Reporter's Notebook

Dairy's 3-M's: Markets, Margins, Management

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2009 changed everything

- Farmers lost avg $100/cow/month & billions in equity
- Credit issues compounded problem
- **Farmers' share of consumer dairy dollar fell from 42% in 2002 to 27% in 2009-10**
- Supermarket sticker shock (Fluid milk & butter eventually moved lower with farm milk price BUT cheese, ice cream and other products MOVED HIGHER)
- Supply management discussion went mainstream
- Channel consolidation: market power / antitrust
- Poor price discovery (CME manipulation)
- Support Program & MILC poor safety net; prolonged downturn
- U.S. balanced the world supply
- Local economies: tax base and dairy related jobs at risk
- **Farmers' Message: Pricing Overhaul**

Top of Mind

- **Antitrust investigations & workshops**
- **Imports / Exports:** Fair Trade? Fair competition? Is it dairy? Are we marketing?
- **Standards of Identity:** (Follow up on 2001 GAO reports (FDA “withholding enforcement” or “using enforcement discretion.”)
- **Enforce and reduce SCC limits**
- **Hauling charges?** States try but can’t unless it’s national
- **Mandatory, audited NASS inventory reports**
- **Price Discovery and Pricing Overhaul**
  - Less CME influence
  - Mandatory daily reporting on more products… What is my milk worth in the market on any given day?
  - Example: Fresh Italian cheeses are more than 40% of cheese market but are not reported.

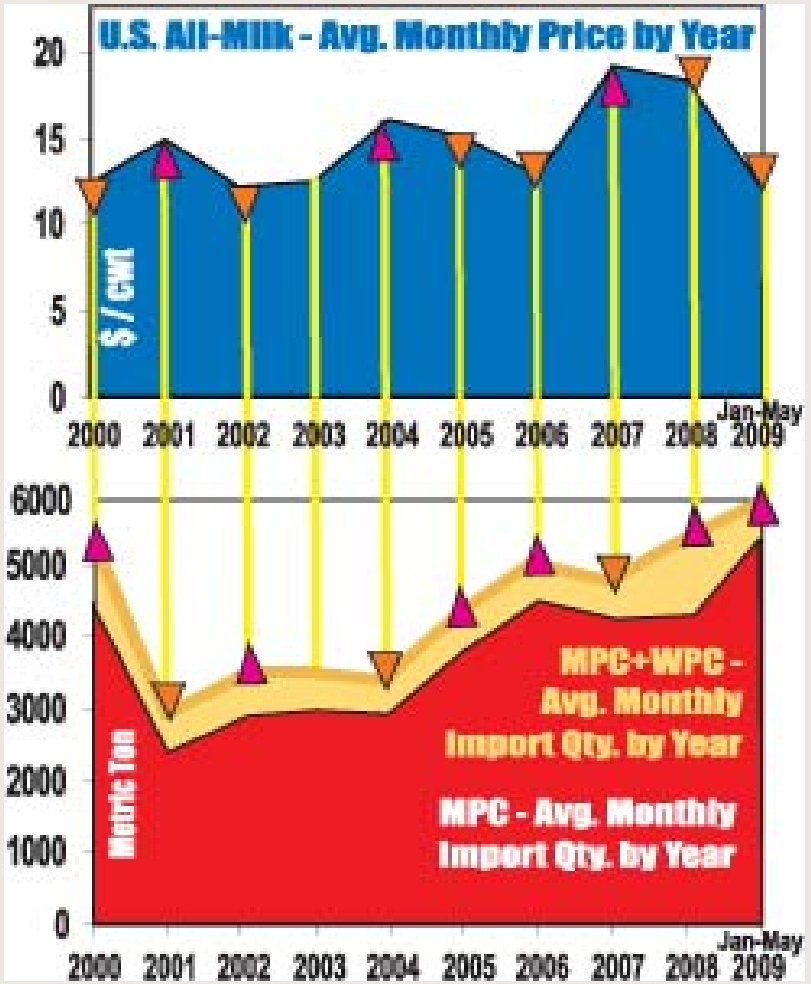
MARKETS…

MPC + WPC Imports vs. All-Milk price

MPC = Milk Protein Concentrate; WPC = Whey Protein Concentrate

- Imported MPC + WPC has inverse relationship with All-Milk price

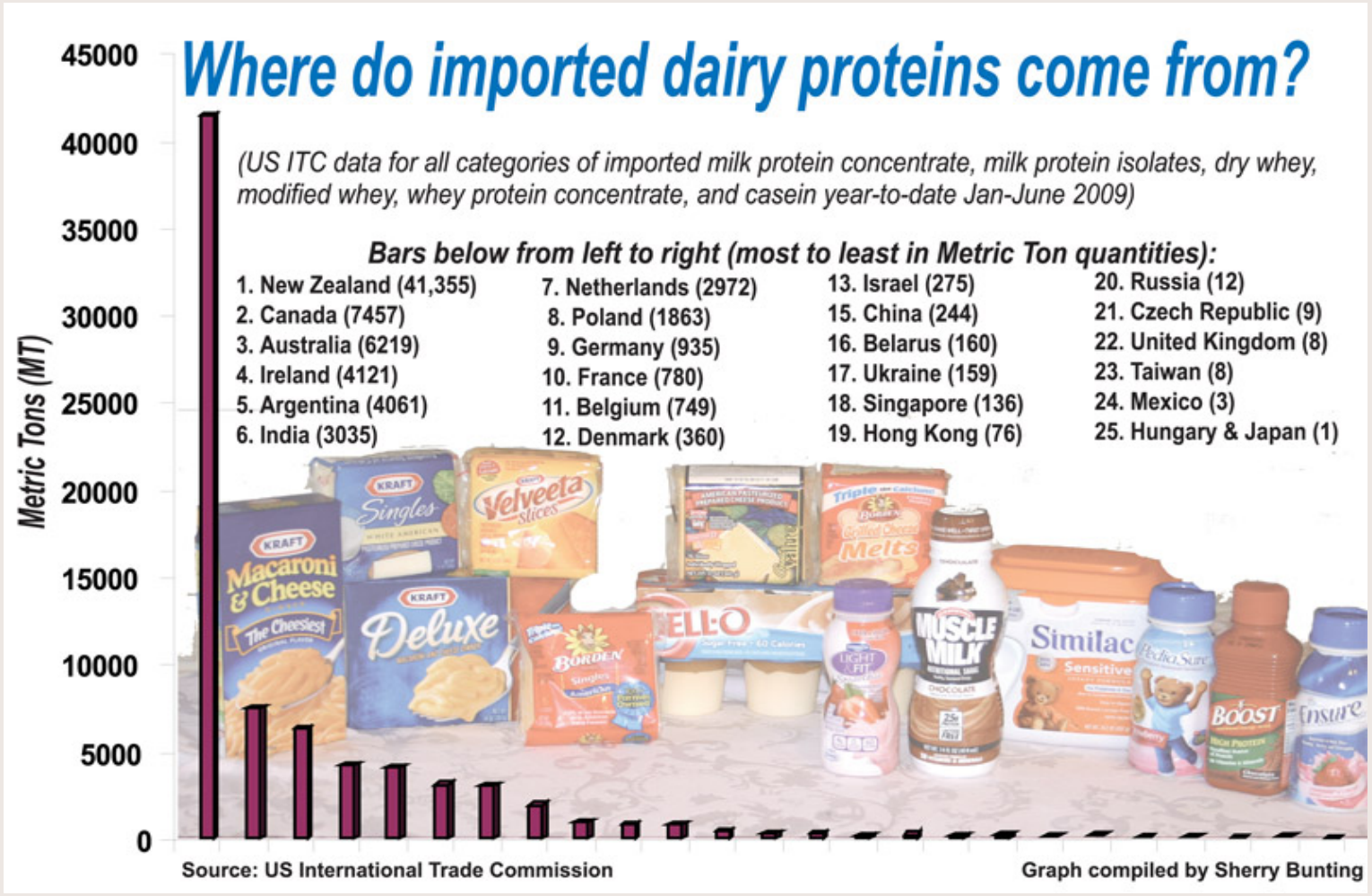
- During USDA's Class I hearing (2009), Fonterra testified: **"…whey is used in nearly identical products as MPCs,"** and testified that **"whey production is primarily domestic (U.S.), but most MPCs are imported…"**



Sources & Uses

Safety concerns: See refusals at

- http://www.accessdata.fda.gov/scripts/ImportRefusals/ir_index.cfm



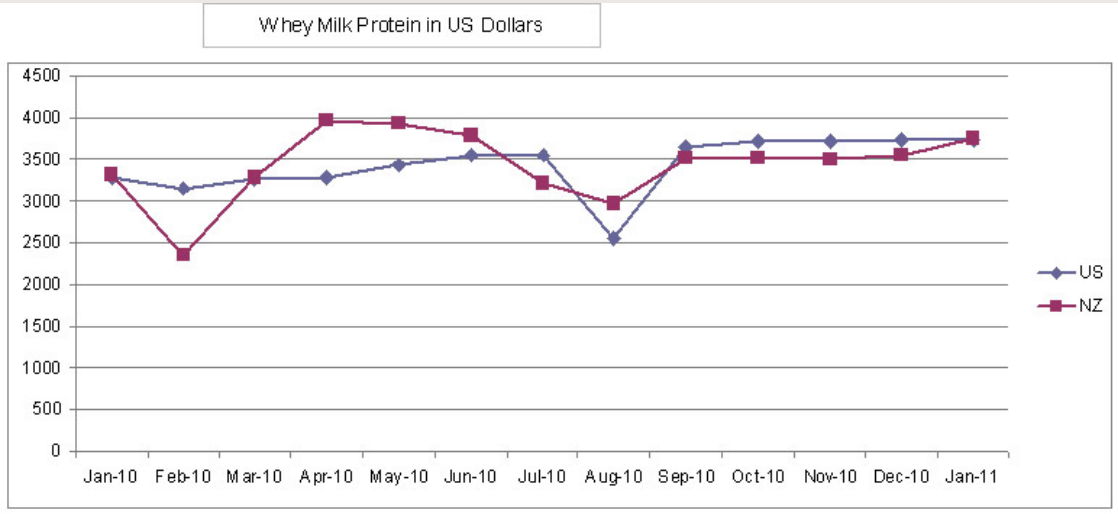
Dozens of codes & categories

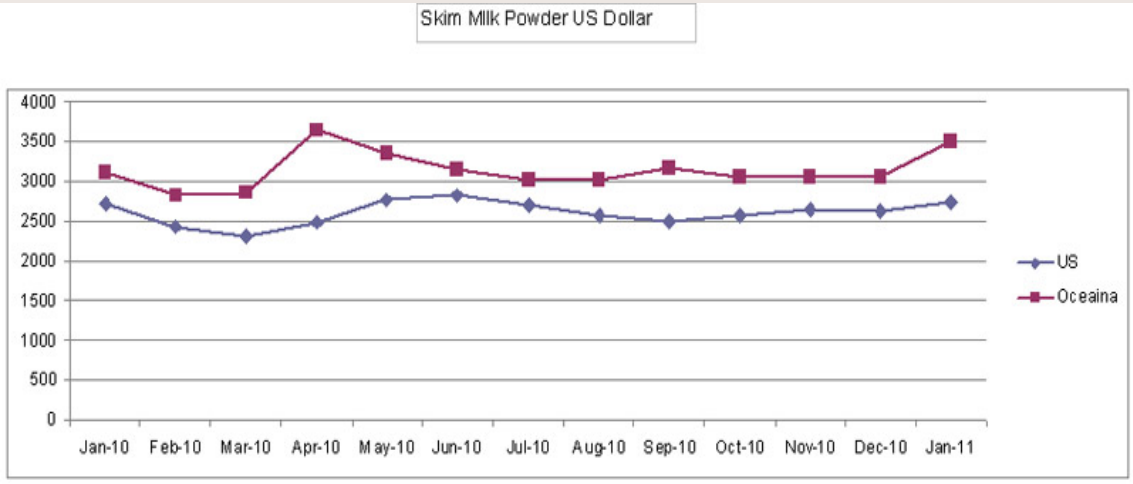
- **HTS 0404** – “Milk Constituents”
  - Frozen desserts; protein fortified, low-calorie dairy beverages and yogurt; Infant formula (vs. WPC)
  - Non-standard cheese (pizza cheese / process cheese)
- **HTS 3501** – “Casein Derivatives, Casein Glue” Mixed uses:
  - Dairy Foods: Example: “low carb / high protein” bars/drinks
  - Non-Dairy Foods: Example: non-dairy coffee creamers, etc.
  - Non-Food: cardboard coating, other industrial
- **HTS 2106 –** “Textured Proteins”
  - **This Category is increasing** / *Example:* Fonterra’s Protein wafers 20% rice / 80% MPC or Whey Protein
  - Fonterra tried to import under duty-free 3501 but U.S. ruled must be 2106 (some duty paid)

Exports

- **Record U.S. dairy exports in 2010**
  - **Represents nearly 13% of production on solids basis**
  - U.S. Export Volume Up 19% over the past 7 years
  - U.S. Exports topped Imports in 2007, 2008, 2010
- **NEW TRENDS:** China imported 7x more Whole Milk Powder (WMP) from NZ in 2010 vs. 2008
  - China imported 64% more SMP (NZ & US)

Can U.S. Farmers compete at the World Price?





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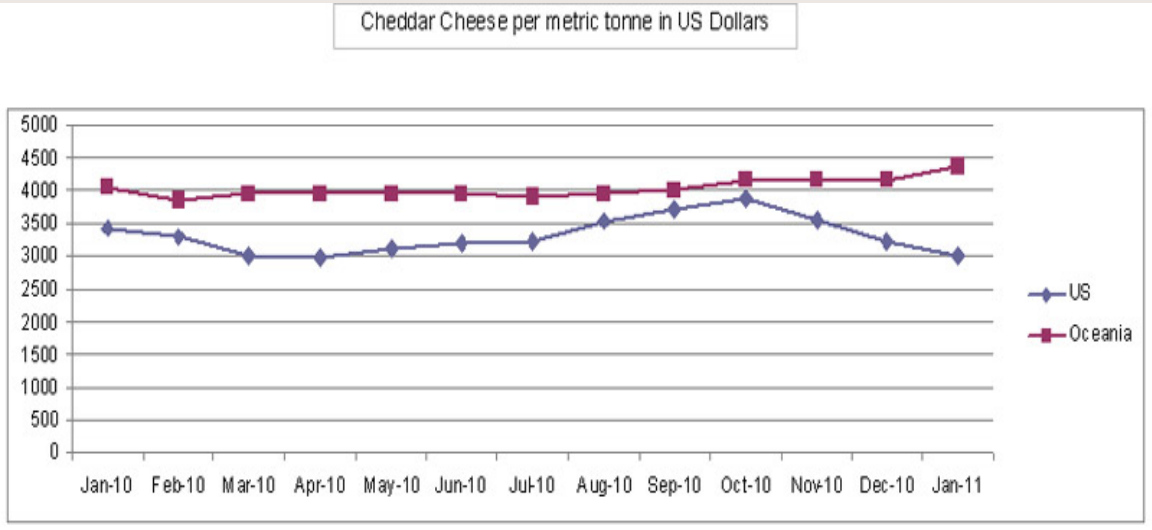

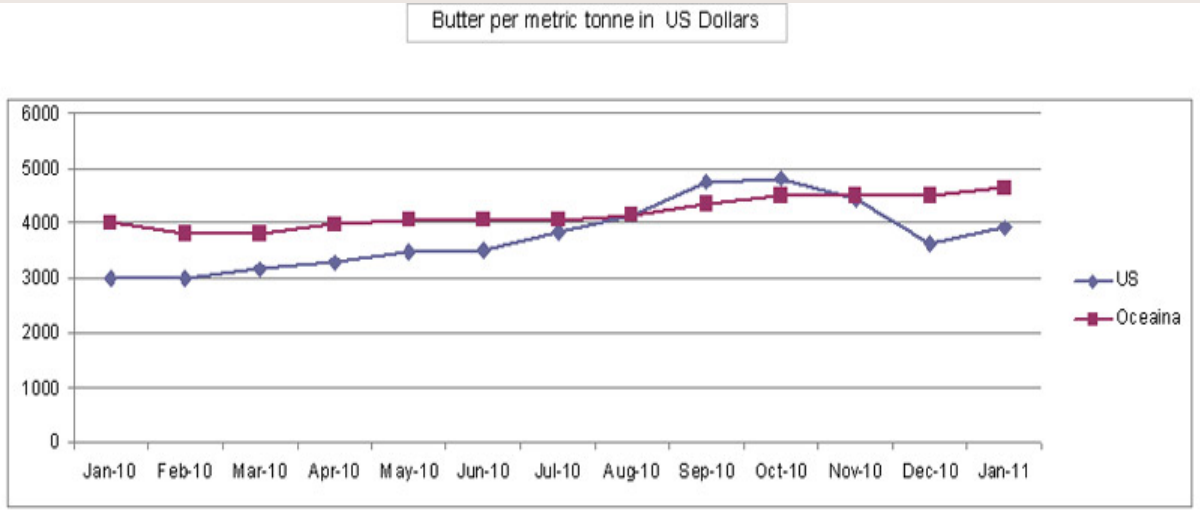

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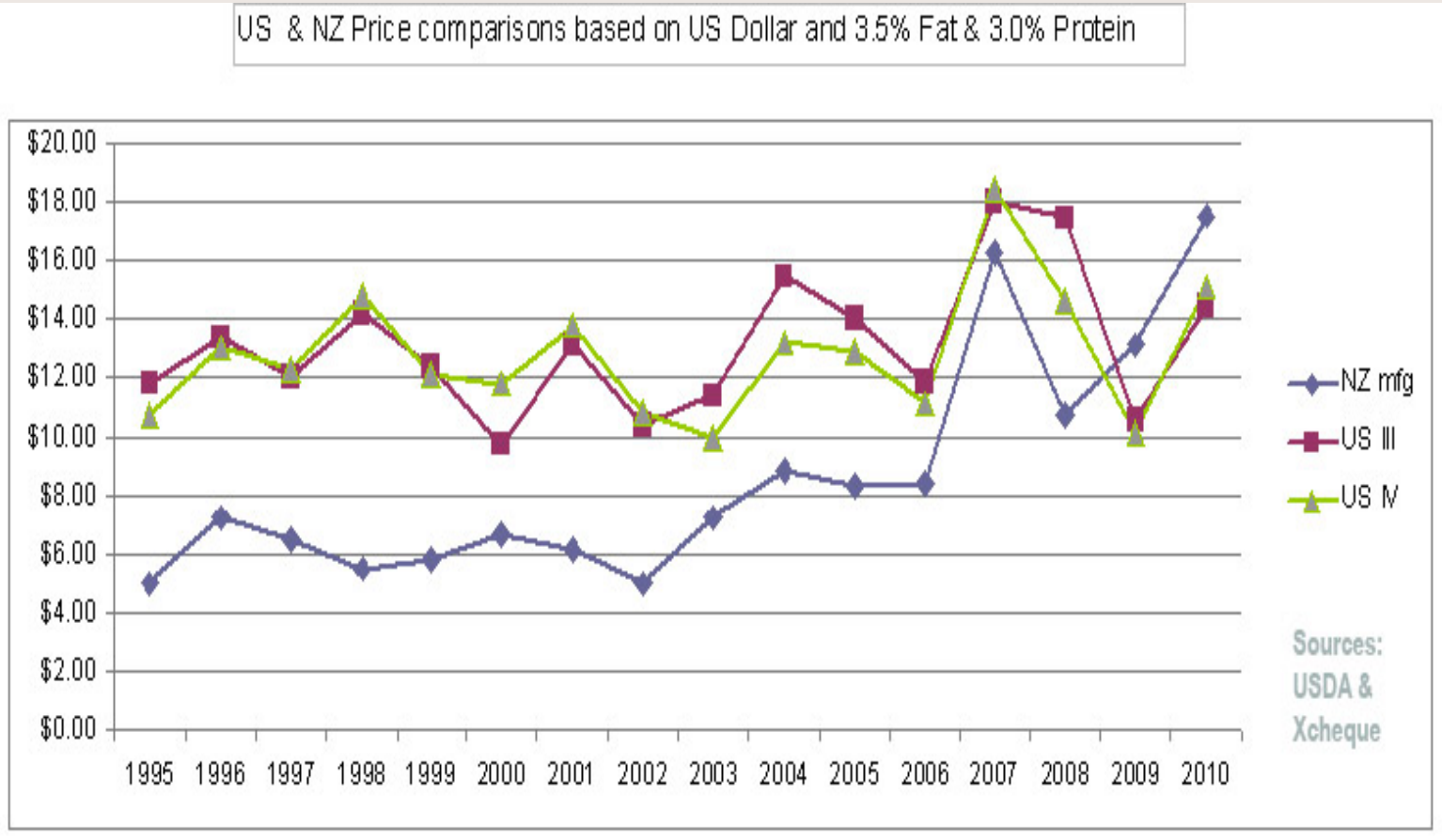


Demand shifts / Factors we can't control!

* Ice cream – smaller containers

2008: downsized to 1.5-1.75 qt vs. 2 qt conventional size

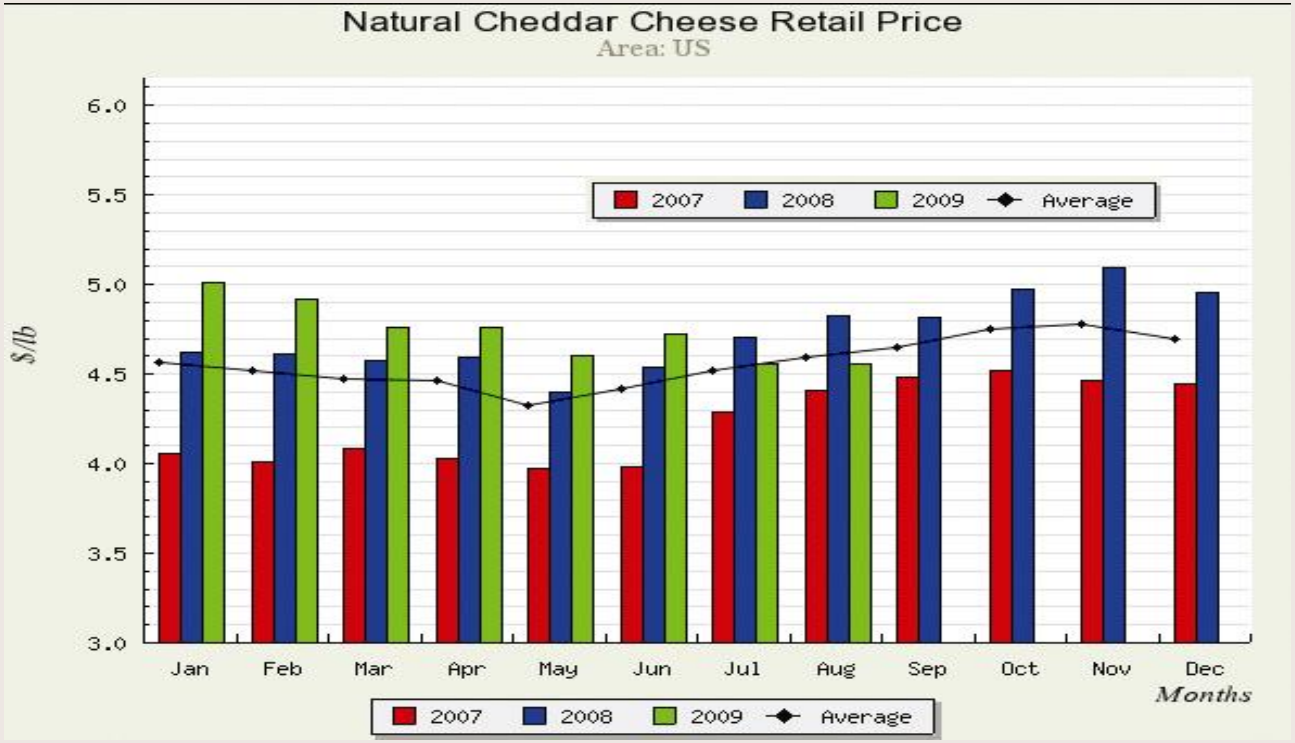
- National brands: Reduced container size in 2008 due to higher milk prices.
  - Ice Cream containers are still smaller at 1.5 to 1.75 qt vs. 2 qt
- Cheese: 1 slice or 2 on the McDonald's double cheeseburger?
- Food industry formulations (frozen entrees / restaurant trade)
- Stocking rates – product mix – inventory management
- **Less product @ same price = MORE PROFITS**
- **"Unseen" demand hit – lands at the farm level**

Supply shifts – CME drives farm price

- Did increased cheese yield per cwt of milk help drive “over” production? (MPC usage boosts yields 30%)
- Cheese is the driver in reduced raw milk price paid to farmers
  - CME limited # of traders and actual sales, BUT this dictates NASS Survey Price used by Federal Milk Marketing Order to set minimum milk price paid to farmers.
- Same or increased retail price paid by consumers!
- Dairy farmer pays ‘make allowance’ (total $2.77/cwt subtracted in the product formula price)
- **100% OF PRICE RISK IS ON THE DAIRY FARMER**

Retail cheese prices were higher than 2008 for first half of 2009

Notice… Cheese price started going up in Oct/Nov, which is when Milk Price was heading downward and that is when MPC importation was ramping up Nov through Apr.



Domestic Use

2009 vs 2008

- Cheese consumption up 2.6% (all categories)
  - Jan-July up 4%
- Butter consumption up 17.6%, but manufacturer's stocks were UP even though production was DOWN. Why? Imports of butter and milk fat were WAY UP.
- Powder consumption down 20%; Government CCC purchases; U.S. pulled out of world market at the end of 2008 to get 5 cents more per lb. By selling to Uncle Sam.

Fluid Milk:

- FLUID MILK consumption
  - **2009 fluid milk sales were <u>UP 1.6</u>% over 2008**
  - **2010 fluid milk sales were <u>DOWN 1.4%</u> below 2009**

Make allowances = $2.77/cwt.

cheddar / butter / NFDM / whey

- Increased by 50 cents 2009. Former Ag Economics professor Ken Bailey predicted lower producer prices as a result – more processor complacency bad for market and bad for farmers.

- Dr. Ken Bailey objected: *"My bottom line is: If prices are bad right now (2006) and they take off another 50 cents based on an administrative hearing, our producers will find that to be outrageous."*

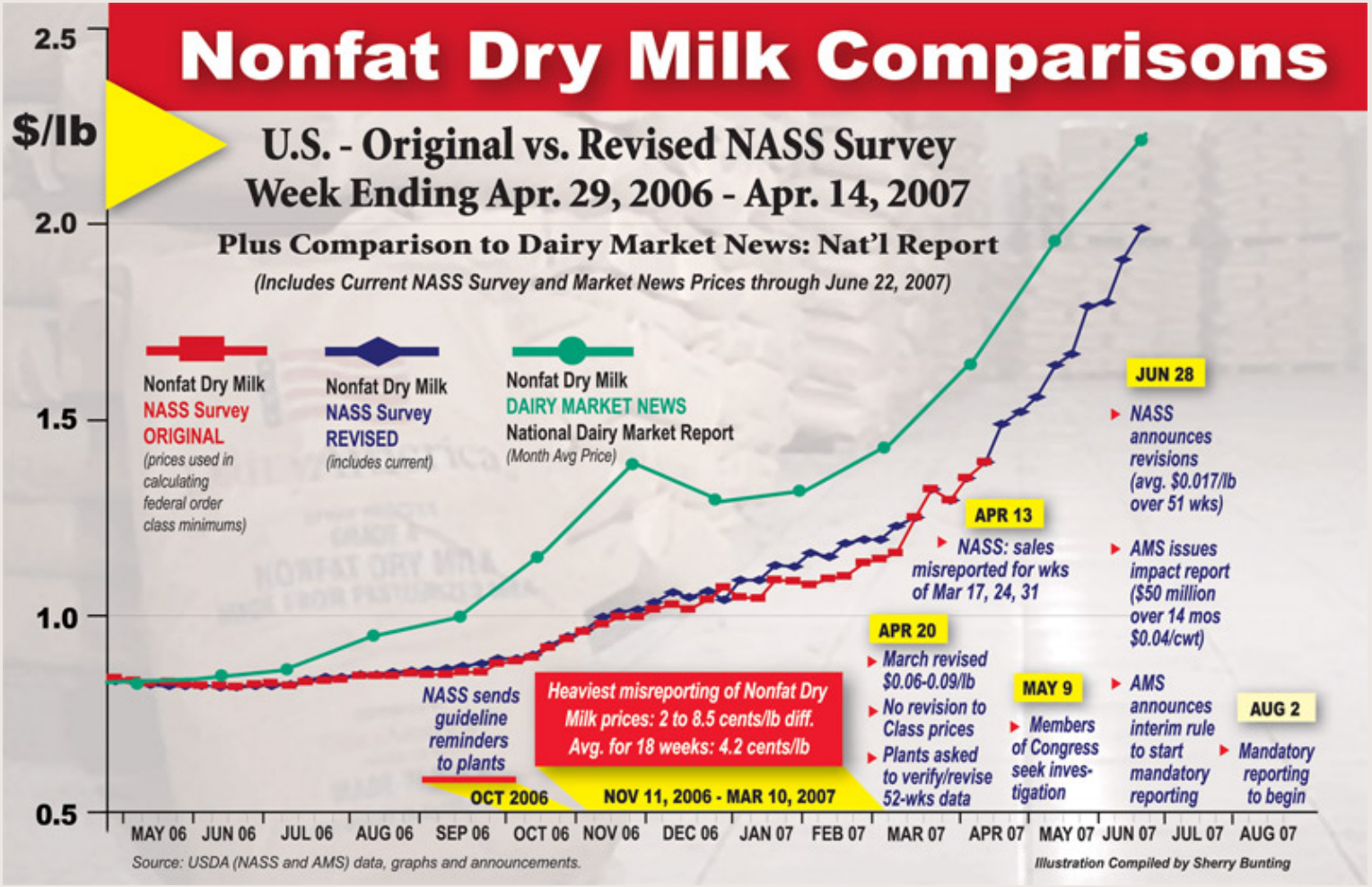
- 2006-07 hearing, Bailey also said: *"If cheese make allowances are so bad, why are we building more cheese plants? We need to find other product outlets for these components."*

‘Make allowance’ complacency

- Sellers have no incentive to sell higher
- Processor focus: being more efficient on costs than the guaranteed make allowance pays them.
- Lack of incentive for true product innovation in the U.S.
- Fonterra joint ventures “fill the gap.” They are looking to U.S. as big market for New Zealand products.
- U.S. starting to take back “some” marketing control.
- Need to be market-savvy: World wants SMP – we make NFDM
  - U.S. NFDM often not up to world customer spec
  - Government Support Price program adds to complacency
  - Built-in “margin” (make allowance); fail safe buyer (Uncle Sam)

Why reporting & auditing is so important

Remember the mis-reported powder?



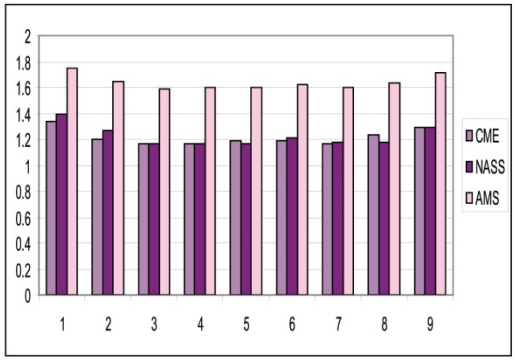
Wider spread NASS vs Dairy Market News

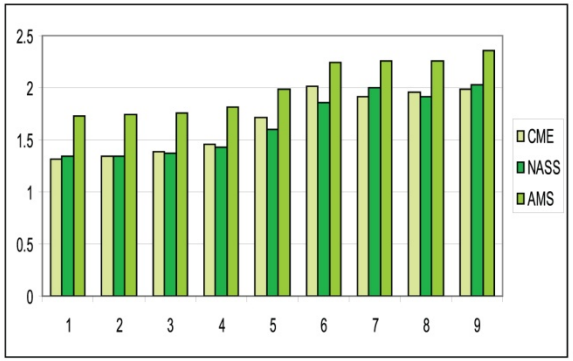
CME vs NASS vs AMS MARKET NEWS 2006, 2007, 2008, 2009

In downcycle: spread between CME & NASS Survey narrows; spread between NASS Survey & AMS Market News reported spot price widens
In upcycle: spread between CME & NASS Survey widens; spread between NASS Survey & AMS Market News reported spot price narrows.
The 6- to 14-cent wider spread for 2006 and 2009 versus 2007 and 2008 = $0.60 to $1.40 per cwt. impact on the blend price.

Avg spread AMS vs NASS -$0.42 / lb

Avg spread CME vs NASS +$0.01 / lb





Avg spread AMS vs NASS -$0.36 / lb

Avg spread CME vs NASS -$0.03 / lb

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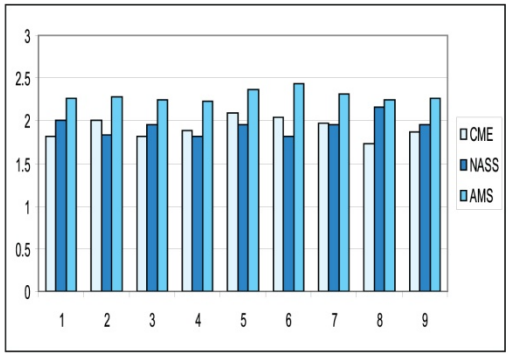
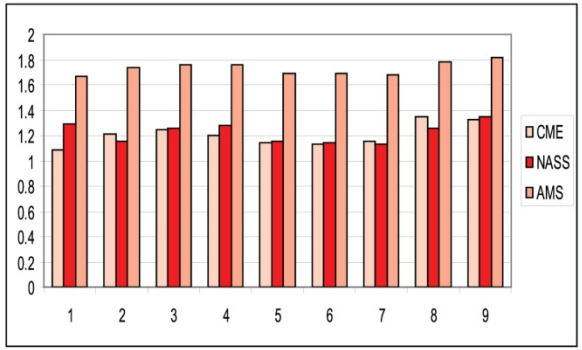
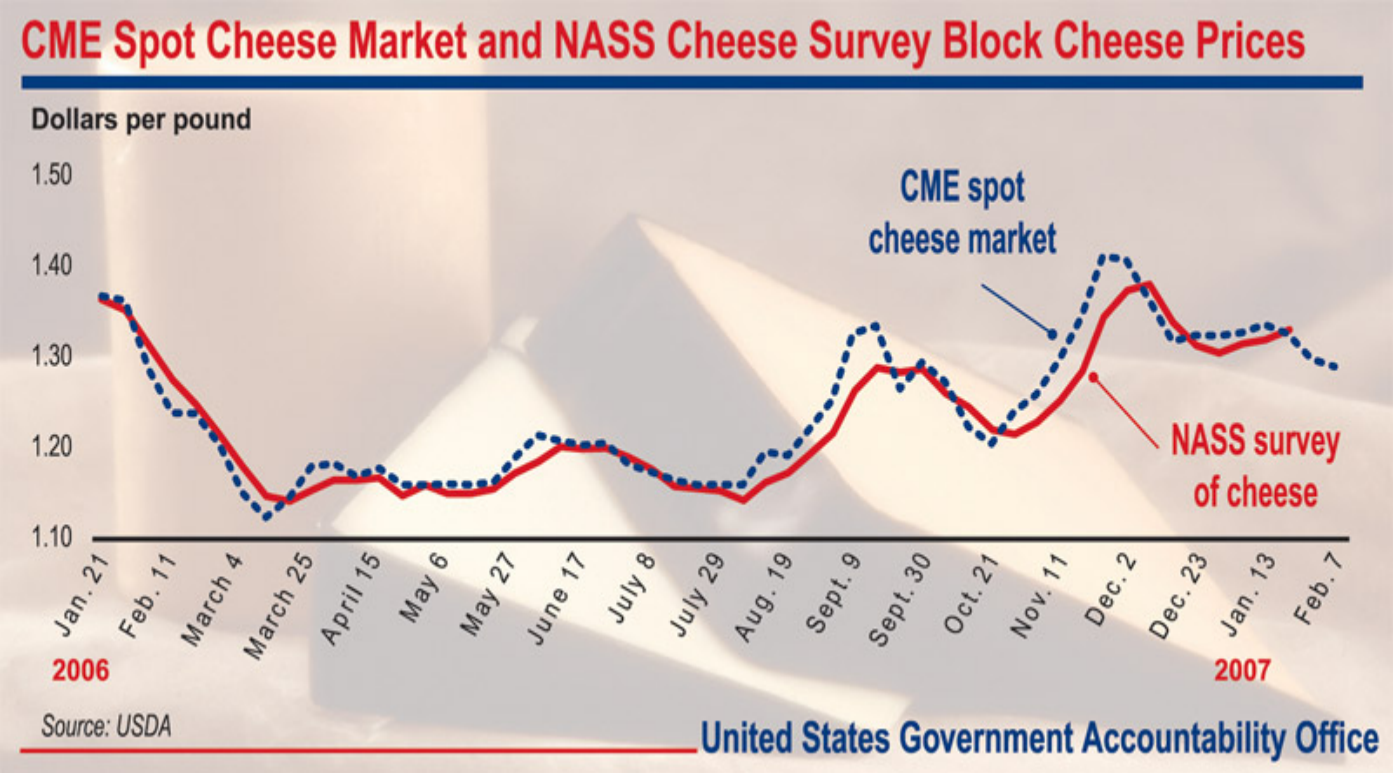




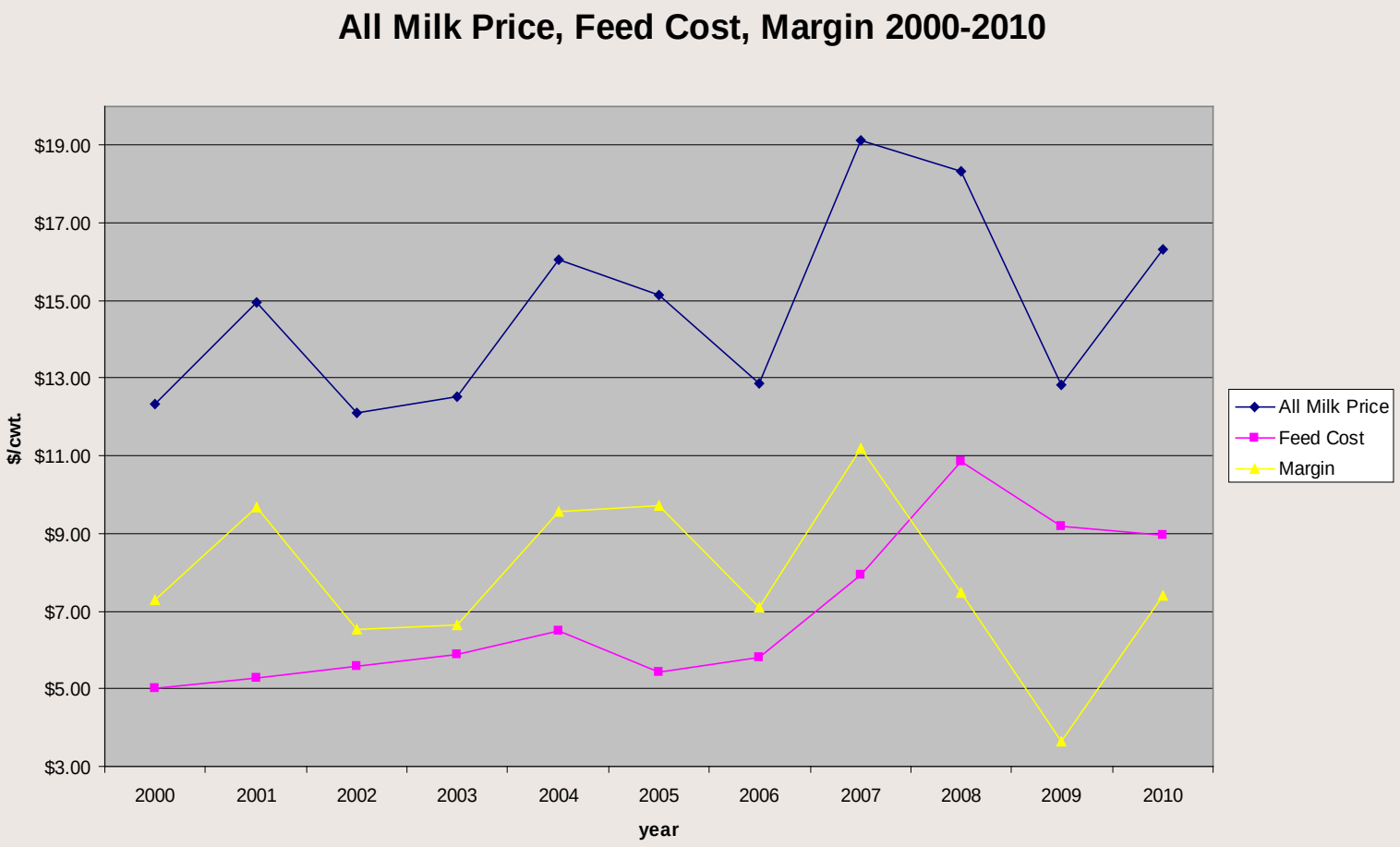
Avg spread AMS vs NASS -$0.50 / lb

Avg spread CME vs NASS +$0.02 / lb

Cheese and the CME



“Margins” vs. Price



Proposals – NMPF
Foundation for the Future (FFTF)
On the fast track in D.C.

SAFETY NET

- **End Dairy Product Price Support**
  - Around since 1949
  - Changed to product support in 2008 – at $9.90 equiv
  - Expected to be terminated 11 years ago!
  - Obstacle to being a consistent supplier on the world market
  - Obstacle to product innovation
- **End MILC**
  - Around since late 2001
  - Made payments in 50 out of 109 months (range 3 cents to $2)
  - Favors smaller farms
  - Not effective enough when margins are stressed by higher feed costs
  - Expensive for Federal Government to maintain

FFTF will replace these programs with Margin-triggered national Dairy Producer Margin Protection Program (DPMPP) and Dairy Market Stabilization Program (DMSP)

FFTF's Margin Protection & Market Stabilization (hand-in-hand)

- National margin between feed cost and milk price
- Base level expected to "kick-in" at $4 margin
  - Would have triggered a payment in 8 months of 2009
  - No payment would have triggered in 2006 or 2003.
  - Producers can "buy up" to cover higher margins on up to 90% of their base milk
  - Base for the "insurance" is the highest of 3 years prior to Farm Bill implementation: Locked in for 5 years.
- Market Stabilizing Penalties trigger on the same "margin" as the national insurance

FFTF Stabilization Program

- When margin hits $6 / producers are paid for 98% of their base (up to cap of 6% penalty)
- When margin hits $5 / producers are paid for 97% of their base (up to cap of 7% penalty)
- When margin hits $4 / producers are paid for 96% of their base (up to cap of 8% penalty)
- **DIFFERENT BASE than insurance program:**
  - When margin hits trigger for 2 months; producer gets letter and 30-day notice of non-payment for 2, 3, or 4% of base.
  - Base is rolling avg of previous three months before trigger
    - Seasonal dairies can pick the same month of prev year

Where does the money go?

- Processors still pay for the milk
- Money collected by MA for “demand enhancing fund” run by a board
  - Cheese purchases for food assistance
  - Export enhancement?
- All premiums on “penalty milk” also withheld
- Class I bottler subsidizing cheese purchases?
- Price risk still 100% on dairy farmer

Impact of mandatory supply management

	Baseline	Agri-Mark	Holstein	NMPF
all milk price ($/cwt.)	$15.32	$15.55	$14.63	$15.49
avg. deviation ($/cwt.)	$0.83	$0.30	$0.28	$0.35
govt. exp. (mil.$)	$2,936	$1,174	$1,023	($171)
fluid sales (mil. lbs.)	544,008	542,464	544,886	541,809
cheese sales (mil. lbs.)	101,707	101,223	102,356	101,169

Analysis by Charles Nicholson and Mark Stephenson

All three programs reduce volatility
No notable increase in producer price
Less government cost
Faster consolidation of industry

NMPF Federal Order Reform

Details still sketchy – Approved by NMPF Board 3/8

- Competitive price instead of product formula price to determine Class III price
- NMPF calls it a 2- class system: fluid and manufacturing
  - **In reality it is a 4-class system**
- No minimum manufacturing price
  - Class I differentials pooled
  - Class IV receives “credits” (reduce competition for milk)
  - Class II – add 30 cents to Class III weighted competitive average
- No minimum component prices
- Butter and powder plant credits
  - credit back the lowest competitive Class III price
- Hearings for balancing and transportation credits

Dairy Industry Advisory Committee

- 109 page report to Sec. Vilsack
- Some good ideas:
  - Devise Profitability benchmark
  - Farm Savings Accounts (tax deferred profits)
  - SCC down to 400,000 in 48 months
  - Review Federal Order Pricing
  - Split vote 9 to 8 on “growth management”

DPAC

- **Working on alternative bill**
  - Eliminate Dairy Product Price Support
  - Eliminate or transition MILC
  - Save Federal dollars and redirect to enhance voluntary LGM Dairy tool for risk management
  - Market Cow Bonus program (under eval)
  - Direct Sec of Ag to receive proposals on simplified pricing
  - Reform “bloc” voting in Federal Orders
  - Increase transparency with more frequent reporting and auditing

Critical questions?
Let's peel the onion

- Can U.S. dairy producer compete at the "world" price. (World price was higher than U.S. price 2009-10!)
- Are exports only profitable for U.S. dairy farmers when there is a crisis somewhere else. (NZ production steady despite dry weather – demand is growing)
- Does the U.S. produce too much milk? (Commercial disappearance exceeds U.S. production)
- Canada has a separate "export class," why can't we? (WTO rules: Canada's imports are used only for export – in-and-out)
- Does it make sense to add a layer of government-mandated supply management on top of a broken system?
- What policies will position producers to be profitable?
  - **Opportunities vs Guarantee**
  - **Margin "tools"**
  - **Producers are getting involved**

Read, Learn, Speak Up

- Milk is your product, get involved in how it is marketed to your consumers
- Pricing system is broken
  - Need more transparency, more products reported and more plants reporting
  - More of retail $ back to farmer
  - **Get involved**
  - **IT IS YOUR DAIRY FARM**