May 31, 2012

MCT COMPASS

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Unintended Consequences

The dairy provisions included in the House and Senate versions of the 2012 farm bill are now making their way through Congress. The proposed policy changes are a direct response to the devastating cost-price squeeze dairy producers experienced in 2009. It appears the chances of a farm bill passing this year—despite it being a presidential election year—have increased in recent weeks, but the dairy provisions remain controversial.

There could be a number of unintended consequences from this policy, including higher consumer prices and a resulting pullback in demand.

The dairy provisions of both the House and Senate versions of the farm bill consist of two key programs: margin protection and dairy stabilization. The margin protection program works like an insurance program to offer dairy producers various levels of protection against severe losses caused by a plunge in milk prices, a spike in feed costs, or a combination of the two.

Under the proposed margin protection program, margin is defined as the all-milk price minus feed costs. Feed costs are determined based on a ration that reflects feeding practices across an entire operation—milk cows, heifers, and dry cows. The basic level of protection provided by the federal government would replace Milk Income Loss Contract (MILC) payments as well as the Dairy Product Price Support Program. Producers would also be able to purchase supplemental coverage.

Basic payments would kick in when the margin falls below $4.00/cwt. for the defined two consecutive month periods (January and February; March and April; May and June; July and August; September and October; and November and December). Enrolled producers would then receive the difference between the actual margin and $4.00/cwt. on a portion of their milk based on a predetermined formula. Supplemental coverage, which is only partially subsidized, is above and beyond basic protection.

Producers who enroll in the proposed margin protection program are automatically enrolled in the market stabilization program, which serves as a supply management-type program. Because the program is considered voluntary, producers who do not participate in

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Ken's Corner

by Ken Meyers
President , MCT Dairies Inc.

The dairy provisions in the current farm bills making their way through Congress raise a number of obvious concerns as mentioned in "Unintended Consequences," but there are other, less obvious, potential consequences as well.

First, the liquidity of dairy futures markets could be significantly reduced because producers have access to subsidized, or no-cost, margin insurance, thus depriving the market of producer side hedging.

Second, when the margin stabilization program kicks in, it is unclear which markets would be left short of milk. Assuming milk flows first to fluid, yogurt, ice cream, and cheese plants, supplies of nonfat dry milk and butter could decline—hurting U.S. export volumes. Currently the United States exports almost half of its nonfat dry milk/skim milk (NFDM/SMP) output. After years of dedicated effort on the part of exporters, the United States has finally become a reliable supplier to world markets. If the margin stabilization program is enacted, the United States would likely lose that distinction.

It is also important to note what is not included in the dairy provisions of the 2012 farm bill, such as any changes to our antiquated milk pricing system, which hinders our competitiveness in global trade. Look for more on this topic in next month's Compass. **MCT**

Mixed Signals...

Just as dairy producers around the globe are getting the market signal to produce less milk in the form of lower milk prices, the U.S. Cheddar cheese market is heating up. The latest increases in the CME spot block and barrel markets appear to be driven by the low stock build that occurred in April when U.S. milk production was near its peak. American cheese stocks on April 30, 2012, totaled 628.4 million pounds, up just 5.8 million pounds vs. the prior month and 6.3 million pounds greater than last year. Over the past five years, stocks typically increased by 15.7 million pounds in April which was just 37% of the five-year average. **MCT**

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV	Whey**	NFDM**
May	1.5225	1.4700	15.25	1.3530	13.55	0.5430	1.1550
Jun	1.5850	1.5400	15.50	1.4250	13.70	0.5225	1.1650
Jul	1.6150	1.5700	16.00	1.4750	14.10	0.5100	1.1775
Aug	1.6400	1.6050	16.35	1.5250	14.45	0.5000	1.1950
Sep	1.6600	1.6350	16.60	1.5400	14.75	0.5150	1.2100
Oct	1.7000	1.6750	16.90	1.5900	15.05	0.5200	1.2300

** CME prices.*
***NASS prices.*

Loss of jobs & exports...

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the margin protection program are not required to cut production when the stabilization part of the program kicks in.

Under the stabilization program, which is triggered when margins fall to $6.00/cwt. or less for two consecutive months, producers would receive payment for a percentage of their established base milk marketings or a percentage of their current milk marketings, whichever is greater.

Milk production above these levels would still be picked up and processed, but producers would not receive payment for it. Instead, processors would pay USDA for the milk, and USDA would in turn use the funds to buy milk for food aid programs.

The program would then remain in effect until margins exceed $6.00/cwt. for two consecutive months, or when U.S. Cheddar cheese and nonfat dry milk prices exceed world market prices by various amounts and/or durations, yet to be determined.

There could be a number of unintended consequences from this policy, including increased consumer prices and a resulting pullback in demand. Other potential consequences include reduced exports, job reductions, and a reluctance of dairy processors to invest in new facilities. According to a recent International Dairy Foods Association press release, dairy exports have accounted for nearly two-thirds of the industry's growth since 2000, rising by about $3 billion in value. Last year alone, U.S. dairy exports climbed 13% in volume and more than 20% in value, setting a new record high. USDA estimates that 8,400 jobs are created for every $1 billion increase in agricultural exports, thus the $3 billion in growth of dairy exports since 2000 equates to the creation of more than 25,000 jobs.

A new study by Andrew Novakovic, economist with Cornell University, and Mark Stephenson, economist with the University of Wisconsin, shows that had the new policy been in effect from January 2007 through December 2012, it would have been active for 16 months—about 19% of the time. Dairy producer income would have actually declined during the period, between $13,746 for a small farm with 100 cows to $137,465 for a very large dairy with more than 1,000 cows. Moreover, producers covered by the basic level of margin protection would net lower income due to lost revenues caused by the stabilization program. **MCT**

 MCT Dairies, Inc., 15 Bleeker St., Millburn, NJ 07041 (973) 258-9600 fax: (973) 258-9222 www.mctdairies.com. For more information, email **info@mctdairies.com.**