Milk Producers Council

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TO: DIRECTORS & MEMBERS **FROM: Rob VandenHeuvel**

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE
Blocks +$.0675 $2.0000
Barrels +$.0500 $1.9700

Weekly Average
Blocks +$.0465 $1.9540
Barrels +$.0700 $1.9180

CHICAGO AA BUTTER
Weekly Change -$.0200 $1.5300
Weekly Average +$.0020 $1.5360

NON-FAT DRY MILK
Week Ending 7/11 & 7/12

Calif. Plants	$1.3503	17,717,337
NASS Plants	$1.3957	17,511,896

DRY WHEY
NASS w/e 7/12/08 $.2667 **WEST MSTLY AVG** w/e 7/18/08 $.2800

John Kaczor is unavailable to write his commodity comments for this week's report. He will be back next week.

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FRED DOUMA'S PRICE PROJECTIONS…

July 18 Est.	**Quota cwt. $18.84**	**Overbase cwt. $17.14**	**Cls. 4a cwt. $15.95**	**Cls. 4b cwt. $17.65**
Last Week	**Quota cwt. $18.76**	**Overbase cwt. $17.06**	**Cls. 4a cwt. $15.99**	**Cls. 4b cwt. $17.44**

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WHEY REVIEW COMMITTEE COMPLETES WORK; ***Recommends no immediate change, but urges the California Secretary of Food and Agriculture "to create the opportunity for competition for producer milk between the current regulated system and a new regulated and/or unregulated system."*** *(By Geoffrey Vanden Heuvel)* Last October, in response to a petition from a group of medium-sized California cheesemakers, a hearing was held on the class 4b cheese milk pricing formula. The cheesemakers were complaining loudly that they were paying too much for milk. In particular they wanted to completely eliminate any value in the formula attributable to the marketing of whey solids. Producers recognized that there were problems with the existing formula and did work together to propose alternatives that would have granted some relief to those cheesemakers. Those offers were rejected by the cheesemakers. Fortunately, rather than giving in to the cheesemakers, Secretary AG Kawamura recognized that there is a producer value to the whey stream and decided to convert the controversial whey formula to a fixed value of $0.25 per cwt.

Initially this decision meant a significant reduction in the California 4b price but the rapid decline in the dry whey market over the past six months has produced a situation where the current formula with the $0.25 fixed whey factor actually generates a higher class 4b price than we would have if we had stayed with the old formula.

Given the controversy surrounding the hearing decision, Secretary Kawamura decided to appoint a committee made up of producer and processor representatives to evaluate the whey issue and come up with recommendations. The committee began its work at the end of December and had meetings throughout the winter and spring. As we all know, a serious mismatch between California milk production and California manufacturing capacity emerged during that time, leading to severe disruptions in the marketing of milk. Cheese and powder prices, in addition to dry whey prices, went through big variations resulting in a significant drop in milk prices. At the same time feed costs were escalating rapidly. Our industry was – and to a large degree still is – dealing with a series of factors that are unprecedented in their magnitude.

The uncertainty inherent in the current market situation also applies to processors and ultimately consumers. The entire dairy marketing chain is under pressure and the conclusion of the majority of the Whey Review Committee this week is that **the best course for the department to follow is to essentially call a "timeout"**

from hearings and give the industry a stable and predictable, albeit imperfect, regulatory environment to work through the problem that confront us.

There was also some real discussion in the committee about the broader California regulatory system. The California state order is very strict in its pricing regulations, which in the view of some – including me – prevents innovation and growth as we mature as an industry. The secret to California's ability to rapidly expand production over the past 25 years has been that we had a cost of production advantage on our competition in other parts of the country. We also had a State order, which allowed us to collectively take a piece of that cost advantage and give it to large commodity manufacturing plants as an incentive to get them to expand in California. **That model no longer works**. Our cost advantage has evaporated as other areas of the country have adopted our style of dairying and as feed prices have escalated. Our practice of purchasing the vast majority of our feed, sometimes from very far away, has put us at a distinct disadvantage from our competition which is located closer to the feed and to the population centers in the Eastern part of the US. We no longer can afford to allow our processors to buy our milk at a substantial discount to what our competitors are receiving for their milk.

So what do we need to do? First we need to recognize that the current regulated system is incapable of providing any meaningful relief to producers. Moving $0.15-$0.25 per cwt. from processors pockets to our pockets will not make any meaningful difference in dealing with the problems we face. Furthermore, given the increase in energy costs, any attempt to raise producer prices at the expense of the processors will be countered by processors claims for higher make allowances. The reality we face is that current milk production is still significantly higher than last year and that fact will dominate any CDFA decision on granting milk price relief to producers.

Which points out the second thing we need to do: we need to get a handle on the milk supply. That is beginning to happen with the base plans that have been implemented by most handlers in California but it is happening very slowly.

The third thing we need to do is to create a business environment that will foster innovation in the processing sector. One of the things I learned from getting to know the processor members of the Whey Review Committee was that the volatility that distinguishes the way we price milk in California is a killer to many of the end users of our dairy products. Big price changes month to month hurt our ability to foster long-term sales and value growth of dairy products. The existing California system does not allow for any other business relationships to be developed. All Grade A milk in California must by law be purchased at the monthly regulated minimum price. In addition, as one of our leading co-op managers in this state says often, our future market growth may very well come from the West. By that he means the Pacific Rim. He is right about that and we need to recognize that we must make investments in market and product development if we are going to have a future that is better than simply managing the decline of the California dairy industry.

A wise man once said, “Necessity is the mother of invention,” and competition is the tried and true way that creates the necessity that drives the invention. The current California system is designed to minimize risk by making everyone equal. There were very good reasons to put this system in place many years ago, but the system in its current form appears unable to provide the policy framework to allow the industry to meet the challenges that face us. That is why the Whey Review Committee voted by a vote of **10-3** to recommend to Secretary Kawamura that he work **“To create the opportunity for competition for producer milk between the current regulated system and a new regulated and/or unregulated system.”** An **example** of the type of arrangement that could be adopted was produced by one of the Whey Review Committee subcommittees. It was named “Alternative 4” and is attached to this Friday Report:

"ALTERNATIVE 4"

This alternative proposal recognizes that the regulated pricing system, as it exists, is fundamentally incapable of facilitating economically good business decisions. There is no direct connection between where milk goes and the price the dairy farmer receives for it. The tightness of the system severely mutes economic signals so that the true "fair price" being sought cannot be discovered. The proposal contends that the minimum regulated price system needs to encourage competition and allow choices to be available in the marketing of milk.

Current realities:

- California has been and is in a significant plant capacity deficit position.
- The California producer model, which is heavily dependent on purchased feeds, is rapidly removing California producers national dominance as low cost of production leaders. California's practical cost of production could be well approaching several dollars per cwt. higher than their Midwest competition.
- The requirement that all California processors who purchase market milk (Grade A) must pay the regulated minimum price for that milk regardless of whether or not they are a pool plant means that the only current tool to add incentive for additional plant capacity is to discount the regulated minimum price.
- Given the already expensive cost of doing business for processors in California, the **further discount** in the regulated price needed to add incentive for additional plant capacity could amount to more than one dollar per cwt.
- Discounting the regulated price to add incentive for further plant capacity expansion in California has the potential to be very inefficient because:
    1. All processing plants get the increased margin regardless of whether or not they expand capacity. Given that there is a lot of capacity already, the marginal cost to the producer pool of the increased capacity becomes enormous.
    2. That increased margin in and of itself does nothing to encourage the innovation of the processing sector and may discourage it.
    3. Because it is a government-granted regulated incentive that is subject to political pressure, there is no assured "shelf life" to the policy thereby creating huge risk to processors who are contemplating an expensive plant capacity expansion that needs a return over the long term.
    4. Despite the large regulated margins this would create, the reality of significant month-to-month changes in the regulated milk price makes development of higher-valued non-commodity cheese markets difficult.

As the McKinsey Study pointed out and as recent events confirm, California needs to consider a new policy:

Proposal:
To create the opportunity for competition for producer milk between the current regulated system and a new regulated and/or unregulated system.

Proposed changes:

- The regulated class 4b price should be directly tied to the Federal Milk Marketing Order (FMMO) class III price. The proposal suggests using the class III minus $0.50 per cwt as the equivalent price.*
- Secondly, a new Section would be added to the Food and Agriculture Code allowing purchasers of Class 4b market milk the option to drop out of the regulated minimum price system.

What is contemplated is a scenario where the regulated system would include all class 1, 2, 3, 4a and whatever 4b milk wished to be part of it. The class 1, 2 and 3 revenues would provide sufficient dollars to cover the quota payments for those producers who have quota. Cheese plants would be free to contract for a milk supply from producers and cooperatives outside of the pool, not subject to any minimum price requirements. Such producer milk would have no access to the regulated pool and would have no pool obligations. Cheese plants could establish any number of types of contracts to purchase Grade A milk with regards to duration, volume and price. This flexibility would stimulate the opportunity to innovate. However, the cheese plants would have

to compete against the regulated system for a milk supply. The regulated system would have the advantage of the inclusion of the higher classes of milk and a higher regulated class 4b price because the plant expansion incentive need not be included in the class 4b regulated price.

The way this system would work in practice is that producers and cooperatives would make a decision about where they wanted to sell their milk. They could contract to sell all or part of their milk to a cheese plant for whatever terms they could mutually agree to. The milk that was sold to the cheese plants under this arrangement would not participate in the regulated pool. The milk that is sold to a buyer on a regulated basis would participate in the pool and producers will be paid the quota and overbase prices out of the regulated pool. A cheese plant could buy both regulated and unregulated milk at the same time. However all milk purchased, both regulated and unregulated, must be sold by contract which would state, at a minimum, volume and price. CDFA will publish on a regular basis (no less frequently than semi-monthly) the total statewide volume and average price at which the unregulated milk supply is being sold.

NOTE

* The proposal uses the FMMO class III price less $0.50 to account for the California specific cost and distance factors. The FMMO price is a good one to benchmark off of because it is what the competition in the rest of the country is using for a benchmark. The FMMO class III price includes a value for the whey solids stream. The criteria USDA uses to establish the FMMO Class III price mirrors the criteria that must be considered when California establishes its minimum price and therefore a California 4b price that references the FMMO class III price would meet the California statutory requirements.

Upside Potential:

- Creates the opportunity for a much more efficient and effective incentive mechanism for the expansion of cheese manufacturing in California through the use of business arrangements that are not legal today
- Greatly increases the ability of the market signals to be transmitted back to both producers and processors
- Enables the regulated price to be higher than is possible in a system where all milk must be regulated
- Facilitates milk price discovery through real-time transparency

Downside Potential:

- Creates risks both to producers and processors