Milk Producers Council

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

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

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE
Blocks +$.0425 $1.6500
Barrels -$.0475 $1.6375

Weekly Average
Blocks -$.0455 $1.6175
Barrels -$.0385 $1.6465

CHICAGO AA BUTTER
Weekly Change -$.0500 $1.6350
Weekly Average -$.0710 $1.6480

NON-FAT DRY MILK
Week Ending 10/31 & 11/01

Calif. Plants	$ .9289	17,518,729
NASS Plants	$ .9132	21,596,866

DRY WHEY
NASS w/e 11/01/08 $.1901 **WEST MSTLY AVG** w/e 11/04/08 $.1700

CHEESE MARKET COMMENTS: The cheese market showed signs of steadiness this week. Prices for blocks rose 4.5 cents per lb, while barrel prices fell to their normal spot just below blocks. Even with the increase, the average block price this week is the lowest since April 2007. Forty four sales were made this week, filling short term needs of some buyers, and a lot of offers to sell were left untouched. Total demand for cheese (as well as for a lot of other food and non-food items) continues to slow, reflecting general economic conditions and sour consumer sentiment. Following the recent announcement of another CWT herd retirement program, the expectation is growing that milk supply increases will continue to slow, to the point where domestic sales will clear current production. Lower milk production would be a big deal

BUTTER MARKET COMMENTS: Butter prices on the CME this week lost 5 cents per lb, with only two sales during the week – an orderly move. Dairy Market News reports that **butter production in September was the highest it's been for that month in 65 years**. That's big news, but even bigger is the fact that stocks of butter and butterfat products for September, reported two week ago, were 46 million lbs lower than a year earlier. Production of butter should be moving lower, as other holiday products use up cream. The adequacy of supply of butter and butterfat products is measured against **domestic and export sales**, and export sales are now facing what some experts are calling a "global economic slowdown". CWT's continuing efforts regarding export subsidies for butterfat products is critical, because DMN reports that few non-supported orders are being received. Historically, butter prices decrease from this point on through the end of the year, so look for lower prices, but hope that the changes are not as great as the current futures market project: $1.41 in December, $1.35 in February. Those prices are believed to be reflective of expected lower sales rather than expected greater supply.

NONFAT POWDER COMMENTS: The following quote from DMN's weekly comments on the nonfat powder markets summarizes the current situation very well. "*The continued movement of powder into the CCC Support Program is a factor in all buying, selling, and pricing decisions. The trade assumes all relevant price series will continue to move nearer the price support level of 80 cents per pound."* A total of 43 million lbs of nfdm have been sold to the CCC in October, and more sales are coming. The good point about these sales is that they reduce the amount of product in inventory; the bad point is that sales at 80 cents per lb pull the average prices down, and the product in CCC warehouses can be sold at 88 cents per lb, which could impair upward price movements. International sellers (other countries) have been adjusting prices downward, and those prices are approaching the $.80 per lb level. The western "mostly" price range this week was 85 to 95 cents; the full range was 80 cents to a dollar. California plants – no, California producers – continue to carry the burden of the lowest powder prices, as prices in the central part of the country continue to be about 10 cents per lb higher than California's. That's a buck per cwt of Class 2, 3, and 4a milk, California producers.

WHEY MARKET COMMENTS: Whey prices this week in the west were unchanged. Inventories appear to be not too high, but buyers simply do not want to pay even what it costs to produce the product. Prices for whey protein concentrate, which showed signs last week of recovery, went back to "mixed" this week. DMN reports that WPC "mostly' prices this week in the western region are 62% below where they were a year ago. Global demand continues to be weak; domestic demand is described as fair to good.

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FRED DOUMA'S PRICE PROJECTIONS…

Nov 7 Est:	**Quota cwt. $15.89**	**Overbase cwt. $14.19**	**Cls. 4a cwt. $12.32**	**Cls. 4b cwt. $14.64**
Oct Final:	**Quota cwt. $17.16**	**Overbase cwt. $15.46**	**Cls. 4a cwt. $13.75**	**Cls. 4b cwt. $16.63**

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REVIEW OF SEPTEMBER'S USAGE OF MILK: *(By J. Kaczor)* The following table reports and compares the U.S. and California major milk usage categories that were produced during September. In September, USDA estimated that total milk production increased by 1.7% over a year earlier. CDFA reported that production of milk in California increased by 0.7%, but the combination of milk production, imports, and exports of bulk milk reduced the increase of milk available for usage to +0.3%. The numbers in the table indicate percentage changes from September 2007.

	U.S.	**CALIFORNIA**
CATEGORY		
Butter	+7.4%	+6.8%
Nonfat Dry Milk	-4.0	+1.1
Skim Milk Powder	+161.1	n/a
Other Dried Products	n/a	+55.3
All Cheese	+2.3	-5.3
American Cheese	+5.7	-9.8
Cheddar Cheese	+2.2	-21.1
Dry Whey	-5.7	n/a
Whey Protein Concentrate	+6.7	+6.2
Cottage Cheese	-4.4	-28.3
Sour Cream	+1.1	-5.9
Yogurt	-0.1	+3.2
Frozen Desserts	+6.5	-0.5
Condensed & Evaporated	+34.6	-13.7

Sales of Class 1 products in California during the month increased well above the percentage increase of milk that was available. Gallons reported as sold by California plants **in California** increased by 3.0% above September 2007 levels; these sales include a substantial amount of organic milk that is packaged out of state for California plants. Class 1 usage of pool milkfat and solids – not - fat increased by 5.0% above the September 2007 level.

MY VIEW ON MILK PRODUCTION INCREASES: *(By Sybrand Vander Dussen)*
The dairy industry in California continues in its addiction of over-production of milk. Dairy producers seem to have only one clear focus; produce more milk. As costs go up, as milk prices decline, we produce more milk. As coops battle to place milk and milk products, we produce more milk. With 3x milking, rBST, advancing genetics, gender-specific semen, we produce more milk.

In a perfect world, where the milk we supply and the demand for those products remained somewhat in balance, this would be a strong sign of a vibrant and healthy industry. But the reality is, dairymen produce in an unrestrained fashion with ***no*** consideration of demand, leaving the industry in a perpetual state of overproduction which causes a myriad of problems, ***all of which should be unnecessary***.

The typical dairyman is a good cow-man; he knows how to produce milk efficiently, and with high quality. As long as he is not on the wrong side of his banker or the dairy inspector, he is king of his domain. His coop puts wheels under his milk every day, his banker tells him what interest rate he pays on loans, the beef market dictates the price he gets for culls, and the California State regulatory system sets his milk price. He is not a milk or milk product marketer, does not need to innovate new desirable products, doesn't need to concern himself with milk sales – his coop will do all that.

Sounds like the epitome of socialism! It's all good and works well, right?

Not even close.

Our crazy "produce more milk!" entitlement mentality, that we can produce ever more milk, no matter what, causes such huge problems that our industry finds itself in a constant state of confusion and tension. Our coops cannot demand higher prices from Buyers, simply because they must get rid of more milk than the market wants. They are in a position of finding "holes", transporting milk over long distances, "selling" milk to calf ranches at cents on the dollar, and disposing of milk in other ways best not to put in print. This places the Buyers in an incredibly strong position.

Further, and worse, even when a coop is able to extract a premium of a few cents, ***another coop*** comes along and underbids them, and that premium is lost.

But things may be changing. There has occurred, in recent times, several "sea changes" that must alter the face of the industry; 1. Near effective irrelevance of the support program, 2. Less mid-west smaller dairies, 3. Imposition of production bases by all three major coops in California.

Let's explore them.

Support Program. In 1933, the federal government authorized the creation of the Commodity Credit Corporation (CCC), and in 1949 the CCC was given the responsibility to assure an adequate supply of milk for consumers – the Dairy Price Support Program was born. The CCC is required to buy all nonfat dry milk, butter, and cheese the industry offers to it at predetermined prices. The initial purpose was to remove excess product in the spring and release it in the fall, all in an attempt to flatten out supply. ***This law was intended to benefit consumers, not producers,*** and initially it worked as planned. But the dairy industry quickly saw it as a market (read that "loophole") not a market of last resort, especially when President Reagan, in 1981, finally froze the rising support price at $13.49 cwt, because we were generating huge volumes of product to government warehouses. (That $13.49 cwt, by the way, translates into $29.97 cwt in today's dollars!) The industry saw it as an actual market and produced giddily, resulting in the government dumping huge amounts of product in 1983-84, followed by a federal government producer buy-out to reduce production. In the short term, that solved the overproduction problem. Since then, the support price has dropped to $9.90 per cwt making this outlet definitely the last resort and definitely unattractive, especially when our milk prices were well above that price. With feed costs soaring due to the congressional ethanol mandate, that $9.90 per cwt "market" should effectively be closed to us.

Mid-west Dairies. In years past, when we out-produced demand, and milk prices declined, many mid-west dairies, those many thousands of producers with 20-80 cows, just quit, and stayed with farming only. That soon dried up the excess production, and milk prices gained strength, making us once again, okay.

In the last decade, our west coast style of dairying has been exported to Idaho, Texas, New Mexico, and even to the mid-west. Now, when prices decrease, those dairies, being larger and much better capitalized, have much more staying power. Except for last year's "bubble," the milk price does not recover as before. The drops we see are deeper and more sustained and the recoveries are anemic and certainly less dramatic. It seems like it has become a game of the titans seeing who could hemorrhage the longest and still survive. (The polite word for this pattern is "volatility.")

Coop Bases. Apparently, out of sheer frustration with the oceans of milk presented to our California coops, Land O'Lakes, California Dairies, Inc., and Dairy Farmers of America instituted base programs. This was done with little warning and apparently with little forethought, and certainly was not planned in concert with other coops. The only immediate accomplishment was the targeting of those dairies that just happened during that time frame to be in a growth mode, and after a small across-the- board fee, all costs to dispose of excess milk was charged to those "over-base" producers. One Southern California dairy suffered a charge of over $600,000 for the period of March-July, 2008. Because at all times, various dairies are undergoing expansion, the institution of bases at another point in time would have simply targeted other dairies, perhaps different than those punished now. Sort of like musical chairs-when the music stopped, for those without a seat, they got whupped. And hard.

In partial response to the unexpected imposition of bases, many cows were sold to out-of-state producers. Between that, and producers so affected reducing their production, a short term positive response has occurred.

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So why do so many producers have as their primary goal to just produce more milk? The answer lies in the magic of pooling, which was instituted at the same time quota was issued. Pooling of milk is a brilliant, efficient method of valuing and distributing milk in California. Imagine two buckets; one, a large "milk" bucket and the other a large "money" bucket. All milk produced in California is "poured" into the milk bucket. At the bottom of that bucket are 5 faucets. One faucet for each milk usage. Class 1, 2, 3, 4a & 4b. As milk enters the bucket, it loses its producer identification and then, various processors, whether it be for their intended use of bottled milk, cheese, powder, etc., tap into the faucet corresponding to that use. As milk is processed for those various uses, that identifies a value based on our pricing formulas, Class 1 price, cheese, etc. The payment for the corresponding usage value is then "placed" into the money bucket.

At the end of the month, it will have been determined how much milk has been produced and what its value is, strictly according to how and where it was used. That amount of money is then reported as a pool total, which then has deducted from it transportation credits and allowances, the quota payout of $1.70 cwt (less the RQA) according to quota holdings, and what is then left is divided equally according to volume of milk, and milk components to all producers.

This is a wonderful system. It establishes an equitable price to all, allows maximum availability of milk for higher-valued products, and allows a quota producer to ship to a powder plant or a non-quota producer to ship to a Class 1 bottling plant. All very efficient and equitable.

However, for all the positives this system provides, it has a serious flaw. Because all milk is pooled, the common value established by usage and the equitable payout to producers means when a lower value is created by overproduction ***that devaluation is shared by all producers simply by an across-the-bucket reduction in total proceeds*** . Stated differently, and simpler, 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 $16.00 cwt for that load. But remember, the income to the pool bucket is about $10.00! That $6.00 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.*** Indeed, the producer who hasn't expanded in recent years is sucking air. So many others have expanded, and that expansion, if it exceeds market demand, by definition has largely gone to lower or lowest value uses. This flaw in an otherwise brilliant system is described best by the two hikers in the forest being chased by a bear. Those two do not need to outrun the bear, one just has to outrun the other! So my and your best business plan is to keep producing more, because the system, as designed, rewards individual growth but punishes producers industry-wide. The negative effect of me producing that "one more load" will be picked up by you.

As a side note, when milk in neighboring states comes into our pool, it enters as Class 1 usage, and receives Class 1 price. The problem with that is each load so delivered displaces a California load which takes that load from Class 1 all the way to the bottom value, reducing our pool total. This financial rape should not happen.
[This concludes part one of a two part discussion of my views. Next week, more views, some examples of success, and a possible solution.]

MPC REBUTS ARGUMENTS MADE BY PROCESSORS AT THE RECENT CDFA HEARING: (By Rob VandenHeuvel) Today, MPC sent a letter to CDFA, refuting many of the arguments and claims made by processor representatives at last week's CDFA hearing on the Class 1, 2 and 3 formulas. I've posted the letter on our website: http://www.milkproducerscouncil.org/110708brief.pdf. As I mentioned in last week's newsletter, Secretary A.G. Kawamura now has about two months to decide whether any changes to the formulas are warranted, and what, if any, those changes would be.

GOOD QUESTIONS RAISED DURING LAST WEEK'S HEARING: *(By J. Kaczor)* The petitions for a hearing to consider increases and decreases in prices that were received by the California Department of Food and Agriculture, and the letters that either supported or opposed even having a hearing, were direct in what they covered, but had obvious implications on what may happen if any change is made. CDFA's hearing panel members have been roundly criticized in the past in MPC's *Weekly Update* for asking few and often times superficial questions of witnesses who present their cases. Not this time. At last Thursday's hearing the panel members were prepared. While the questions that were raised by the panel did not directly reference statutory standards, they specifically addressed each proposal's potential effect on real issues that are pertinent to what the industry has been and is presently dealing with. Moreover, the questions were addressed, in one form or another, to all the witnesses. That approach gave everyone who attended the hearing the opportunity to hear the questions that were foremost in the minds of the panel, to hear the answers that were given, and gave the witnesses time to reply or respond at the hearing, or through a written brief. High marks are given.

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