Milk Producers Council

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

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE

Blocks	*+$.0100*	$1.5100
Barrels	*-$.0050*	$1.4875

Weekly Average

Blocks	*+$.0540*	$1.5030
Barrels	*+$.0455*	$1.4915

CHICAGO AA BUTTER

Weekly Change	*+$.0600*	$1.4100
Weekly Average	*+$.0575*	$1.3640

DRY WHEY

WEST MSTLY AVG	w/e 10/29/09	$.3500
NASS	w/e 10/24/09	$.3264

NON-FAT DRY MILK
Week Ending 10/23 & 10/24

Calif. Plants	$ .9928	11,298,553
NASS Plants	$1.0345	10,900,605

CHEESE MARKET COMMENTS: While block prices edged up again on the CME this week, it appears that some manufacturers continue to be unconvinced that those prices are sustainable. Continuing increases in cheese production and the possible concern about what might happen if the temporary support price increase ends on October 31st, could be what is creating the uncertainty. *Dairy Market News* (DMN) reported this week that cheese “disappearance” so far this year is 4% higher than in the same period last year and cheese production is up by 1.7%. Yet, cheese in storage at the end of September was 16% higher than last September; that storage increase was about equal to the increase in the amount of cheese produced. To the extent that most of the increase in stored cheese was Cheddar for aging, the ratios of production/storage/usage do not look too bad, provided manufacturers begin to place more importance on having a current outlet for their production. That appeared to be the case in the latter part of 2007 and the early part of 2008, and prices responded very well. For the next several months, at least, there should be less milk available for all usages – which may affect cheese output and turn some people’s doubt into belief, and it wouldn’t hurt if Secretary Vilsack would extend the temporary higher support price levels indefinitely.

BUTTER MARKET COMMENTS: The market for butter continues to show signs of strength and optimism. In addition to steady retail sales, there is the expectation that butter production will continue to decrease as the milk supply dwindles, cream for usages other than for churning is increasing seasonally, and international brokers continue to inquire about obtaining possible supplies. The international interest is mainly from Western European brokers and their customers because DMN’s latest report shows butter prices f.o.b. docks in Europe to be at about $2.06 per lb but only $1.27 per lb in New Zealand. European buyers don’t necessarily want any butter, they want cheap butter, but New Zealand’s cheap butter seems to be fully committed. U.S. buyers are selling off stored butter and are said to be replenishing supplies now in anticipation of higher prices ahead. After holding steady with little activity through Wednesday, prices on the CME moved up $.06 per lb this week ($.05 on Friday). A fine finish for the week.

POWDER MARKET COMMENTS: DMN describes the U.S. markets for nonfat dry milk, whole milk powder, and buttermilk powder as either firm or strong, or both. Production for all three is generally trending lower and there is more demand for spot loads than availability. The NASS average price for nfdm was slightly affected by the sale of three truck loads to the CCC at $.92 per lb, for the purpose of testing a new type of bag. The California average for last week moved to within 4.2 cents of the national price. The amount of manufacturer stocks of nfdm at the end of August was 54 million lbs lower than two months earlier, and next week’s report for September is expected to show further decreases. DMN reports that lack of product for “spot” sales is causing some buyers to use condensed products, which gives them product sooner and is often less expensive than buying and storing powder.

WHEY PRODUCTS MARKET COMMENTS: The market for dry whey is generally well-balanced and prices continue to move higher. The West's "mostly" average this week reached $.35 per lb, the highest it's been since January 2008. Inventories so far this year have held surprisingly even, ranging from a low of 47 million lbs to a high of 56 million lbs, reflecting the good market balance. According to DMN, the market for whey protein concentrate (34% protein) is strong and inventories are tight. The "mostly" price this week rose to $.78 per lb, and is now about where buyers are beginning to look for non-dairy protein ingredients instead of WPC. WPC prices were last at $.78 in July 2008 when they were on their way down from their peak of $1.64 per lb in July 2007.

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Fred Douma is unavailable to provide projections this week.

October Final: Quota cwt. $ 13.60 Overbase cwt. $11.90 Cls. 4a cwt. $11.51 Cls. 4b cwt. $12.69

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CWT'S LATEST HERD REMOVAL PROGRAM: SMALLER BUT ESSENTIAL: *(By J. Kaczor)* In what is hoped to be the final stroke in an extraordinary effort to rebalance milk supply with demand, CWT announced this week that their members elected to remove about 26,000 more cows by the end of this year. Adding this number to the estimated 212,000 already removed by CWT this year will bring the total to about 238,000. That program, along with a substantial additional number of cut-backs by individual producers in response to the huge financial losses they were incurring, resulted in a total of 245,000 more dairy cows culled through this September than for the same period last year. Partially offsetting these cutbacks is approximately 37,000 cows that have been added to existing herds, for a net reduction in herd size of 208,000 cows since last December.

For whatever reasons, the reports for the last three weeks show that 6,000 fewer cows were culled this year than in the same three weeks last year. That could mean that producers have cut back to the level where they believe they can make it to the time where milk prices rise to where they at least cover their costs. Dairy commodity prices are rising, inventories are coming down, and milk usage is at least stable. There is basis for real hope. On the other side of the equation, it appears that the recession still has some time to run and most economists believe the recovery of jobs, which is essential to a recovery in consumer spending, is a lagging factor and therefore could be as much as nine months off.

By December, the number of dairy cows in the U.S. should be lower than the numbers that were on hand in December 2006, but the amount of milk produced is likely to be slightly more, because of the fairly steady increase in production per cow over that time span. That brings us to some important questions: is that enough of a cutback; will milk usage be high enough to avoid another buildup of unneeded, unwanted, unusable, dairy commodities; will the population increase over that three year period result in at least some additional consumer demand; and finally, will the U.S. be able to capture and hold enough of what is hoped to be a recovering international market for dairy products?

That last question is very important, and that's where CWT can play its next critical role. The U.S. needs to have a well-planned, well-executed, export assistance program for key dairy products. CWT, along with the U.S. Dairy Export Council, Dairy America, and other major exporters have the knowledge, expertise, and resources to do exactly that. A program such as that would represent a stable component in total U.S. milk demand and would validate the U.S. dairy industry as a reliable supplier of high quality dairy products to customers throughout the world. That's why it is hoped that the current herd removal program will be the last, for a long time. Based upon CWT's latest financial projection, it looks like they may be about $30 to $40 million in the hole once this latest herd removal program is funded. That's enough; move on. Income is projected to be about $9.5 million per month. Only $20 million is allocated for export assistance in 2010, which is far too little to have any impact whatsoever. **CWT, National Milk, are you listening? Isn't it time to recognize the opportunity to establish a lasting legacy by creating something rather than the opposite?**

MILK PRODUCERS COUNCIL SUBMITS ALTERNATIVE PROPOSAL FOR UPCOMING CDFA HEARING: *(By Rob Vandenheuvel)* This week, Milk Producers Council submitted our alternative proposal for the November 9th hearing scheduled by the California Department of Food and Agriculture (CDFA) to consider changes to all five milk pricing formulas (Classes 1, 2, 3, 4a and 4b).

For those of you that are not familiar with the CDFA hearing process, the term "alternative proposal" can be deceiving. Our proposal is not a reflection on whether or not we support the underlying petitions that led to this hearing. In fact, MPC will be testifying in support of both the underlying petitions sent in by the Alliance of Western Milk Producers *(for a permanent increase in the Class 1, 2 and 3 milk prices)* and Western United Dairymen *(for a temporary increase in all five classes)*. However, when CDFA called for the hearing, they opened up all five class formulas, and the MPC board felt there were two important items that deserve **immediate attention** by CDFA.

MPC's alternative proposal has two pieces to it, each dealing with a different commodity product that drives our milk price. The first I will discuss is nonfat dry milk (NFDM) and the second is dry whey.

<u>The first proposal – Nonfat Dry Milk</u>

The value of nonfat dry milk, or NFDM, is used in determining the price of four of our five classes of milk. Most prominently, nfdm value drives the Class 4a (butter/powder) formula, with **the Class 4a price moving up or down approximately $0.09 per cwt for every penny the nfdm moves up or down**.

The value of NFDM also drives the Classes 2 and 3 formulas, since those two prices are based directly on the Class 4a price. Class 1 also utilizes NFDM prices in its formula, using a "higher of" formula that will use either NFDM/butter or block cheddar cheese/dry whey, depending on which calculation is higher.

CDFA utilizes different tools to determine the "value" of the four different commodities. For instance they use the Chicago Mercantile Exchange (CME) price for 40-lb. blocks of cheddar cheese for use as a "cheese value" in our formulas. For butter, CDFA uses the CME price for Grade AA butter. For NFDM, they use a different tool: the California Weighted Average Price (CWAP).

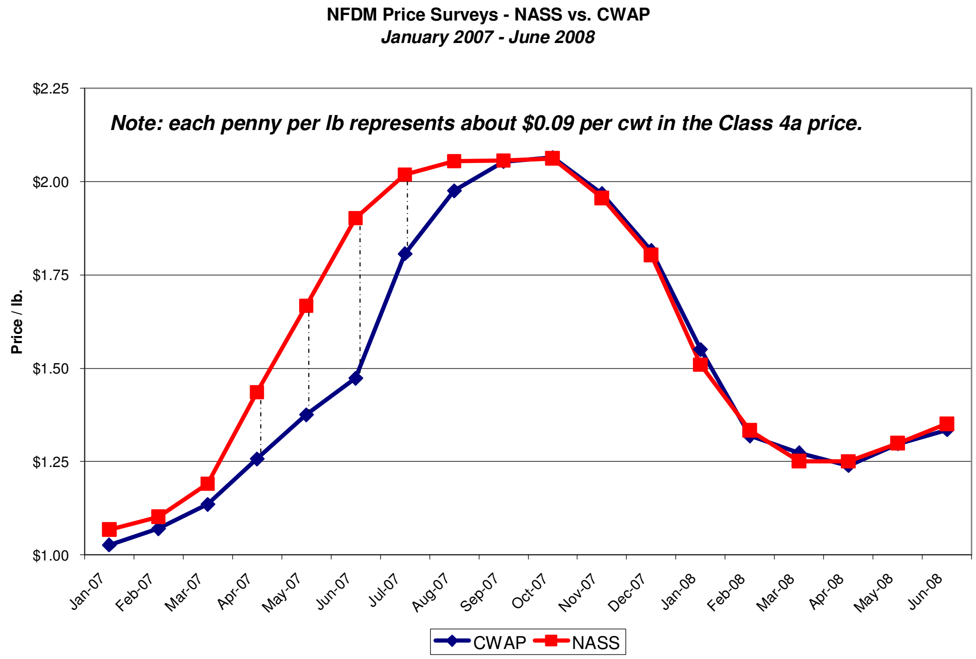
The CWAP is operated by CDFA, and is a survey of California powder plants to find out how much nfdm they sold and at what price. On a weekly and monthly basis, powder plants in California report this information to CDFA. That information is then released on a weighted-average basis, and used as the value of nfdm for purposes of determining our Class 4a price (as well as for Classes 1, 2 and 3, as I explained above).

Milk Producers Council has been troubled for several years about the validity of the CWAP. While this survey has a long history in California's pricing formula, the nature of the powder manufacturing industry in California has significantly changed over the past several years. It is the understanding of MPC that the vast majority (in excess of 90%) of the powder that makes up the CWAP comes from two cooperatives who jointly market their powder through a single marketing agency in common. The structure of the current 4a formula essentially insulates these handlers from being exposed to market forces because **whatever price they decide to sell their powder for becomes the product value price that determines the milk price they are subjected to**. They have very little incentive to move the nfdm price up.

In the Federal Milk Marketing Orders (FMMO) that regulate much of the rest of the country, their formulas use a different survey – the National Agricultural Statistics Service (NASS) – to determine the value of NFDM. The NASS survey includes a much broader spectrum of powder makers throughout the U.S., including California.

In 2007, a huge variance emerged between the CWAP and the NASS prices for NFDM. As a result of that variance, **California producers were shorted millions of dollars of legitimate revenue because of the inadequacies of the CWAP**. According to John Kaczor's calculation, published in this newsletter in 2007, California producers missed out on about $200 million in legitimate revenue because of this simple variance. In August 2007, CDFA held a hearing and made only modest changes, based in some ways on assurances from the powder makers that while producers lost money as prices moved up, they would recover those higher prices as the market moved back down. However, as evidenced by the chart on the next page, California producers never recovered the losses; the CWAP fell in lock step with the NASS price when market prices crashed in 2008.

Over the past year and a half, powder prices have been at the bottom of the price cycle and the CWAP and NASS prices have tracked very closely. But the powder market is now recovering and once again California producers are experiencing a CWAP that is lagging behind the NASS powder price. **MPC is very concerned that California producers, who are in desperate need of income, will be deprived of legitimate revenue because of the lack of incentive that California powder makers have in keeping California powder prices in line with the market price as revealed by NASS**.



As I said before, the price of NFDM has a huge impact on dairy farmers' revenue, as the Class 4a price moves up or down by approximately $0.09 per hundredweight for every penny NDFM moves per pound. So the differences you see between CWAP and NASS may seem small – $0.04 per lb this week and $0.06 per pound last week – but that difference represents about **$0.36 - $0.54 per hundredweight on our Class 2, 3 and 4a prices** – which make up about 40 percent of the pool price. And of equal concern is that as the powder market continues to strengthen, **we are vulnerable to see another repeat of 2007, with the CWAP price lagging behind the NASS price, with no hope of recovering that money "on the way down" as some so eloquently claimed in 2007**.

In order to keep California producers in alignment with our fellow producers in neighboring states, and give our state's powder makers the incentive to generate more income from their powder sales, **MPC is proposing that the CDFA replaces the use of the CWAP in our formulas, and instead utilizes the NASS survey to determine a value for NFDM. This is a simple change to our state's pricing regulations that will be a vast improvement for our industry.**

The second proposal – Dry Whey

From 2003 – 2007, California's Class 4b (cheese) formula included a variable dry whey factor that moved up and down as the *Dairy Market News* announced dry whey price moved. However, after a hearing in late 2007, CDFA replaced the variable dry whey factor that had been in the Class 4b formula with a static $0.25 per hundredweight factor.

While 2007 saw the value of dry whey get as high as $0.80 per pound, in the roughly two years since CDFA's change in the formula, the value of dry whey has primarily ranged between $0.15-$0.30 per pound. With dry whey valued at that level, the $0.25 per pound static dry whey factor has been adequate to compensate producers for the value of the whey stream.

However, **the market for dry whey has begun to show strength again in recent months**, and MPC is concerned that if the value of dry whey continues to rise significantly, **California producers will be deprived of legitimate value that is being earned on Class 4b milk**. Our producers will also fall farther behind producers in the rest of the country, as the FMMO formula continues to have a variable dry whey factor in the class III formula.

The issue of how to incorporate the value of dry whey in the Class 4b formula was discussed not only in the 2007 hearing, but in a subsequent Whey Review Committee in 2008. That committee met several times, but in the end was unable to come to one solution. As a result, the $0.25 per hundredweight factor that was implemented by CDFA in 2007 remains in place. But despite this Committee's inability to come to consensus, there is a huge vulnerability on the part of the California producers that must be addressed. Given the hit on dairymen's equity in 2009, our producers cannot afford to simply forfeit the increased revenue stream if and when the dry whey market strengthens to the point of pushing the price dramatically above current levels. MPC is proposing two changes for how dry whey is treated in our formulas:

1. **In calculating the value of the dry whey for California's formulas, we propose using the NASS-reported price for dry whey. This is consistent with how our fellow producers in FMMO areas value their whey stream.**

2. **In addition to the $0.25 fixed whey factor in the Class 4b formula, we propose that when the NASS Dry Whey price exceeds $0.35 per pound, the additional value be split 50/50 between producers and processors.**

One thing that seemed clear from the discussions in the Whey Review Committee was that dry whey is a different type of commodity than NFDM, butter and cheese, and as such, should be treated differently. That is why MPC is proposing a formula that would share the revenues from a strengthening dry whey market 50/50 between producers and processors. This is different from the other commodities *(NFDM, butter, and cheese)*, which utilize a make allowance to carve out a fixed, guaranteed margin for our processors.

MPC is adamant that both these proposals be seriously considered in the upcoming hearing. In both cases if the department does not adopt the proposals we have made, **potentially millions of dollars of legitimate, much needed, market-based revenue will not flow into producers' pockets**. If CDFA does not act now, both of these issues will inevitably be dealt with in the future because the current 4a and 4b formulas are deficient as outlined above, but **the damage done to California's producer sector by waiting will be incalculable**.

I would strongly encourage any producer that's available to come attend this hearing. We need all the support we can get at the hearing. It starts at **8:30 am on Monday, November 9th**. It will be held at CDFA's main auditorium at **1220 N Street, Sacramento, CA 95814**. Given the number of alternative proposals that were submitted and the fact that the formulas for all five classes are eligible for amendment, it's possible the hearing could go more than one day. But if any of our producers are able and willing to go, I strongly encourage you to do so.

LONGTIME CHINO DAIRYMAN HARLAN MIERSMA PASSES AWAY AT AGE 59: *(By Rob Vandenheuvel)* Last Friday, we lost a long-time member of the Chino dairy family as Harlan Miersma passed away at the age of 59, after battling cancer for the past six years. Harlan's memorial service was held today, with friends and family from near and far packing First Chino URC to pay their respects to a wonderful man. He is survived by his wife, Greta; four children, Vickie, Harlan, Laura and Cheryl; and six grandchildren. Our thoughts and prayers are extended to all of Harlan's family.

CDQAP EVALUATOR SCHEDULED TO BE IN SOUTHERN CALIFORNIA THE WEEK OF NOVEMBER 16TH: *(By Rob Vandenheuvel)* As I've mentioned in previous newsletters, dairies who are willing to get certified by the California Dairy Quality Assurance Program (CDQAP) will receive a 50% reduction in their annual water board fees. This certification process includes six hours of classroom education and an on-site evaluation by CDQAP.

The evaluator, George Salsa, is making his way through the Central Valley, and is scheduled to be in Southern California the week of November 16th. Any dairymen, whether in Southern or Central California, wishing to get CDQAP-certified, should contact George at (530) 574-0524 and set up an appointment for the evaluation. George will charge a $500 fee for the evaluation, but assuming that your dairy is certified, you will make up for that cost in the reduced water board fees.