was higher than the world price, and other periods where the opposite was true.

Dr. Sexton’s reference to the “law of one price” is also complicated by the system of tariff-rate quotas that prevents unrestricted flows of products across our borders. Add to that the fluctuation in currency valuations. The fact is that the issue of imports and exports in this global market is too complicated to write it off as the “law of one price.” If Dr. Sexton is going to make that claim, he needs to provide more real-world data to back that up.

Dr. Sexton: “Supply-management programs have a long history in agriculture in the U.S. and elsewhere, but the track record of success is mixed at best.”

- Supply management is a broad term; it would be helpful if Dr. Sexton would give examples of other programs in the “long history.” Milk is a unique industry with a unique history. We are unaware of any other industries similar to the dairy industry, where we must sell a perishable product every day to buyers that don’t need our products everyday.

The one obvious example of a supply management program utilized in the dairy industry is in Canada. Whether or not that program is “successful” is in the eye of the beholder. They certainly provide their dairy farmers with a rate of return on their investment, but it comes at a price. The Canadian system of quotas, which have capitalized over the years and now cost more than \$30,000 per cow, has put the industry in a “strait-jacket,” providing a profitable industry for those already in, but largely keeping any new entries out. That type of system has never been broadly accepted among U.S. dairy farmers, but for Dr. Sexton to claim that “the track record of [supply-management programs] is mixed at best” without any kind of supporting facts is of little value to this debate.

Dr. Sexton: “If, through supply management, U.S. prices rise above average levels for the rest of the world, marketers have incentives to redirect dairy products to the U.S... We believe it is unquestionable that imports of dairy products to the U.S. will increase under a supply-management program that succeeds in raising dairy product prices in the U.S. above world levels.”

- Again, Dr. Sexton is making assumptions under the “law of one price” that are not necessarily applicable within the global dairy market. Over the last 10 years, we have had periods of time where the “world prices” have been below the U.S. price, and other periods where the opposite was true.

Further, the Dairy Price Stabilization Program is not designed to enhance prices over the long term, which only happens if you are “shorting” the market of milk. The DPSP provides an incentive for dairies to manage their production, but it allows the industry to continue growing with the market. The analysis done by Cornell University’s Program on Dairy Markets and Policy shows that by creating this incentive for dairies, we will keep a better supply/demand balance, which will shrink the “peaks” and “valleys” but will not dramatically enhance the average all-milk price over the long term.

In the world economy, the large sources of milk are from Australia/New Zealand (low-cost producers), Europe (high-cost producers) and the U.S. (in between those two). The DPSP won’t change our relative position between those two regions. We will still be cheaper than Europe, but more expensive than Australia/New Zealand.

But the more important question to ask is how cheap do we want to make milk? We are in a global economy, with dairy products coming into and going out of our country everyday. Is anyone proposing that we continue to subject our dairymen to massive equity losses just so we keep the milk price cheap enough to hold every pound of imported dairy product out? New Zealand and Australia can produce milk substantially cheaper than we can – should we be selling our milk at huge losses so that they can't profitably bring any of their products into the U.S.?

Dr. Sexton: "Cheating on Supply Management...Any successful supply management program raises price above producers' marginal costs of production, creating an incentive to expand production beyond the producers' base allocation."

- This sentence shows a clear misunderstanding by Dr. Sexton on the design and intent of the Dairy Price Stabilization Program.

Today in the dairy industry, anytime producing milk is profitable, all 50,000+ dairies across the country have every incentive to go out and make as much milk as possible. Does that mean they're all adding corrals or building new barns? Of course not. But we all know that when the price of milk is high, dairies hang on to beef cows a little longer, dry up cows a little later, and simply do everything they can to maximize the amount of milk going into their tank. That's how we operate *now*.

So how would the DPSP be different? According to Dr. Sexton, it wouldn't. But in reality, our dairy producers would act much different under the DPSP. Under this program, when it's profitable to produce milk, dairies will have a decision to make: do I grow my production (and pay the market access fee) or do I hold my production in line (and receive the revenue stream from those who pay the market access fee – the market access fee "dividend").

So Dr. Sexton's claim that the program would "create an incentive to expand production" couldn't be further from the truth. We have that incentive right now. The DPSP – for the first time – would give dairies an incentive to manage their production, even when it's profitable to milk cows.

Dr. Sexton: "Despite the required reporting of individual production records, we believe that production would be expanded in excess of what the proponents of the program envision. Excess production would come from groups of producers who would seek and likely receive exemption based upon the type of milk they produced (e.g., organic) or their geographic region (e.g., milk deficit regions)."

- What is Dr. Sexton's evidence that groups of producers would "likely receive" an exemption? As I understand it, he was asked to analyze the plan as it's drafted, so what "exemptions" is the report referencing?

Under the DPSP, everyone across the country operates under the same set of rules. Dairies that wish to expand their share of the market must pay a market access fee. Those dairies that are not in "expansion mode" will receive those market access fees, thereby creating a financial incentive for dairies to manage their production.

Dr. Sexton: "If, through supply management, U.S. prices rise above average levels for the rest of the world, marketers have incentives to redirect dairy products to the U.S...We believe it is unquestionable that imports of dairy products to the U.S. will increase under a supply-management program that succeeds in raising dairy product prices in the U.S. above world levels."

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Dr. Sexton: “If though supply management, the U.S. succeeds in raising the domestic price for dairy products above world levels, U.S. marketers will be (a) unable to export at prices commensurate with domestic levels and (b) unwilling to export at lower prices (in the absence of any export subsidies). Thus, supply management will reduce exports, meaning more production will be directed to the domestic market under supply management.”

- There are a lot of assumptions in these two sentences. First, that the DPSP would enhance average prices over the long term. I’ve already explained above that the DPSP is designed to take the wild swings out of the milk price, but over the long term, the average milk price would not be significantly enhanced under the program.

Second, Dr. Sexton is assuming in this sentence that price is the only thing that moves product. If that were true, how does the European dairy industry, which has a higher cost of production than the U.S., export unsubsidized dairy products and ingredients? Price alone is not the only variable in the world of exports.

The volatility that processors have experienced in the price they pay for their milk supply has certainly been harmful to them as well. While the low milk prices hurt dairies, the high milk prices hurt demand. It is logical that a more stable supply/demand relationship domestically would give our exporters *more* opportunities to engage in long-term business relationships with our trading partners.

As an industry, we need to be more of a strategic exporter of our products – not just an exporter that gets Fonterra’s “leftovers” whenever New Zealand and Australia dairies take a hit in production. The DPSP would give us a more stable price surface that would enable us to be a more strategic exporter.

Dr. Sexton: “Pure price stability is probably not a realistic goal.”

- I don’t know Dr. Sexton’s definition of “pure price stability,” but that’s not the goal of the DPSP. The goal of the DPSP is to create an incentive for dairies to actually pay attention to how much milk is going into their tanks and manage that production. Cornell University’s Program on Dairy Markets and Policy has modeled the program and found that if dairies have a financial incentive to manage their supply, we can maintain a much better supply/demand balance, which in turn will result in taking the massive booms and busts out of our milk price.

Dr. Sexton: “Perverse incentives created by the plan...Due to the Market Access Fee applying to the entire production of producers who exceed their base, an incentive is created to (i) dump milk to avoid exceeding the base by a small amount (whether it is legal to do so or not); (ii) expand production in each period up to the maximum increment allowed to avoid sacrificing growth in base that potentially valuable; and (iii) undertake any expansion beyond the allotted base on a large scale because the Market Access Fee per cwt. of expansion is continuously decreasing in the volume of the expansion – i.e., the Market Access Fee paid on the existing base is spread across an ever increasing volume the larger the expansion.”

- So in that 116 word sentence, what Dr. Sexton is really saying is, “If you create an incentive for dairies to manage their supply, they will manage their supply.” That’s the point; although dairies will likely take steps to manage their supply before producing the milk, rather than dumping it. But other than that, what is the point of this sentence?

On the issue of applying the market access fee to the entire production of a producer, the coalition supporting the DPSP has heard those concerns. In response, the DPSP has been modified to include an option for producers who expand their production:

- (1) pay the market access fee on all your production (just as before); or
- (2) pay the market access fee on only the excess production, but at a rate five times higher.

By making this change, a dairy facility that wishes to grow more incrementally (i.e., 10-15 percent growth) can do that and only pay on their excess production. But the underlying incentive still exists, since only the dairies that stay at or below their allowable milk marketings are entitled to their share of the market access fee “dividends.”

Dr. Sexton: “When a quota is proposed to apply to production, economists almost always recommend that the quota be transferable, so that the most efficient producers can acquire quota and less efficient producers can sell it, insuring that output is produced efficiently.”

- It’s truly shocking to read an economist report with the words “economists almost always,” only to find that there are absolutely no references to back up that claim.

Addressing the specific point of transferable quota, the most visible example of a quota-trading system in the dairy industry is in Canada. The production quota in Canada has capitalized and is trading for roughly \$30,000 per cow. So when an “efficient producer” must buy the quota from a “less efficient producer,” those thousands (or millions) of dollars leave the industry, removing valuable working capital that’s now locked up in the value of the quota.

Dr. Sexton is completely mistaken in making this claim. The system of transferable quota in Canada has resulted in moving profits out of the industry and into the retiring generation. It does nothing to make it easier for “efficient producers” to expand their market share.

What the DPSP does is provide a “market allocation” tool for the industry to allocate future growth in our market. It’s essentially a deal amongst the producers. If you want to grow your share of the market, you must pay your colleagues who are also producing milk to hold their production in line. Those funds stay in the industry, and are not shipped to the retiring generation in the form of “quota transfers.”

So when is an “analysis” really an analysis?

Drs. Mark Stephenson and Chuck Nicholson from Cornell University’s Program on Dairy Markets and Policy have done extensive work over the years on the issue of milk price volatility, as well as analysis of the concept behind the DPSP. With Dr. Sexton now entering the world of “analyzing” dairy policy proposals, let’s compare the experience and work of these two groups.

	Cornell University*	Dr. Richard Sexton**
Has evaluated volatility in the U.S. milk price	Yes	No
Has hosted multiple conferences with economists and industry to discuss milk price volatility	Yes	No
Ran the Growth Management Plan through an economic simulation model	Yes	No
Presented a list of further areas to explore	Yes	Yes
Posted the findings of their work on their website, allowing for public review	Yes	No
<p>* Analysis was done by Drs. Mark Stephenson and Chuck Nicholson, Cornell University's Program on Dairy Markets and Policy. http://dairy.cornell.edu/CPDMP/Pages/Publications/Pubs/GMP_Report.pdf</p> <p>** Dr. Richard Sexton is from UC Davis's Agriculture and Resource Economics Department. http://www.agecon.ucdavis.edu/people/faculty/info.php?id=30</p>		

We are in the process of having a debate about the future of the dairy industry. Dr. Richard Sexton was hired to review the DPSP and come up with a list of problems with the program. He did that and as we have demonstrated above, there are answers to the questions he raises.

Let me leave you with this. Producers are losing a lifetime of equity they built into their dairies and are demanding long term solutions that will give them a chance at rebuilding what has been lost. The DPSP is the best chance we will have in this generation of putting the dairy industry on a stable footing for the future. There is a lot of grassroots support building for the DPSP, and if we are going to be successful in making this common sense proposal a reality, we need all of you to be engaged. I've said it before, and I'll say it again. Call your coop board and management. Call your trade association board and management. Ask them why they don't endorse the DPSP. And if they say they do, ask them to add their name to the list of supporters.

LAST CHANCE – MONDAY IS THE DEADLINE FOR CHANGING YOUR MILC “START MONTH”:
(By Rob Vandenheuvel) Hopefully you have all reviewed the MILC contract that you filled out earlier this year to find out what month you set as your “start month” for fiscal year 2010 (October 1, 2009 – September 30, 2010). The reason it's important is because with the start of a new fiscal year, your 2.985 million pounds of milk that's eligible for a payment starts over.

While there is no way to know exactly what next year in milk prices may hold, those who project future MILC payments (such as Cornell University's Program on Dairy Markets and Policy – <http://dairy.cornell.edu>; and the University of Wisconsin's Dairy Marketing and Risk Management Program – http://future.aae.wisc.edu/collection/software/current_MILC_est.xls) are estimating that given projections of a gradual increase in the milk price, the MILC payment will gradually decrease over the future months. If that indeed holds true, it would mean it's in everyone's best interests to start collecting the new fiscal year's MILC payments in the earliest possible month (October 2009).

When you all signed up for the MILC program this past February or March, you were asked to choose a start month for the next five years. Some of you may have chosen October 2009 as your start month for “fiscal year 2010,” while others of you may have left that area blank, which by default selects the same month you chose for the previous fiscal year (i.e., February or March). If you aren't sure what month you chose for fiscal year 2010, you should contact your local FSA office immediately.

If you need to make a change to select October 2009 as your start month, your paperwork ***MUST*** be submitted by **Monday, September 14th**. That means your paperwork must be received by your FSA office by this upcoming Monday. If you need to make changes to your start month, you'll need to fill out two forms: the CCC-580M (*MILC Modification*) and the CCC-926 (*Adjusted Gross Income Statement*). MPC members who need assistance filling this out should call the office at (909) 628-6018.