President's Letter
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A New Approach to Federal Milk Pricing

For Discussion Only

GOALS

- In the future, the price of raw milk must be stabilized at a sustainable level so that the dairy industry can survive and thrive. With the inherent volatility of the current price structure, only traders and processors are benefiting and dairymen are being forced out of business.
- Pay prices to dairymen must be stabilized if we are to maintain our industry and preserve markets.
- It is important from a food safety standpoint, as well as from a homeland security standpoint that a wholesome and abundant supply of dairy products be produced domestically for American consumers.
- Price paid for raw milk must reflect true supply and demand.
- Government involvement must be minimized.
- Any milk pricing policy must allow our country's dairy industry to participate in world markets.
- Any milk pricing policy must allow individual dairymen to react, as they see fit, to market conditions without government or other interference.
- Policy must prevent market manipulation by traders or processors from determining the price of all dairy products.
- Policy should not discriminate against any dairy based on size, location, or management style.

WHY A CHANGE IN PRICING POLICY IS NEEDED

- When an excess supply of raw milk occurs, the price drops and cheese plants and powder plants can then dramatically increase production, using cheap raw milk, and then stockpile finished products. With the "make" allowance funds available to them, they make a profit at the expense of the dairymen right off the bat. Further, the finished products being held in storage serve to keep pay prices to dairymen at low levels when inventories are reported and factored into the current pricing formula.
- In the future, considering the federal budget deficit, it is unlikely that adequate funding will be available to service existing dairy programs.
- MILC (Milk Income Loss Contract) and DPSP (Dairy Price Support Program) do not allow for market signals and supply/demand indicators to work. MILC

pays producers when supplies are long and prices are low to continue producing and adding to the problem oversupply. Under DPSP, when world prices drop below support levels, we lose our export market and the problem of excess supply and low prices is worsened.

- The NASS (National Agricultural Statistical Service) survey price, a major input in the pricing formula, does not have a direct connection to retail prices for milk and cheese and other dairy products, so there is no correlation between the price the dairyman receives for raw milk and the price paid by the consumer at the supermarket. During this past year, dairymen consistently received less for their milk than the costs of production and many dairies were forced out of business. Extremely low raw milk prices were not reflected in consumer prices for dairy products at supermarkets. Processors and cheese makers enjoyed one of the most profitable years ever, largely at the expense of the dairy producers.
- Current milk pricing policy does not factor in any costs of production. Last year's disaster for dairy producers was actually worsened by rising feed costs and fuel costs that occurred as a result of federal ethanol subsidies and the conversion of feeds to fuels. Future milk pricing systems must be linked to production costs!

WHAT WE NEED TO DO

- Get rid of all federal milk pricing programs (especially MILC and DPSP).
- Remove pricing influence from CME and NASS with a stable new pricing program.
- New program to be implemented through the regional Federal Milk Marketing Order with the assistance of the federal administrators.
- Keep the current milk classification system with minor changes. (Class I—Fluid, Class II—Manufacturing, Class III—Powder, No Class IV)
- Allow local price enhancements and incentives (because of regional pricing program).
- Utilize the Suggested New Milk Pricing Formula, as follows:

SUGGESTED NEW MILK PRICING FORMULA

Part 1:

- Sets price for 90% of rolling 12 month average base production.
- Readjust every 6-12 months.
- Fair and stable base pricing.
- Set up as follows:
    1. Cost of production: Feed, fuel, utilities, labor, interest, environmental, & regulatory.
       Suggested weight: 25%

2. Average retail prices of milk and other dairy products…true supply/demand.
   Suggested weight: 25%
3. Previous period 90% formula price…this dampens volatility.
   Suggested weight: 25%
4. Previous period Part 2, 10% formula price…reflective of current markets.
   Suggested weight: 25%

Part 2:

- Sets price for 10% of rolling 12 month average base production.
- Readjusted every 1-3 months.
- Fine tuning mechanism, controls any surplus quickly.
- Set up as follows:
    1. World powder price.
       Suggested weight: 25%
    2. World cheese price.
       Suggested weight: 25%
    3. Competitive pay prices for raw milk, as determined by actual market activity.
       Suggested weight: 25%
    4. Milk futures and CME (Chicago Mercantile Exchange) Pricing.
       Suggested weight: 25%

<u>EXAMPLES</u>
Dairy A:

- Operating at 100% of historical production.
- Market conditions at excess supply of 3%.
- **Under Part 1:**
    - 90% of milk gets base formula price.
- **Under Part 2:**
    - Of the other 10% of total production:
    - 7% will be paid out at the reduced level formula price, which will be considerably less than the Part 1 price.
    - For the other 3%, the dairyman will receive no compensation, but he has 30 days to make the 3% surplus disappear or he may donate it for processing and distribution in disaster relief or feeding programs.
    - This will avoid surplus production and it will be a great public relations move.

Dairy B (excess supply market):

- Operating at 105% of historical production.
- Market conditions at excess supply of 3%.
- **Under Part 1:**
    - 90% of milk gets base formula price.
- **Under Part 2:**
    - Of the other 15% of total production:
    - 7% of historical total production will be paid out at the reduced level formula price, which will be considerably less than the Part 1 price.
    - For the other 8%, the dairyman will receive no compensation, but he has 30 days to make the 8% surplus disappear.
    - This will effectively discourage growth during times of surplus.

Dairy B (shortage supply market):

- Same dairy, same production.
- Market conditions at shortage supply levels.
- **Under Part 1:**
    - 90% of milk gets base formula price.
- **Under Part 2:**
    - All of the other 15% gets paid at the Part 2 price, which may, during these times, be higher than the Part 1 price, depending on the conditions of supply and demand in the world market.
    - It would not be necessary to divert or process any surplus product for donations during these times, as there would be no surplus.

CONCLUSION

We dairy farmers should not have to attempt to guess at a futures market that is always moving to be able to make a profit. When we are assisting a cow having a calf at midnight, then getting up before dawn to start a new day, we should not have to wonder whether, overnight, the traders decided to drive down the price of milk and suddenly we are working for free again! We need to remove our financial future from the hands of a select few traders, processors, and market manipulators; whether you own a small 50-cow herd or a large 2000-cow herd, the same problems confront us all. We cannot produce milk for less than our cost of production. While it is easy to say that the market will eventually work it all out, many of us will wind up being “worked out” at the same time.

This program, as designed, would allow individual dairymen the opportunity to produce their historical production base as efficiently as possible. In times of excess, extra production would be discouraged and the individual dairyman would be incentivized to

shut off his excess milk at the farm gate—not allowing it to keep depressing our prices as it sits in private or government commodity warehouses. No counter-productive MILC, DELAP, DPSP, or any other government programs, no CWT programs, just good old-fashioned business management and something that we can put into effect IMMEDIATELY!

Please note that when milk is in excess, the 90% formula Part 1 would not change, only the 10% Part 2 formula would be drastically decreased and a portion would be "no pay." The result would be that an individual dairyman could afford to and would cut enough production to comply if he had a stable price for 90% of his historical production. Most dairymen would cut their "no pay excess" immediately and produce their Part 1 formula as efficiently as possible. Otherwise, as in our current situation, all producers continue to make as much milk as possible to dilute their overhead and production costs because they receive a much lower price on all 100% of their milk. It's apparent that the current pricing mechanism was designed to keep milk prices as low as possible for as long as possible. If this is going to take an act of Congress to be accomplished, now is the time to get started. I believe that we, the American Dairy Farmers, can fix this problem!!

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