



Milk Producers Council

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DATE: August 30, 2013

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TO: Directors & Members

FROM: Rob Vandenheuvel, General Manager

MPC FRIDAY MARKET UPDATE

CHICAGO CHEDDAR CHEESE

Blocks	+\$1.125	\$1.7825
Barrels	+\$1.1275	\$1.7700

Weekly Average, Cheddar Cheese

Blocks	+\$0.0470	\$1.7370
Barrels	+\$0.0625	\$1.7355

CHICAGO AA BUTTER

Weekly Change	+\$0.0425	\$1.4375
Weekly Average	+\$0.0520	\$1.4215

NON-FAT DRY MILK

Week Ending 8/23 & 8/24

Calif. Plants	\$1.7585	4,568,958
Nat'l Plants	\$1.7741	13,088,851

DRY WHEY

Dairy Market News	w/e 08/30/13	\$0.5775
National Plants	w/e 08/24/13	\$0.5829

Prior Week Ending 8/16 & 8/17

Calif. Plants	\$1.7564	6,389,435
Nat'l Plants	\$1.7713	13,694,371

FRED DOUMA'S PRICE PROJECTIONS...

Sept '13 Est: Quota cwt. \$19.19 Overbase cwt. \$17.49 Cls. 4a cwt. \$18.89 Cls. 4b cwt. \$16.49
 Aug '13 Final: Quota cwt. \$19.04 Overbase cwt. \$17.34 Cls. 4a cwt. \$18.79 Cls. 4b cwt. \$16.32

MARKET COMMENTARY: (By Sarina Sharp, Daily Dairy Report, sarina@dailydairyreport.com)

Milk & Dairy Markets

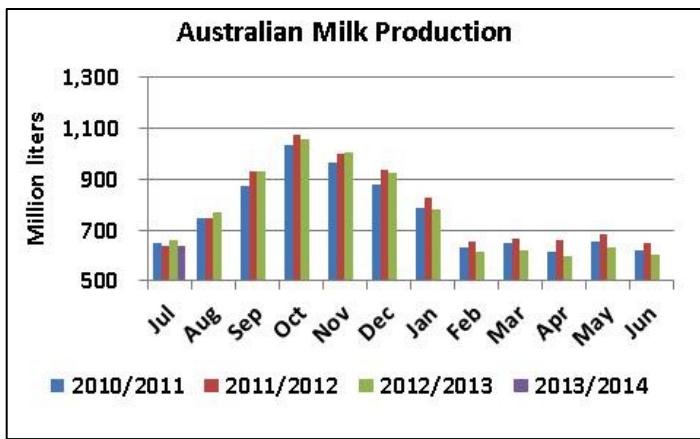
The butter market has finally found its footing. After months of severe discounts to the global market, and ever softer prices, U.S. butter has rebounded from the lows established early last week. It did so with impressive volume, which might imply conviction on the part of buyers. A whopping 25 carloads changed hands at the CME spot market on Tuesday, the highest daily volume in years. Over the course of the week, spot butter prices added 4.25¢/lb. Nonfat dry milk (NDM) prices held steady, allowing Class IV futures to rise.

Class III futures also settled higher. The September contract, which posted steep declines last week, added 55¢. October closed 46¢ higher. A decline in Cheddar blocks on Thursday created confusion and pushed Class III futures sharply lower, but both blocks and Class III milk came storming back Friday. All told, blocks added 11.25¢ this week and barrels were up 12.75¢.

In contrast to the spot market, the National Dairy Product Sales Report (NDPSR) showed a sharp decline in butter prices. NDPSR prices are a lagging indicator, as they report the average sales price from manufacturers over the past 30 days. For the week ending August 24, NDPSR butter averaged \$1.3577/lb. down nearly 8¢ from the prior week. Cheddar barrel prices were slightly lower, but all other dairy product prices increased. NDPSR NDM prices were incrementally higher, averaging \$1.7741. The California Weighted Average Price for NDM increased to \$1.7585. Sales volume diminished to 4.6 million lbs.

Dairy product prices overseas were also mostly higher, according to *Dairy Market News*. The exceptions were butter prices in Oceania, which declined 2.5%, and European whey powder, which dropped less than 1%. Global milk powder prices continue to rise. Despite heavy U.S. dairy product inventories and the possibility of global milk production growth, major cooperatives in Oceania clearly expect continued strength in dairy product prices. Fonterra, Westland and Murray Goulburn have all increased their forecasted milk price payouts for the new season to multi-year highs. Farmgate milk prices in Europe are also elevated.

Despite the promise of much higher milk checks, the Oceania milk production season is off to a ho-hum start. Australian output totaled 1.45 billion lbs. in July, which was down 3.5% from July 2012 but slightly larger than



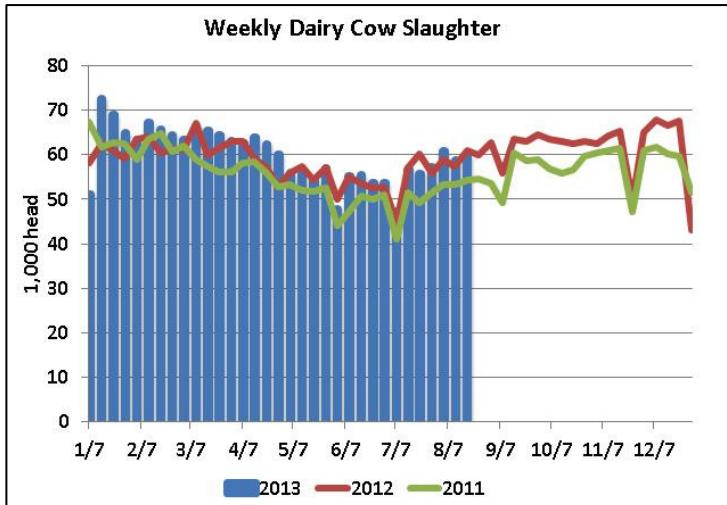
July 2011. New Zealand produced nearly 269 million lbs. in June, which is 6.9% lower than the start of the 2012-13 season and down 3.9% from June 2011. While lower than the two previous years, June's milk production exceeded historical norms. Early season milk production in Oceania is not a good indicator of production trends. If the weather allows, producers will certainly respond to higher milk prices and lower feed costs by increasing milk output.

Consumers' fears that they may contract botulism from beverages with whey protein are unfounded. After great

loss to their bottom line and reputation, it turns out that Fonterra did not produce whey that contained Clostridium botulinum. New Zealand's Ministry for Primary Industries announced that the whey in question contained Clostridium sporogenes, which poses no health risk to consumers, although it can result in early spoilage. However, discovery of either form of bacteria highlights hygiene issues at Fonterra's Waikato facility.

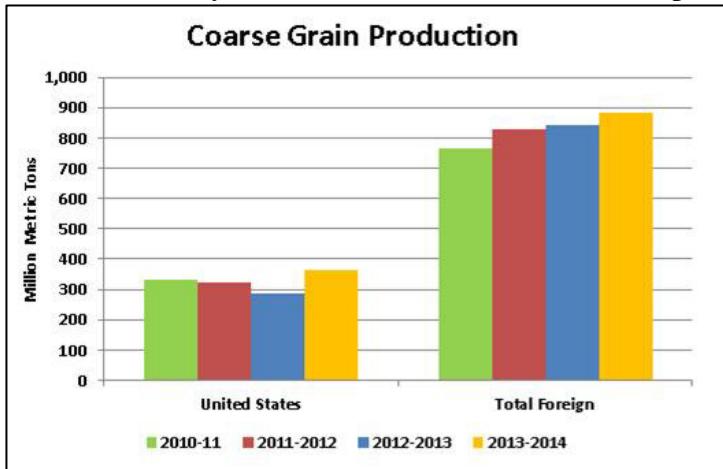
Weekly dairy cow slaughter totaled 59,519 head, down 2.5% from the same week a year ago. Year to date slaughter is 2.8% higher than in 2012.

With the promise of lower feed costs and still-high beef prices, the price of feeder calves for beef feedlots is moving higher. But while a rising tide lifts all boats, some breeds are proving more buoyant than others. Angus-jersey crossbred calves sold for at least \$10/cwt. more than Holstein steers at the same weight. Now that fewer cattle packing plants in the Southwest will accept Holsteins for slaughter, Holstein feeder prices in the region are more deeply discounted relative to beef breeds. Cattle supplies will be short for years, and dairy steers represent a valuable supply of cattle for the beef industry. However, steers with some beef genetics promise an even greater payout.



Grain and Hay Markets

A dome of heat settled over the Midwest this week, and feed prices rose along with the mercury. December corn futures topped \$5.00/bushel this week for the first time since mid-July. But after some introspection and a slight improvement in the forecast, traders began selling again and December corn settled at \$4.82, up 12¢ from last week's settlement. Some areas received spotty rains, and more are promised this weekend. But the calendar, not the forecast, may be the reason that corn could not spend much time above \$5.00. Combines are already rolling as far north as St. Louis, and the weather will have only a marginal impact on yields in points north.



Meanwhile, overseas grain production is solid. Canada is expected to produce its largest canola and corn crops ever, and the largest wheat crop in 22 years. USDA expects global grain production to be 10.4% higher than last year.

New crop oilseed supplies will be tighter than grains, and weather is still critical to soybean yields. Thus, soybean and soybean meal prices moved higher this week. November soybean futures reached new contract

highs early in the week and settled nearly 30¢ higher than last Friday's close. Old crop soybean supplies continue to tighten. Old crop export shipments now total 1,328 million bushels, topping USDA's estimate of 1,315 million bushels. Old crop ending stocks carried over into the new crop year will be minimal.

But it seems unlikely that the disparity between very high soybean prices and relatively cheap corn will be able to last for long. South American farmers will surely respond by continuing to switch acreage from corn to soybeans. Agroconsult, a widely followed Brazilian analyst firm, is calling for a 7.7% increase in Brazilian soybean production this year. Unless there is adverse weather in South America this year, cheap grain prices and large canola supplies could limit rallies in the soybean market.

Dairy and grain markets will be closed Monday for Labor Day.

A LOOK AT CALIFORNIA POOLING AND THE UPCOMING CDFA HEARING: (*By Rob Vandenheuvel*) Regular readers of this newsletter will recall that we've written previous articles about how our pooling system works, the interaction of the five classes of milk, and how modifications to any or all of those class formulas/prices impact the overall system. With a hearing coming up at the California Department of Food and Agriculture (CDFA) to discuss proposed increases to the Class 4b price (milk sold to California's cheese manufacturers), it's worth a refresher on exactly why it is critically important that CDFA establish proper pricing formulas, both for producer income and the relationship between the classes.

For those of you who have attended any of the Class 4b formula hearings in the past several years, you undoubtedly remember hearing testimony opposing increases to the minimum prices. After all – those witnesses have said – it is merely a minimum price, with no limitation to premiums that are paid on top. Sounds pretty logical, doesn't it? While this may seem like a rational argument, it completely ignores the fundamental reality of pooling, and the fact that the individual price formulas do not operate in a vacuum, but instead impact the entire California milk pooling system.

So today, I will be looking into the "big picture" impact of changes to the Class 4b price and why it's so critical that the formula generate prices that are not only in a reasonable relationship with comparable milk sold around the country, but also in a reasonable relationship with the other classes of milk in California.

Before getting into the specifics, let's take a quick look at the California pooling system. Most of you already know these things, but bear with me for the sake of those who want a refresher:

Manufacturers are obligated to pay for their milk based on the monthly State-established minimum price formulas. There are five individual formulas, with each representing a different utilization of the milk:

- Class 1 (fluid products)
- Class 2 (soft products like yogurt/sour cream)
- Class 3 (frozen products)
- Class 4a (butter/powder)
- Class 4b (cheese/whey products)

So a plant that uses their milk to make sour cream would pay a price based on the monthly Class 2 price. If that plant also makes cheese, they would pay the Class 2 price for the milk they used to make sour cream, and the Class 4b price for the milk they used to make cheese.

However, as all California dairymen know, under the pooling system, the processor you sell your milk to doesn't pay you the Class 2 or Class 4b price, but rather **the blended "Overbase" price (or the "Quota" price for those that own Quota, but that's another topic for another day).**

So how does the accounting work? Every month, CDFA calculates the monthly "Overbase" price, and reconciles each manufacturers' account with the pool. Here's a simplified example, using data from July 2013 (*I say "simplified" because (1) this does not factor in the Quota payments, and (2) all the figures below are "per cwt," while CDFA determines the financial obligations per pound of "fat" and "solids-not-fat."*):

- Class 1 price (*plants in No. CA*): \$19.59/cwt
- Class 1 price (*plants in So. CA*): \$19.86/cwt
- Class 2 price (*plants in No. CA*): \$18.31/cwt
- Class 2 price (*plants in So. CA*): \$18.54/cwt
- Class 3 price: \$18.26/cwt
- Class 4a price: \$18.61/cwt
- Class 4b price: \$15.65/cwt
- Overbase price: \$16.85/cwt

So using this information (and ignoring the Quota calculation), we know that California dairy farmers that participated in the pool in July (which is most of them) were entitled to the Overbase price of \$16.85/cwt, regardless of what plant you shipped your milk to and what products that plant makes. On the other side of the equation, there is some reconciling to do:

- Class 1 plants in Northern California paid their dairy farmer suppliers or cooperatives the Overbase price of \$16.85/cwt, but then paid an additional \$2.74/cwt (\$19.59 - \$16.85) into the California pool, making their total obligation \$19.59/cwt (the Class 1 price).
- The same kind of calculation occurred for the Southern California Class 1 plants, as well as all Class 2, 3 and 4a plants.
- Class 4b plants, on the other hand, had to pay their dairy farmer suppliers or cooperatives the same Overbase price as everyone else (\$16.85/cwt), but rather than make an addition payment to the pool, they actually got a payment *from* the pool amounting to \$1.20/cwt (\$16.85 - \$15.65).

So this, in very simplistic terms, is how our system is structured. Plants pay for their milk based on how they use it, and producers are paid a blended average price. CDFA manages the differences by requiring pool contributions for some plants and making payments to other plants.

So at this point, some of our readers may be asking, “So what does this have to do with the upcoming hearing?” The answer is EVERYTHING. Each of the five class prices contributes to the ultimate blended Overbase price. In the case of the Class 4b price, it represented about 45% of the pool in July, making it the largest since class of milk in the pool.

So let’s take a look at an alternate scenario for July where the Class 4b price is held in a closer relationship with the Federal Order Class III price (the benchmark price used for milk sold to cheese plants around the country). Over the course of the past ten years, the other major manufacturing class in California (Class 4a, butter/powder) has averaged about \$0.28 per hundredweight below the comparable Federal Order Class IV. During that same period of time, the California Class 4b price has averaged about \$1.71 per hundredweight below the Class III price. **So what if the California Class 4b formula were modified to maintain a price that averaged \$0.28 per hundredweight below the Federal Order Class III price, keeping it in the same relationship that CDFA keeps the Class 4a price?** What would the July 2013 numbers have looked like in that scenario? **(The red bolded numbers are what changes in this scenario.)**

- Class 1 price (*plants in No. CA*): \$19.59/cwt
- Class 1 price (*plants in So. CA*): \$19.86/cwt
- Class 2 price (*plants in No. CA*): \$18.31/cwt
- Class 2 price (*plants in So. CA*): \$18.54/cwt
- Class 3 price: \$18.26/cwt
- Class 4a price: \$18.61/cwt
- Class 4b price: **\$17.10/cwt**
- Overbase price: **\$17.50/cwt**

For starters, the first thing you see is that the change would have increased the Overbase price by \$0.65 per hundredweight. That’s the direct impact the change would have on **producers** – a significant (and much needed) increase in producer revenue. In fact, over the past 3 ½ years, this scenario of maintaining our Class 4b price within \$0.28 per hundredweight of the Federal Order Class III price **would have raised the Overbase prices to the tune of almost \$930 Million**. Stop and think about that for a second; all CDFA would have had to do is establish a Class 4b price that maintains the same relationship as the cooperative-owned butter/powder manufacturers are asked to maintain (still lower than the Federal Order prices), and producers would have received almost \$930 Million in higher Overbase prices. **How much of your dairy's debt could have been retired for your share of that amount???**

This change would also have an impact on the plants. As mentioned earlier, the manufacturers of Classes 1, 2, 3 and 4a all made pool contributions during the month of July. That contribution was above and beyond what the plant had to pay its producers in the Overbase price. In the case of Class 4a plants, which are owned and operated by producer-owned cooperatives and represents the 2nd largest volume of California milk (approximately 30-35% of the pool), those plants had to send \$17.6 million ***to the pool*** in addition to the Overbase payments they made to their suppliers. At the same time, the State's cheese manufacturers received \$18.3 million from the pool in order to be able to pay their producers the Overbase price.

Under the revised scenario where the Class 4b price remains in a more reasonable relationship of \$0.28 per hundredweight below the Federal Order Class III price (which still represents a significant discount for our State's cheese plants relative to their Federal Order competition), those California cheese plants would have still received a payment from the pool, but it would have shrunk to \$6.5 million. At the same time, our Class 4a plants would have still been required to make a pool payment, but it would have shrunk to \$10.6 million.

So why are all these figures important? In a single month, it may seem like a modest difference. But over the past 3 ½ years, California's cheese manufacturers **have drawn \$456 million out of the California pool** in order to be able to pay their producers the Overbase price. At the same time, our cooperative-owned butter/powder plants have had to **contribute nearly \$375 million** above and beyond their Overbase payments to their producers. Consider the inequity of a butter/powder plant competing for a milk supply with a cheese plant, with both plants having to pay the same Overbase price to their producers, but experiencing very different economics, courtesy of the State-run pooling system. **Think about that the next time you hear our State's cheese manufacturers tout "free markets" and brag about the generous premiums they pay.**

Now some of you may be saying, "That's just the way the pooling system works." And you'd be right **IF** our Class 4b price were constantly lower than the other manufacturing classes for legitimate reasons – like the value of milk sold to cheese plants around the country was chronically lower than the value of milk sold to butter/powder plants. **But that has NOT been the case.** Our Class 4b price is chronically discounted because of **an administrative decision by CDFA to maintain an artificially low price.** How would the past 3 ½ years have looked for Class 4a/4b plants if the Class 4b price maintained a \$0.28/cwt relationship with the FMMO Class III price?

2010 - Present	Actual Pool Contributions/ (Withdrawals)	Pool Contributions/Withdrawals under a \$0.28/cwt relationship	Difference
Class 4a (butter/powder)	\$374.7M Contribution	\$66.2M Contribution	\$308.5M
Class 4b (cheese/whey)	(\$456.2M) Withdrawal	\$56.7M Contribution	\$512.9M

What a difference in balance between the two classes! In fact, what this demonstrates is that around the country, the Federal Order Class III and Class IV prices maintained a very close average relationship (less than \$0.10 per hundredweight gap). If California had kept that same relationship, you can see the difference it would have made.

While nothing can be done about the past 3 ½ years, the CDFA hearing this month represents an opportunity for the Department to begin rectifying this obscene disparity. The modest proposal being discussed the hearing – based on a written offer by the Dairy Institute (<http://www.milkproducerscouncil.org/070813dairyinstitute.pdf>) – slightly shrinks this gap. But to be certain, we must continue efforts to close that gap in the long term. **California dairy families cannot afford to leave another \$930 Million on the table over the next 3 ½ years!**

**MPC's Board and Staff want to wish you and your families
a wonderful and safe Labor Day Weekend!**