Milk Producers Council

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

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE

Blocks	*-$.1375*	$1.1325
Barrels	*-$.1775*	$1.1300

Weekly Average

Blocks	*-$.0866*	$1.1942
Barrels	*-$.1059*	$1.2283

CHICAGO AA BUTTER

Weekly Change	*-$.0100*	$1.1300
Weekly Average	*-$.0100*	$1.1367

DRY WHEY

WEST MSTLY AVG	w/e 01/02/09	$.1525
NASS	w/e 12/26/08	$.1733

NON-FAT DRY MILK
Week Ending 12/26 & 12/27

Calif. Plants	$.8110	12,324,771
NASS Plants	$.8323	15,594,786

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CHEESE MARKET COMMENTS: Prices for block cheese on the CME this week gave a last heave, and dropped to the CCC support level. Barrels were close. Block prices have now fallen 14 straight trading days, a total drop of $.6575 per lb. since December 9th. Dairy Market News reports that buyers are simply not willing to carry inventory over the year end, so stocks are building at manufacturing plants' warehouses. There have been no particular pieces of news to account for the drop to support. Cheese has joined nonfat dry milk at support level, butter at just above support, and dry whey continuing to be sold below the cost of producing the product. Somber news, indeed.

BUTTER MARKET COMMENTS: Milk and cream continued to stream into churning plants this week, as fluid usage reflected schools' closings, and usage of cream for many of the holiday products wound down. Butter prices on the CME this week held at $.08 per lb above the support price level. DMN reports that buyers may be ready to move early next year. These very low prices for butter and cheese should help attract ads and retail customers. Butter inventories are expected to rise a bit because of the recent extra production and lower export volume.

NONFAT POWDER COMMENTS: Product continues to move into warehouses leased by the Commodity Credit Corporation. Some sales this week may have been made by other than California plants, but located in the West. The total amount now owned by CCC represents a full month's worth of production. DMN reports that buyer interest is moving steadily lower.

WHEY MARKET COMMENTS: The news continues to be good for whey protein concentrate prices. The "mostly" price this week increased by 2.5 cents per lb, and DMN comments that demand is at least equal to the current supply. However, demand and prices for dry whey remain about where they have been, at about $.17 per lb, with some sales in the west continuing at the $.10 per lb level.

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FRED DOUMA'S PRICE PROJECTIONS…

Jan 2 Est:	**Quota cwt. $12.36**	**Overbase cwt. $10.68**	**Cls. 4a cwt. $ 9.54**	**Cls. 4b cwt. $ 9.54**
Dec Final:	**Quota cwt. $14.36**	**Overbase cwt. $12.66**	**Cls. 4a cwt. $10.31**	**Cls. 4b cwt. $13.95**

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INDUSTRY DISCUSSION CONTINUES ON A POSSIBLE CALIFORNIA FEDERAL ORDER: *(By Rob Vandenheuvel)* This week, MPC Vice-President Geoffrey Vanden Heuvel was interviewed on DairyLine Radio on the growing discussion regarding a possible California Federal Order. **(An audio file of the interview has been posted on http://www.milkproducerscouncil.org.)** Below are some excerpts from the radio interview:

- "California is no longer isolated. For many decades we were able to do our own thing; we had a low cost of production relative to the rest of the country and we had a Class I market that nobody else could reach because we were isolated from the rest of the country."
- The barriers have been broken down the last 10-15 years and plants and dairies have been built just over the border "for the specific reason of exploiting the fact that the state order cannot regulate interstate commerce."
- Officials who run the state order have decided to "keep discounting the California Class 1 price to a point where it makes no economic sense to bring any milk in here."
- For California dairy producers, that means that the amount of revenue they would normally expect to come in from Class 1 sales is not going to be there, which amounts to millions of dollars and "happens at a time when the cost of production advantage that California historically has had, has evaporated as well."
- It has become very expensive to produce milk in California and competitors like Texas, New Mexico, and Idaho "can fully match us in cost of production so something absolutely has to change and a federal order is a very viable option for California and we need to take a hard look at how to do that."
- "We could continue to sell our milk cheap. It would be foolish to do that but we'll see whether the leadership of California is willing to step up and take a serious look at a federal order. They have not been willing to do that so far but there's nothing so powerful, as an idea whose time has come. This is clear."

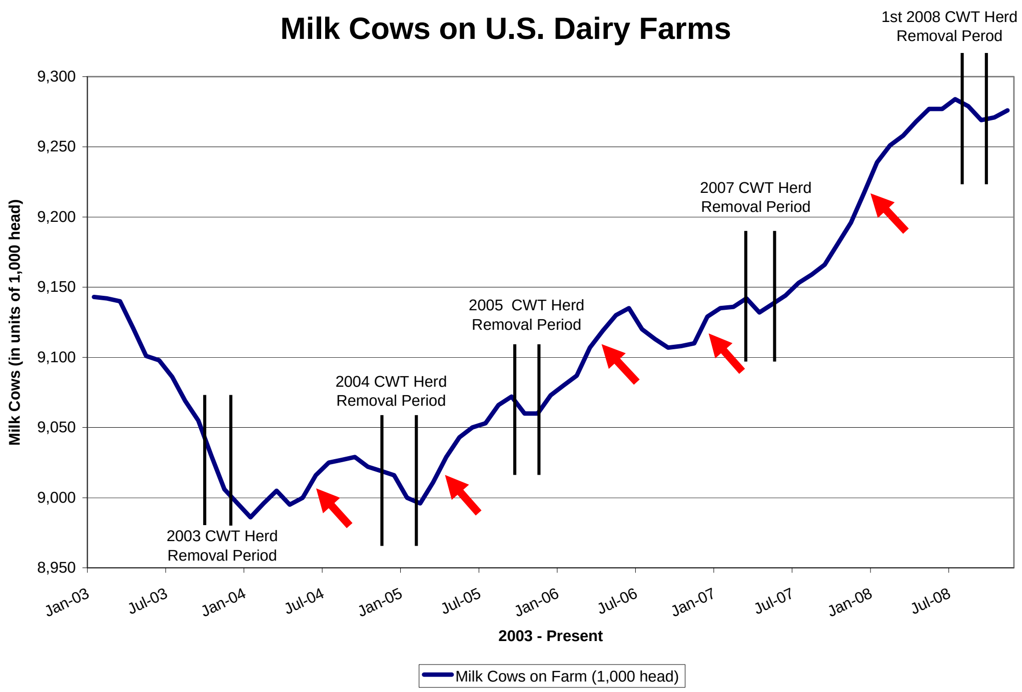
DairyLine also published a written article following the interview which noted that *"Western United Dairymen has notified DairyLine that they will hold industry wide meetings for California dairy producers and processors in February to present an in depth analysis of the federal order issue."* **We look forward to working with our cooperatives and fellow industry groups as we engage in a serious and healthy discussion on this very practical option for re-capturing our state's Class 1 revenue.**

CWT IS CRITICIZED FOR BEING UNABLE TO SOLVE INDUSTRY'S PROBLEMS; A REVIEW OF THE CRITICISM: *(by: J. Kaczor)* Three weeks ago an article in MPC's Update about the latest CWT herd retirement program included a number of supportive statements for the program. However, last week MPC became aware of **a statement of non-support for CWT**, made by one of CWT's long-time cooperative members (and member of National Milk Producers Federation), which cited **the herd retirement program as the main reason** for their position of non-support. Was MPC so wrong three weeks ago?

It was apparent that a lot of thought by the CWT member went into the decision to withdraw its support, and the reasons went well beyond the herd retirement program. Following is a recap of the basic points they make in explaining their position.

- The U.S. dairy industry today is far different from what it was like in 2003, when CWT was formed. It has been affected and transformed by internal and external factors to the point where CWT can no longer fix the industry's basic problems.
- CWT's current programs are no longer able to solve **the industry's major problem** of recurring low prices which result from **a recurring oversupply of milk**, which itself results from more cows that are ever more productive, and from dairy owners' astute responses to opportunity when it is presented.
- CWT herd removals have accomplished sizable bulk removals of cows, but the results are short-term and of decreasing effectiveness because the immediate result is an increase in the value, and then the number, of replacements.
- Instead of massive herd removals and subsidized exports, **corrections to under-supply or over-supply situations should be left to natural market forces** where prices ultimately rise and fall until total supply matches total demand.
- CWT's programs need to be reformed. Subsidies of exports should stop when there is a world over-supply, and the herd retirement program should be restated by timing the herd removals to occur at the bottom of a price cycle and by lowering the price that is offered for the cows.

The CWT member provided plenty of facts and conclusions in its explanation of its position, which filled in and expanded on the above points. A few of them will be reviewed here, on our way to summing up MPC's position. A good place to start is to look at the following graph which shows the number of U.S. milk cows, by month, from January 2003 to November 2008, which is the most recent monthly estimate reported by USDA. This graph is an expansion of the one developed by the CWT member.



The graph does verify one of the points made above that, following CWT's herd reduction programs, there is an acceleration in cow numbers which soon results in more cows than before the program began. But the arrows in the graph also show the same acceleration after major reductions that occurred in this same period without CWT's participation. Before the CWT was even formed in 2003, a major herd reduction was already underway, and producers had already eliminated more than 100,000 cows (January through October) before CWT removed any. Another major reduction occurred in 2006 without CWT's participation, and again was followed by accelerated herd expansion.

Those rapid herd expansions represent "dairy owners' astute responses to opportunity." But the argument that the CWT herd reduction programs also increases the value of cows, whereas a natural market correction does not, also deserves consideration. Is that the way it works? It shouldn't, because the CWT calculation sheet for those who are bidding to have their herds accepted shows quite clearly that the price paid is merely the difference between the estimated slaughter value of the herd at the time of the bid and the value of the cows if they were sold at auction. Those market values already exist, and the CWT program does validate them by agreeing to recognize those values, but that is not the same as saying the values have been increased. The follow-up point that natural market forces (low prices, high costs), causing producers to reduce herds or shut down operations, also reduces the value of cows, seems logical, but needs verification. However, **the data does not seem to substantiate the suggestion that CWT's herd reduction program, unlike market-induced reductions, is the cause of milk production rebounds**. More on this point, below, in a discussion of MPC's concerns about the real cause of price volatility and what can be done to reduce it.

Regarding the point that planned herd reduction programs should be – but are not – timed to coincide with the low point of price cycles, CWT from the start did identify specific cheese and butter prices that reflected targeted levels of milk prices, and periodically updated them as they believed conditions warranted, and this year added a cost of production component to their planning. That multi-factor approach seems reasonable. But it does look like the timing of some of the HRP's can be faulted, although not for the reason cited by the CWT member. The above graph shows clearly that the first HRP in 2003 was not necessary, and contributed little to the downward trend in cow numbers that was already underway. And one can only guess what might have happened if CWT had removed another 30 or 40 thousand cows in 2006, in addition to the 28,000 that "natural market forces" removed, and if many more had been removed earlier this year. The CWT member would have CWT quantify the specific timing, but many would argue that a "sense of the market" is also needed for the very reason that the industry has undergone a transformation from the time CWT was formed.

The suggestion that future HRP's limit the value paid for cows to about what it costs to raise replacements ($1,400 is a number that was suggested as a current cost) would seem to result in far fewer bidders for the simple reason that if the cows are really worth more than the cost of raising replacements, more would be sold for full value than would be bid away. **The real value of CWT's HRPs for those wishing to leave is convenience and the avoidance of auction costs.**

The argument that the export subsidy program is marginal at best, and certainly should not be used during periods when there are world surpluses, has to be disappointing to CWT because they place considerable pride in that program. The program has been expanded to include many more products than were first included, in order to maximize its effectiveness. But the data over the full five years of its operation verify that, except for butterfat products during a portion of 2007, only a small percentage of exports needed subsidies, and trade sources have pointed out that U.S. export prices (subsidized and non-subsidized) have helped to pull all prices down. CWT is now attempting, with the assistance of USDEC, to put together an export program involving specific products for targeted countries which they hope will lead to long-term relationships. It sounds like a good idea, **but price always counts,** so it's difficult to see how this program really can lead to substantial export volumes which continue under all market conditions, without recourse to subsidies.

Milk Producers Council has been a supporter of CWT since its inception, but the support has not been without the belief that constructive criticism helps to improve programs, and concerns that are not voiced contributes to a program's demise. The CWT member that voiced its concerns did so in a way that resembled a tidal wave. If it came without warning, it could be destructive. We presume that warning signs had been posted and measures were taken by CWT to accommodate the force of the message. The timing of this broadside is somewhat unfortunate in that CWT has recently noted the need for CWT to do more (e.g., a national marketing agency in common) at the same time it may be losing support from some of its core members.

Milk Producers Council agrees with the contention that the HRP program's results are short term and their effectiveness may be decreasing. We disagree on the reason why. We disagree that the industry should go through a lengthy free market period where ever-lower prices force producers to close down out of desperation. The short term effects of the HRP's create opportunity for others, but **the uncontrolled exuberant response to that opportunity** is what causes the subsequent over-supply, and the inevitable crash in milk prices. **The effects of that response** on the thousands of individual producers who fill the void with more cows than have been removed **are cushioned by the pooling programs in federal orders and in California.**

MPC and others have devised programs designed to address that cushioning effect. MPC's program is called the "**Growth Management Plan"** and has been tested by statisticians at Cornell University. Cornell found that the program (mandatory and nationwide) would provide **sufficient incentive for enough individual producers to manage their production,** thereby reducing the production swings from their peaks and valleys to something that resembles careful planning. This program, and another like it that has also been tested by Cornell, have not been given the consideration and support by the industry's major cooperatives and trade associations that they warrant. Either program could work in conjunction with CWT's programs, a fact that may have been overlooked by those who discarded their consideration.

MPC agrees with many others that CWT is the only program the industry has to work on short term over-supply problems. It would help if CWT would give itself a top-to-bottom review, but even in its present mode, we believe the industry better with it than without. That's not faint praise; CWT has awesome power and support, and deserves the chance to show what can be done at this desperate time.

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