

Dairy Price Stabilization Program



Spring 2010

Dairy Price Stabilization Program



A Quick Research Project...

Let's pretend for a minute:

- \$17.50 per hundredweight in May
- \$18+ per hundredweight in June
- July, August and September look like \$18-19 per hundredweight

What's going through your mind?

Spring 2010

Dairy Price Stabilization Program

2

To get this discussion started, let's do a one minute research project. Each one of you is going to be the subject of your own research. We are going to do a bit of role-playing. In this exercise, you need to get in touch with your intuition, that motor that is constantly running in the back of your mind, that subconscious part of your brain that is constantly evaluating, reacting and responding to the information that you hear.

Are you ready? Think about the following scenario: May's milk price is going to be \$17.50 and June is going to be \$18. July, August and September all look like they will be in \$18/\$19 range as well. What thought is going through your mind right now?

A Quick Research Project...

What's going through your mind?



- Relieved!
- Getting your dairy back in shape?
 - Put more wholeseed back in the ration?
 - Feed more energy?
 - Look for a few heifers to fill “holes”?
- Whatever you do, you feel an urgency, because after all, you can't imagine the good times will last, right?

Spring 2010

Dairy Price Stabilization Program

3

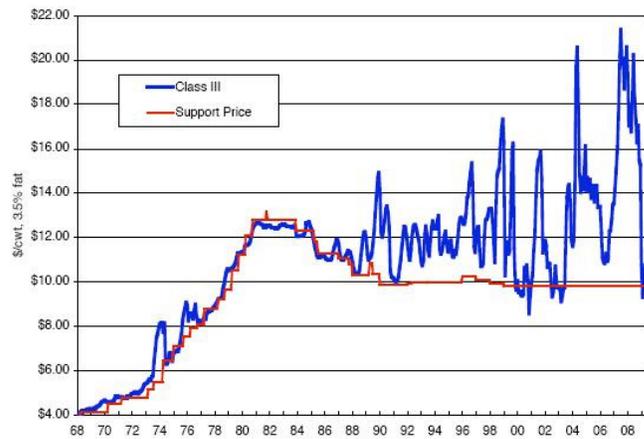
First of all, you are relieved. The long dark night is over. After months of losing money there is light ahead.

Then pretty quickly you start to think about how to get your operation back in shape. Is it time to put more wholeseed back in the ration? Should you feed more energy? Maybe you can get your mineral package up to full strength. Maybe you need to look for a few heifers to fill in the holes that have developed in the past 18 months.

Soon your mind speeds up and moves to the thought that there is some urgency to getting your production up as quickly as you can. You have a lot of lost ground to make up for. You don't know how long it is going to last and you need to get as far ahead as you can before it all collapses again. Isn't that the thought that emerges in the back of dairymen's minds? This nagging sense that the good times cannot last. That everyone is doing what you are doing? That disaster is right over the horizon? That you need to get as far as you can, as fast as you can, to have any chance at surviving?

Why we do dairymen think this way?

Milk Price Volatility Is Not New...



Courtesy of Cornell University's Program on Dairy Markets and Policy

...But It's Getting Worse With Each Cycle

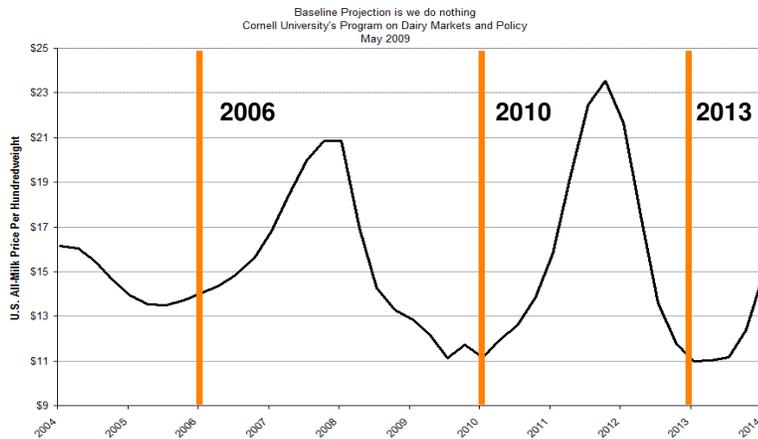
Spring 2010

Dairy Price Stabilization Program

4

Dairymen think that way because this has been their experience. What have we learned over the past decade? Intuitively we know we are in a boom and bust cycle. And that intuition is clearly known on this chart. This is what our life has looked like for the last 10 years. You can see that for many years, the milk price followed the support price. But in the early 80's, when that support price was lowered to a level below the "market" price, the value of milk started to "float." And minor volatility in the 1980's and early 1990's soon gave way to more violent volatility in the late 1990's and 2000's.

The Future Projects More of the Same



***According to the economic model created by Cornell University's Program on Dairy Markets and Policy (CPDMP), this is what the next 5 years could look like.**

Spring 2010

Dairy Price Stabilization Program

5

What we know by intuition based on our past experience has been modeled and is projected on a go forward basis by Cornell University's Program on Dairy Markets and Policy. This model run was done back in February of 2009 and projects the all milk price going forward for the next five years. If we do nothing, Cornell's model is projecting that the all milk price will follow this pattern.

What's Changed?



▪ Back then...

- Small 30-50 cow farms that housed their cows in a fixed tie stall barn, which was not easily expanded.
- During times of a profitable milk price, that model of dairying could not be rapidly expanded.
- It took much longer for dairies to respond to profitable prices with production increases.

▪ Now...

- The “Western-Style” of dairy farming has spread to the entire country.
- Producers have easily expandable milking facilities, with the know-how, the technology and the capital to rapidly expand production.
- During times of a profitable milk price, every dairy has the incentive – and the ability – to rapid increase expansion.

Spring 2010

Dairy Price Stabilization Program

6

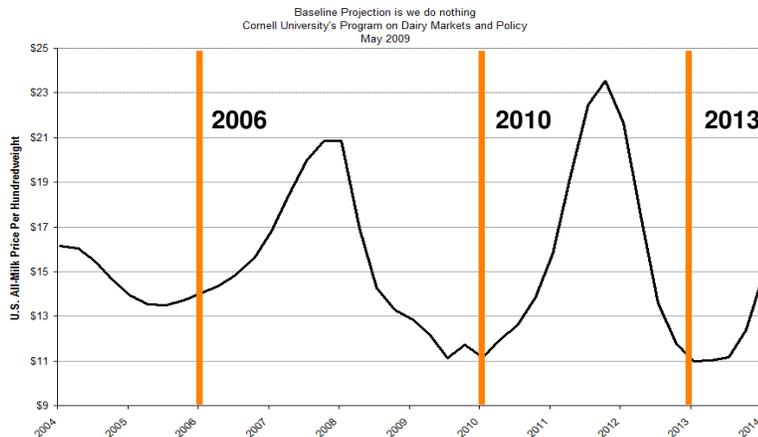
Why is the volatility getting more violent? What is different today about the nature of producers from the nature of producers 25 years ago?

25 years ago the vast majority of milk in the United States was produced on small 30-50 cow farms that housed their cows in a fixed tie stall barn which was not easily expanded. If the milk price was profitable, that model of dairying could not be rapidly expanded. If the barn held 40 cows, you could not put 60 cows in that barn overnight. Because of this, it took much longer for production to respond to positive economics.

Today, the producer sector has totally changed. Large scale dairying that was developed in the West has spread to the entire country. Producers have the facilities, the know how, the technology and the capital to rapidly expand production in response to any positive economic potential.

Further, the small dairies that used to balance the supply and demand by closing their dairies are getting fewer and fewer with each cycle. In the past 45 years, the U.S. has gone from having 1.1 million individual dairy farms to less than 65,000 today. There simply aren't enough dairies willing to just close up shop when we need a supply correction. They've already gone out in the last several decades.

This Chart Tells a Story - Supply/Demand



***According to the economic model created by Cornell University's Program on Dairy Markets and Policy (CPDMP), this is what the next 5 years could look like.**

Spring 2010

Dairy Price Stabilization Program

7

What does it tell us when milk prices are profitable? Looking at this chart, what do the profitable milk prices in 2007 and 2008 tell us?

A profitable milk price tells us that supply and demand are in balance or that demand is slightly greater than supply. Dairymen across the U.S. then respond to that profitable milk price by rapidly expanding their production. And it doesn't take too long with all 65,000 dairies working to increase the supply of milk before the supply/demand balance that caused the profitable milk price is reversed and the prices collapse. And since there is currently no rational and effective program to efficiently cut back the supply, the market price must drop to a point where enough cows are slaughtered to bring supply back in line with demand. Since each of the preceding downturns took out the "weakest" among the producers, each new downturn has to be that much more severe in order to get a supply reduction. Eventually, after collectively sacrificing billions of dollars enough production is removed from the industry and the price recovers, only to start the cycle all over.



What Can We Conclude From This?

- Price alone will no longer keep supply and demand in reasonable balance.
- Our industry is hard-wired to overproduce.
 - The “magic of pooling”
 - Our ability to rapidly increase production
- This may be new for us, but most manufacturers have always been able to produce more than the market can absorb.

We need a new tool to keep a better supply/demand balance.

Spring 2010

Dairy Price Stabilization Program

8

What can we conclude from this? The first conclusion is that we have reached a point in the dairy industry where price alone will not keep supply and demand in a reasonable balance. The industry simply hard-wired to over produce the market demand. Producers have every incentive to maximize milk production due to the way we regulate milk with the use of “pools” that pay the same price for the last gallon of milk you produce as the first, and our producers have the ability to rapidly overwhelm the market demand.

This ability to out-produce the market may be new for the dairy industry, but if you look at just about every other industry, manufacturers of most products have always been able to produce more of their product than what the market could absorb. Cars, shoes, screwdrivers, etc. So we need a new tool to balance supply and demand in the dairy industry.

Why Is the Government Involved in Dairy?



- Milk is unique
 - We have to produce it and sell it every day, to a buyer that does not have to buy it every day.
- This creates an unequal balance of power at the negotiating table.
- This is exactly why the industry has had the government involved as a “referee.”

Spring 2010

Dairy Price Stabilization Program

9

Why not just throw out the whole dairy regulatory system and let the “free market” determine who makes it and who doesn’t? Why is the government involved in the dairy business anyway?

The fundamental reason the government is involved and needs to be involved is actually very simple: **milk is unique**. As dairy farmers, you produce a highly perishable product that has to be sold every day to a group of buyers that do not have to buy every day. Because of this reality, there is an unequal balance of power when producers and processors sit at the negotiating table. This is why decades ago, the government got involved in regulating the dairy industry. The reason for this government involvement is not to dictate the specific actions of producers, but rather to act as a referee between producers and processors.

That reality, that milk is perishable and you have to sell every day to a buyer who does not have to buy every day continues. If we remove the government as the referee, the processors will control producer. Does the government make mistakes? Absolutely. It was interesting last fall to watch the baseball playoffs. TBS puts up that strike zone monitor in the corner of the screen so you can see how the umpire is doing in calling balls and strikes. You can see how often they are wrong. They have 10 cameras watching every play and every call is scrutinized and they get things wrong. Would the game be better if there were no umpires? Would a basketball game work better with no referees? Who would decide and enforce the rules? The strongest players would. And so too in the dairy industry, the strong would dominate the rest of the “players,” and for the most part the strong are the processors, primarily because of the strong negotiating position described earlier.

So What Can We Do?



■ The Dairy Price Stabilization Program

- One stated goal: **Reduce the volatility in the milk price by better aligning supply and demand.**
- The program creates **incentives, not government mandates.**
- Over the years, demand for milk has been amazingly steady, 1-2 percent per year, growing largely with population.
- The problem is when we increase production by 3-4 percent per year.

So what can our dairymen do? What is being presented here today is the Dairy Price Stabilization Program. This program was designed to accomplish a simple task using a simple principle. The simple task is to reduce milk price volatility by better aligning the growth in supply with the growth in demand. The mechanism being proposed is a system of providing incentives and disincentives rather than mandates to get this result.

The growth in demand for milk is amazingly steady, 1-2% per year, growing pretty much with population. Unfortunately, in our current structure, which pays producers the same price for the last gallon of milk you produce as the first, as soon as making milk is profitable we have the incentive to produce all we can. What we have found out is that as soon as we are profitable, producers end up increasing production by 3-4% per year or more, which is simply not sustainable and causes the price to collapse.

Why the DPSP?



■ In structuring the DPSP, we had three priorities:

- #1 – Reduce milk price volatility.
- #2 – Do not create a huge barrier to expansion or new entry into the industry.
- #3 – Avoid creating a significant asset value in the “base.”

■ This is why the program is structured to have the lowest “market access fees” possible.

Spring 2010

Dairy Price Stabilization Program

11

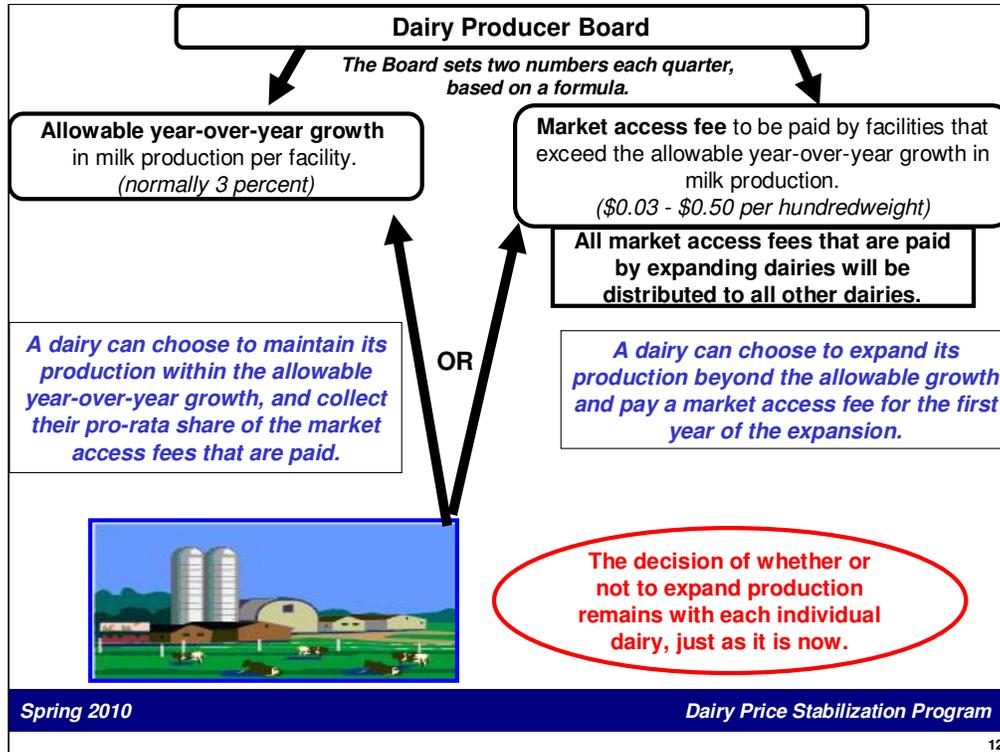
It’s important to understand why the DPSP was structured the way it was, and why it has received support around the country. We all know that implementing a two-tiered supply management program like the Canadian quota system has very little support here in the U.S. But a growing number of producer groups and cooperatives around the country have looked at the DPSP and found the same thing we did: This is a different kind of production management – a uniquely-American proposal for sending direct economic signals to our 65,000 dairy farms.

What the DPSP attempts to do is give individual dairies a direct financial incentive to manage their milk production, while at the same time avoiding the pitfalls we’ve seen in the Canadian system. In developing the DPSP, the authors had three main priorities. First, the primary goal of the program is to **reduce milk price volatility**. That’s important to note. This program is not designed to enhance the long-term average price of milk. The authors of the DPSP fundamentally believe that the market will provide a profitable long-term average milk price for producers. The problem is the booms and busts have gotten so extreme that many quality dairy producers are unable to survive the extreme lows that we’ve seen in 2006, 2009 and beyond. That is exactly why the DPSP aims to simply take the booms and busts out of the milk price and allow the industry to operate in a more narrow range of price volatility.

Secondly, the authors of the program did not want to create a huge barrier to expansion or a barrier for new dairymen. That is a major flaw in the Canadian system. Their quota system has essentially locked out new entries and any serious growth. None of us want to create that kind of industry in the U.S. – an industry that keeps new ideas and new players out and prevents families from helping to get the next generation involved in the industry.

Thirdly the authors of the DPSP wanted to craft a program that avoided a significant asset value in any “base” that is created by the program. When you have a large asset value associated with “base” – such as the roughly \$30,000 per cow cost of Canadian production quota – it creates the huge barrier to growth that is noted in point number two above. Further, a system that assigns a significant value to “base” will result in millions or billions of dollars being locked up in the value of that base and unavailable for investment in the operations of our dairies. An industry structured that way is simply not a healthy industry.

That is why the DPSP is structured to minimize the “market access fees” that must be paid by dairies wishing to expand their share of the market. That issue will be expanded on in a few slides.



Here is how the DPSP is structured. It's actually very simple. Before the beginning of each quarter, USDA will announce two numbers, based on a formula that was developed with the help of economists from Cornell University, who have provided third-party analysis of this program. One number will be the allowable year-over-year growth rate (normally 3%) that any producer can expand their production without paying any market access fee. The other number will be the Market Access Fee (between \$0.03-\$0.50 per cwt., depending on economic indicators in the industry) that will be paid by expanding dairies for the first year of the expanded production. 100 percent of those fees sent as a dividend to the dairies that stayed within their allowable milk production.

And that's it. With that information, each producer will decide how much milk they want to produce. A dairy can choose to expand its production beyond the year-over-year allowable growth rate and pay a Market Access Fee for the first year of the expanded production. Or a dairy can choose to maintain their production within the allowable growth rate and receive their share of the Market Access Fees paid by those who expanded. In essence this plan is an agreement amongst the "family of producers" to allocate future market growth. If you wish to expand your facility beyond the allowable growth rate and grab a larger share of the market, the program allows you to pay your colleagues to hold their production so that the market can absorb your increase in production. It is as simple as that.

We did not come up with these numbers out of the air. We took the idea to the Cornell University Program on Dairy Markets and Policy and they modeled it. They ran hundreds of different scenarios through their model and they discovered that with the structure outlined above, enough producers will decide to hold their production so that the market can absorb the increases of those who wish to expand. The milk production growth rate is slowed up just enough to keep the growth in supply in balance with the growth in demand. This smoothes out the price cycles and gets us off the boom and bust merry-go-round that we are on.

It's That Simple!



- **Everyone** has the opportunity to start a dairy or expand their production.
- **Nothing** in the DPSP prevents a dairy from expanding.
- Every incentive in the dairy industry (tax policy, pooling, etc.) sends a signal to expand milk production.
- The DPSP aims to send a signal for dairies to manage their production growth.

This is not supply management like we've ever seen before...this is a uniquely-American method of production management.

Spring 2010

Dairy Price Stabilization Program

13

It's truly that simple. Despite what the critics of this program may say, the DPSP does absolutely nothing to prevent a dairy from starting or expanding. It does nothing to prevent a dairymen from expanding his share of the market or getting his son involved in the dairy business.

Instead what it does is recognize that as we continue to develop new markets and grow the demand for our products, we cannot constantly have all 65,000 dairies chasing that new market. We need to develop a structure that is flexible and allows those that want to expand their production to meet those new markets to pay their fellow dairy colleagues to hold their production in line, allowing for the market to absorb the new production without collapsing the price.

This is a uniquely-American method of managing milk production. As a comparison, it's got some common features to the way free agency is handled in professional sports. Take baseball for instance. There is no limit on how much a team can spend in the free agent market. But there is also a recognition that there is a limited amount of talent in the free agent pool, and in an effort to keep all 30 teams competitive, baseball instituted a cap on salaries. If a team wants to have a greater share of the free agent pool, they have to pay a luxury tax. And that tax is distributed to the teams that stayed below the salary cap. Does it stop the Yankees from spending top dollar for the best players they can get? Of course not. But does it also allow a small-market team like the Tampa Bay Rays to put together a quality team and have a shot at the World Series? Obviously it does.

More on the Market Access Fees



- The program announces two levels of market access fee:
 - A lower fee per-hundredweight on **all** the milk of an expanding facility; or
 - A higher fee per-hundredweight on only the **additional** milk produced beyond a facility's allowable production.
- This allows the program to maintain a market access fee **as low as possible** – an important part of avoiding a barrier to expansion and high asset values on “base.”

Spring 2010

Dairy Price Stabilization Program

14

There has been much talk on how the market access fee should be structured, and what the fee should be applied to. The DPSP being developed in Congress gives that choice to the dairyman. There will actually be two market access fees announced each quarter – a fee that would only be paid on the milk produced in excess of the facility's allowable production, or a reduced-rate fee that would be paid on all the milk produced by an expanding facility.

A program that only charges a market access fee on the additional milk has to maintain a very high market access fee in order to be effective. And once you have a high market access fee applied only to excess milk production, you have then created a two-tiered program, similar to what Canada has. Remember, under that structure, if you were to try to get your son started on a dairy, all his production in the first year would be “additional production,” subject to the excessively-expensive market access fees.

Not only is that type of system bad policy, but it's unacceptable to our industry, and therefore, it's bad politics too. And as we know, there is simply not enough political support in the U.S. for a two-tiered system that locks out new dairies and large-scale expansions.

Therefore, the DPSP is structured to give producers a choice. Adding a few cows? You'd probably be better off paying a fee only on your additional production. Getting your son or daughter started on a new dairy? He or she would be better off paying the fee on all their milk in the first year at the reduced rate.

This producer option keeps the market access fee as low as possible. And keeping the market access fee as low as possible is absolutely critical to making this program work. **It's also critical to maintaining the support of many of the groups we've been working with.**

More on the Market Access Fees (Cont.)



Milk/Feed Ratio	Allowable Year-Over-Year Growth	“New Milk” Market Access Fee	“All-Milk” Market Access Fee
> 3.00	3%	\$0.15 per cwt	\$0.03 per cwt
2.50 – 2.99	3%	\$0.65 per cwt	\$0.13 per cwt
2.00 – 2.49	3%	\$1.25 per cwt	\$0.25 per cwt
1.75 – 1.99	0%	\$2.50 per cwt	\$0.50 per cwt
< 1.75	-3%	\$2.50 per cwt	\$0.50 per cwt

Spring 2010

Dairy Price Stabilization Program

15

This is a chart of what the legislation creates in terms of the “triggers” for setting the market access fees and allowable year-over-year growth. As you can see, the program relies on the “milk/feed ratio,” a measurement of the profitability of the dairy industry. There are likely a number of different economic indicators that could possibly be used to drive the variables in this program, and those other options are certainly being looked at. But after analyzing the current set of triggers, Drs. Mark Stephenson and Chuck Nicholson – who conducted the original analysis of this program while at Cornell University – determined that the milk/feed ratio is a strong enough indicator of industry health to be used as a trigger moving these variables up and down.

Cornell University's Analysis



- This proposal was taken to Cornell University's Program on Dairy Markets and Policy (Drs. Mark Stephenson and Chuck Nicholson).
- Cornell University has a widely-respected economic model used to project the effectiveness of public policy proposals.
- After running hundreds of scenarios through their economic model, the Cornell model determined that a program structured like the DPSP could, in fact, be effective in dramatically reducing the milk price volatility.
- The model also found that the market access fees could be much more modest than some of the figures discussed in other proposals.

Spring 2010

Dairy Price Stabilization Program

16

There is a fundamental difference between the Dairy Price Stabilization Program and many of the other programs being floated around the industry. Milk Producers Council is not the only organization that has come up with a proposal to address long-term stability in the industry. We are however, one of the few that has put our program through a third-party economic analysis and economic modeling.

The Dairy Price Stabilization Program – or as it was called when Cornell University modeled it, the Growth Management Plan – was taken to Cornell University's Program on Dairy Markets and Policy to be analyzed. The economists who analyzed the program were well-known names in the industry – Dr. Mark Stephenson and Dr. Chuck Nicholson. Cornell University's economic model is a widely-respected tool for forecasting the effectiveness of various public policy proposals.

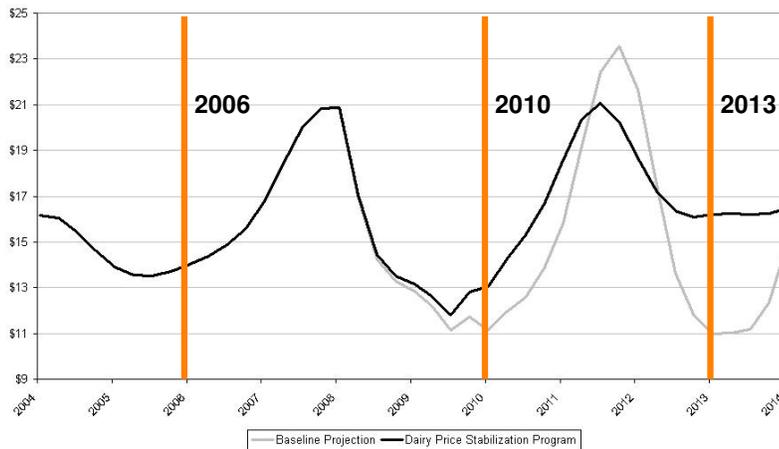
When we asked Cornell University to analyze the program, we gave them the basic structure of the program and asked them to run the proposal through their model and see if it would be effective in reducing milk price volatility. They ran hundreds of different market access fees and allowable growth percentages, and found that the program could in fact create an incentive that would allow continued growth in the industry, but would give enough dairies a tangible incentive to hold their production. This seemingly-simple concept is what stands between today's milk price volatility and a more stable price.

The economic model also found that the market access fee does not need to be a burdensome figure for the program to be effective. The program is not aimed at stopping growth. It's simply aimed at giving enough dairies an incentive to manage their growth so that we don't have all 65,000 dairies expanding their production when we have a profitable price.

Cornell University's Analysis



Baseline Projection vs. Dairy Price Stabilization Program
Cornell University's Program on Dairy Markets and Policy
May 2009



Spring 2010

Dairy Price Stabilization Program

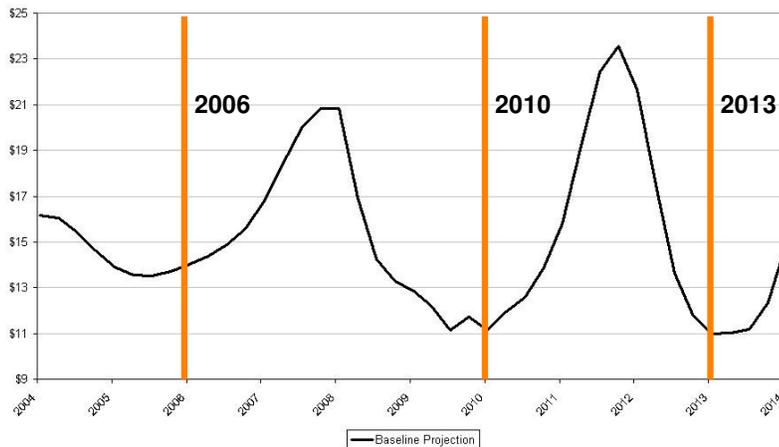
17

And after their economic modeling, this is what their model says the Dairy Price Stabilization Program is capable of doing for milk price volatility. You can see the program is aimed at taking the booms and bust out of the milk price, leaving the industry with a profitable price with a much narrower range of price volatility.

We Can't Afford to Wait!



Baseline Projection vs. Dairy Price Stabilization Program
Cornell University's Program on Dairy Markets and Policy
May 2009



Spring 2010

Dairy Price Stabilization Program

18

We need to do something now. Producers simply don't have the luxury of waiting until the 2012 Farm Bill to tackle these issues. The foundations that will create the next economic wreck in the industry are being established now. This industry is not like a military jet that can turn on a dime. It's more like a big ship lumbering through the water. We need to make adjustments to our industry now in order to prevent the next devastating wreck. Our industry simply cannot afford to wait.

One more thing for you to consider when evaluating the proposals people are bringing to you is what if they are wrong. If our plan is wrong – that is, if the program constrains the milk supply too much – we can adjust. Adaptive management is built into the plan.

Some in the industry are advocating that we deregulate much of our production and get rid of the government safety net programs we are familiar with. What if we go that route and there is no support program and milk prices are deregulated? Where is the bottom if we end up in a surplus situation? Those promoting that route say the existing system is too slow in sending market signals to producers when supply needs to be reduced. But those same folks are promoting "revenue insurance" and forward contracting as remedies. Think about it. The PURPOSE of revenue insurance and forward contracts is to INSULATE producers from negative market signals by locking up a higher price before market prices fall. If a lot of producers adopt this strategy, won't this slow down the supply adjustment of producers when one is needed? And remember, forward contracts expire. And what assurance do you have that when they do expire you will be able to get another one at a profitable price? So what if they are wrong and there is no safety net? What then? These are questions that need to be answered.

Thank you for your attention

Any questions?



For more information, please visit:

www.MilkProducers.org

www.StableDairies.org