Milk Producers Council

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

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE
Blocks +$.0525 $1.7700
Barrels +$.0450 $1.7400

Weekly Average
Blocks +$.0455 $1.7535
Barrels +$.0480 $1.7260

CHICAGO AA BUTTER
Weekly Change -$.0450 $1.5900
Weekly Average -$.0190 $1.6160

NON-FAT DRY MILK
Week Ending 11/14 & 11/15

Calif. Plants	$ .8467	18,907,497
NASS Plants	$ .8666	23,786,980

DRY WHEY
NASS w/e 11/15/08 $.1931 **WEST MSTLY AVG** w/e 11/20/08 $.1600

CHEESE MARKET COMMENTS: Prices increased again this week, as buyers continue to fill short term needs. All increases on the CME this week came from unfilled bids; no sales were recorded. That doesn't mean that cheese is in short supply or that demand is necessarily strong. The general feeling is that sales are holding up well as we enter the normally strong cheese consumption time of year; that is surprising, considering the tailspin our economy is in. Production of cheese is reported to be about normal, and appears to be in line with the monthly changes in milk production. That's good news, because milk production in October was only 1.2% above a year earlier, and the rate of increase appears to be on course to continue downward. Cold storage holdings of cheese at the end of October were 2% higher than a year earlier. It looks like this is an orderly market sitting atop a shaky foundation.

BUTTER MARKET COMMENTS: Butter prices continue to weaken on the CME. The market was closed by the time the October cold storage report was released today; the news was very good; the amount of butterfat products was 47 million lbs **lower** than a year earlier. The decrease from September's level was normal, which could mean that exports recovered nicely in October or a lot of product is being held in warehouses that are not included in the NASS population. Or, it could mean a lot less anhydrous milkfat was produced – or it was just another incorrect report. Back to prices, it's normal for butter prices to decrease this time of year and *Dairy Market News* reports that manufacturers and buyers expect that to happen again. Expectations like that tend to be fulfilled, but the news about the much lower amount of butterfat products in cold storage could help keep prices higher than expected. The expected price level, as indicated on the futures market for February, is just below $1.39 per lb.

NONFAT POWDER MARKET COMMENTS: DMN reports again this week that the sales of nfdm to the CCC from California plants continues to affect prices throughout the world. The throw-away comment was that major exporters in other nations appear to be not willing to lose sales, regardless of price level. What kind of a fix are we in? It looks like a world-wide competition to sell the most product at the lowest price to unwilling buyers. Sales to the CCC have reached a total of 69 million lbs. Weekly average prices continue to edge closer to the $.80 per lb price level.

WHEY MARKET COMMENTS: The average price for the western "mostly" series this week dropped by another half-cent. However, DMN reports that many believe that may be about as low as prices will fall. The comment a few weeks ago that manufacturers of whey protein concentrate may be cutting back on production could have had the expected result – wpc prices are reported to be slightly higher this week.

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FRED DOUMA'S PRICE PROJECTIONS…

Nov 21 Est:	**Quota cwt. $16.09**	**Overbase cwt. $14.40**	**Cls. 4a cwt. $12.16**	**Cls. 4b cwt. $15.12**
Last week:	**Quota cwt. $16.05**	**Overbase cwt. $14.35**	**Cls. 4a cwt. $12.21**	**Cls. 4b cwt. $14.99**

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A QUICK NOTE: (By Rob VandenHeuvel) The past two issues of the MPC Friday Update have included thought-provoking articles by MPC President Sybrand Vander Dussen that delved into the issue of how our regulated milk pricing system has fostered an environment of unrestrained production growth with little – if any – regard for the market demand for our products. In case you missed those articles, you can find them at http://www.milkproducerscouncil.org. The follow-up article below by Geoffrey Vanden Heuvel gives our readers even more to think about. If you have questions or comments about any of these articles, I encourage you to please shoot MPC an email (mpc@milkproducers.org) or give us a call (909-628-6018). We love hearing from our readers.

MORE COMMENT: *(By Geoffrey Vanden Heuvel)* Syp Vander Dussen, in his outstanding articles the last couple of weeks, explained the **"magic of pooling"** concept. He wrote, *"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."*

What Syp is pointing out is the fatal flaw in our milk pricing regulation: **the price risk associated with increased production is not borne directly by the person making the production increase; it is transferred to the group at large.** Basic economics tells us that supply and demand for any product is kept in balance by each individual participant's calculation of risk verses reward. The "**magic of pooling**" transfers the risk to the entire group and the individual is left with the "reward." Because of this reality, it is perfectly **rational** for each individual producer to grow production indiscriminately, while at the same time it is obviously **irrational** for dairy farmers collectively to produce more milk than can be profitably marketed.

News Flash! Processors like this! At a recent milk price hearing, the Dairy Institute made an impassioned argument that CDFA must *reduce* class 1, 2 and 3 milk prices. They claim the cost of doing business in California is so high that California processors need cheap milk in order to expand. The Dairy Institute argues that cheap milk and unbounded growth is good for the California dairy industry because *"Producers who are among the lowest cost and most innovative are also most often those who wish to expand their operations. In many cases these are also younger dairymen, the future of our industry. If these younger, innovative and low-cost producers are unable to grow in California, they will likely move their operations to states where they will have the opportunity to grow. As a result, California will lose its most efficient producers, and the overall cost of production will rise relative to other states."*

It is obvious that the logic of processors is also corrupted by the **"**magic of pooling". They apparently believe that regardless of the price they pay for milk, dairy farmers will produce more than enough milk as long as there is a home for it and a truck willing to take it there. We must admit that our past history is full of evidence that this is true. But why do we, as dairy producers, do this? Is it a rational decision on our part to add production based on the prospect of an increased profitable demand for milk? Or is it simply due to the perverse incentives inherent to the "magic of pooling"?

So what have producers received in return for our "cheap milk" policy in California? Has this cheap milk led to innovation and value-added processing in the state? The fact that nearly one third of California's solids nonfat production is turned into powder would create real doubts about the effect of this policy in bringing about processor innovation. The truth is that California processors don't need cheap milk to spur the kind of innovation that we need to lead this state into the next generation; they need exposure to some competition. It is that competition for a milk supply that would drive processors to innovate so that they would be able to out-pay their competitors and therefore attract more supply to their plant.

In a normal business relationship, buyers and sellers have an incentive to protect the financial health of the other party. If buyers are not profitable, then over time, they will no longer be able to buy. Conversely, if the sellers are not profitable, there will soon be no product to buy. In the dairy business, the "magic of pooling," by design, separates buyers and sellers. It mutes market signals that would normally adjust supply and demand to enable a successful industry. Absent the "magic of pooling" processors would not be so confident that an ever-increasing milk supply would be available for the taking. They would be much more attentive to the financial needs of their producer suppliers. Conversely producers – absent the "magic of pooling" **–** would make production decisions based on real market demand as opposed to the muted signals emitted by the current system.

Because of pooling, California producers have paid little attention to milk marketing and maximum attention to lowering the costs of production. **But simply being a low-cost producer of a product does not constitute everything that is demanded of a successful business**. Finding and developing profitable markets for the products you produce is as much or more of the secret to success as having low production costs.

California processors on the other hand, including our manufacturing cooperative processors, have not had the incentive to work at profitably marketing milk. They have huge amounts of cheap milk coming their way year after year. Big make allowances have facilitated a milk *disposal* strategy as opposed to a milk *marketing* strategy. The result is a California processing sector that is woefully lacking in innovation. This situation is deadly for our industry. We need change.

What kind of change should we look at? While there are some who might argue that it is time to completely scrap the whole system and deregulate (New Zealand and Idaho have done this), in my opinion we do not need to go that far. We can maintain a regulated system, but there needs to be some type of growth management. New production must not be able to demand market share just by showing up; some type of buy-in needs to be created. Secondly, some space in the California system needs to be carved out to create competition for the manufacturers. A huge impediment to processor innovation and value-creation comes from the strictness of the California regulated system. There is only one way to buy Grade A milk in California and that is to pay the state established monthly minimum price. That price fluctuates wildly and that volatility kills processor incentive for market innovation.

Necessity is the mother of invention and the status quo is not sustainable. California has always been a place where we are not afraid to lead and innovate. We have had a great run with the existing system but a recalibration is necessary. **Our basic regulatory program needs to be retooled to create the proper incentives.** Producers and processors must both be exposed to some measure of risk, and flexibility and competition need to be introduced into our system. With the proper incentives there is no reason why our processors and producers cannot adjust and thrive in the future.

There are a number of ideas along these lines that have been suggested by Milk Producers Council over the past year. We have had difficulty getting the industry to engage. There seems to be a real reluctance on the part of the "establishment" to consider serious change. But it certainly is not too late. The California dairy industry has a lot going for it; what we need now is courage to face the future with our hopes and not our fears.

The California dairy industry has taken pride in being a national leader, and we've reached another defining moment. We must use our God-given minds to engage with each other and come up with concrete plans for the future of this industry. The status quo will simply force us to manage our decline as the nation's premier milk producing state. The time for action is now.

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