

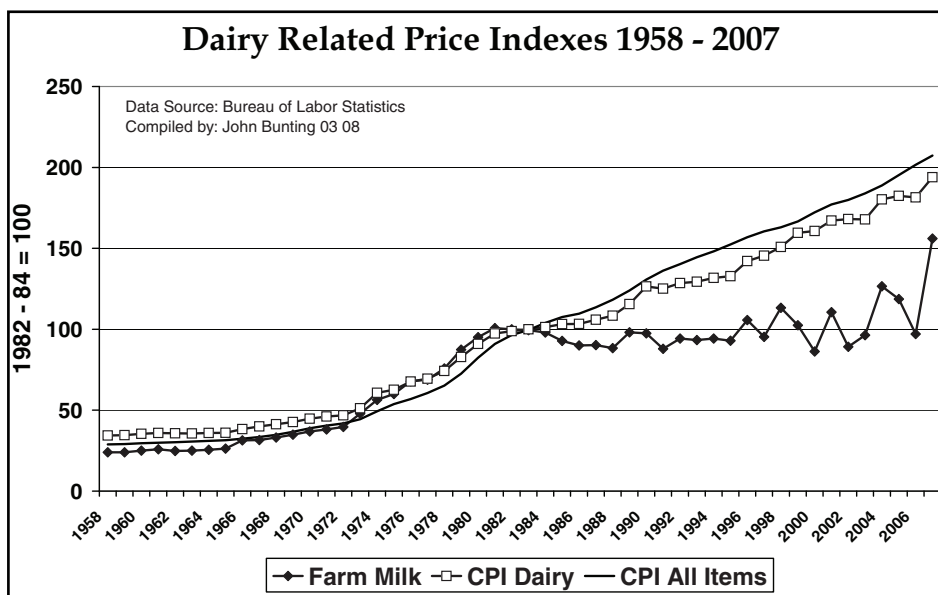
# Charts Detail Who's Got Milk Pricing Power

by John Bunting

Public education provides little information on economics. Most people are simply told: the U.S. has the world's best economic system: a market system. The word economics comes from the Greek and means essentially, the management of the household.

A true market system operates under the principle that prices guide supply and demand. The law of supply states that supply is directly related to price; the higher the price of the product, the more the producer will supply. However, when it comes to milk and dairy farm, in spite of the fact that supply and demand are terms commonly used, the reality is that pure, political power for those with access to political power, calls the shots.

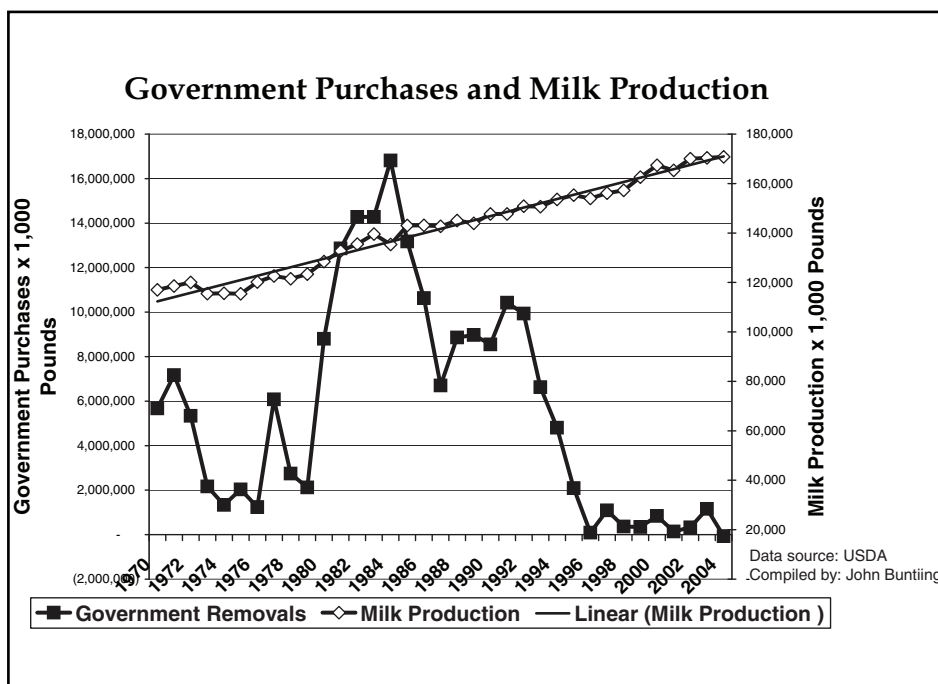
There **really** was a Reagan Revolution. Prior to the Ronald Reagan's presidency, milk pricing regulations had evolved to the point where farmers were paid a price based on input cost plus a profit. The system was known as parity pricing. All parity did was to insure an important facet of capitalism: there generally must be a profit for a business, or industry, to survive and prosper.



With the stroke of his pen, in March 1981, Ronald Reagan eliminated parity pricing for dairy. As can be seen from the above graph, in the 25 years prior to Ronald Reagan's presidency, farm milk price and consumer milk price rose at the general rate of inflation.

An index, as shown in figure 1, demonstrates a per cent change from the base (1982-84) period. For instance, in 1983 the index for all dairy products was 100. By 2006 it was 185. Farm milk price went up and down, but, essentially, never really changed in that same 22 period.

The argument for eliminating parity was that Jimmy Carter had raised the parity price to 80%. As a result the government purchased, or so the story goes, huge amounts of "surplus" dairy products.



Government purchases of dairy products (government removals) virtually ended, when the support price for farm milk was driven to nearly nothing. Annual milk production continued to grow at more or less the same rate, as shown by the linear trend line in the above graph.

Noble prizewinners, Daniel Kahneman and the late Amos Tversky have presented the best explanations as to why most people think government purchases in the 80's related to overproduction. Dr. Tversky once commented that much of what he studied was already known to "advertisers and used car salesmen." The power of suggestion commonly "frames" or "anchors" opinions.

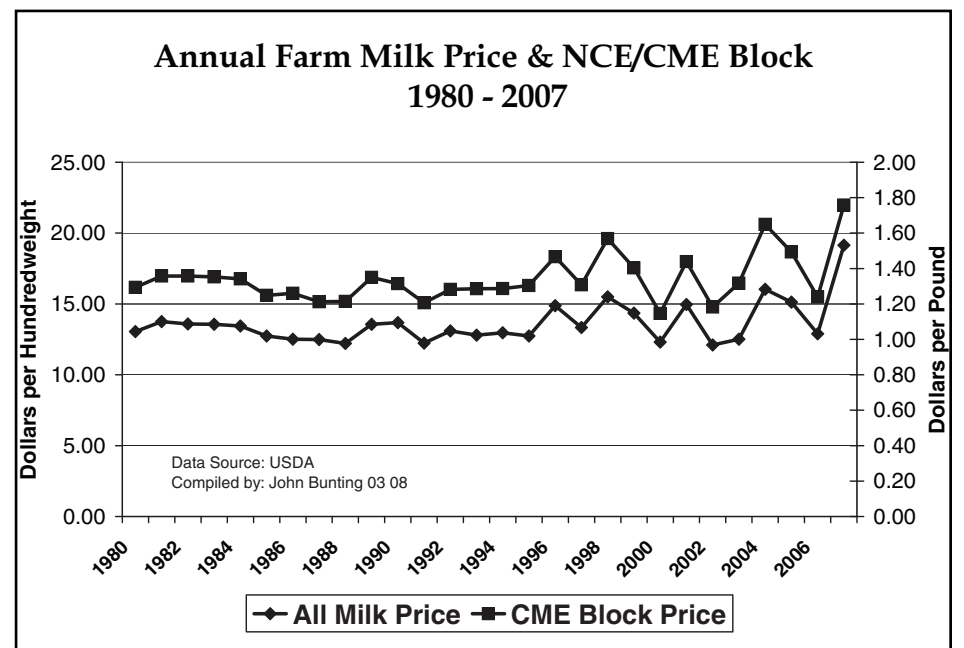
Other elements changed the dairy picture dramatically due to political signals from the early 1980's. Supermarket consolidation grew unchecked in the 1980s and continued into the 1990s. Ronald Reagan had reduced financing available to the Antitrust Division of the Department of Justice to 1/8 of what they'd been the year before he took office.

Food retailers soon became very powerful and were able to dictate terms to dairy processors. Dairy processors accepted the retailer's terms, took their profits and because farm milk price was now determined by the "market", the farmers got what was left.

The "market" for establishing dairy prices was for many years the National Cheese Exchange (NCE) in Green Bay Wisconsin. After an investigation by

the University of Wisconsin, in which government agencies and academics found Kraft Foods had manipulated commodity Cheddar cheese prices, cash cheese trading was moved to the Chicago Mercantile Exchange (CME).

Very little Cheddar cheese is actually traded, because as the University of Wisconsin's 1996 study indicated, the point of the cheese trading is to set farm milk price by way of a government formula.



Several dairy commodities are traded on the CME. Block Cheddar, which is a generic unaged cheese traded in 40 pound blocks. Barrel Cheddar (500 lbs.) is also traded. Barrel Cheddar is the basic ingredient for producing process cheese. Grade AA butter is traded. Since federal order reform of 2000, until March of 2007 both barrel Cheddar and grade AA butter track very closely to the ups and downs of block Cheddar. Nonfat dry milk is nominally traded on the CME.

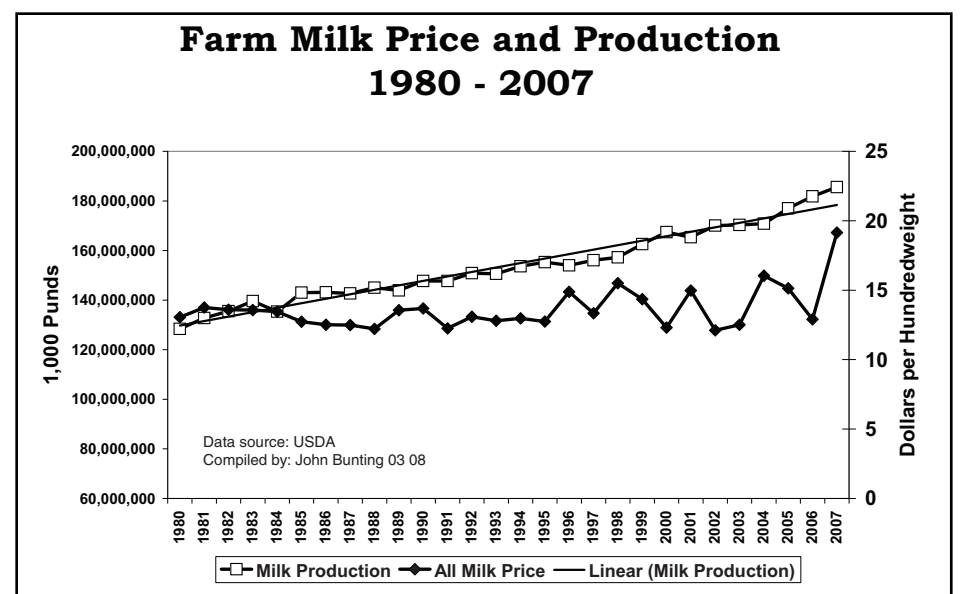
Actually, although the price of nonfat dry milk will occasionally rise or fall on the CME, it is a very rare day when any nonfat dry milk actually changes hands. This is because the rules of the exchange allow for price movement with no actual trading involved.

At the CME, block Cheddar cheese trading is limited to a small handful of traders, historically dominated by Kraft Foods and Dairy Farmers of America. Some erroneously argue, the trading of cheese on the CME constitutes a genuine market regulating supply and demand of farm milk.

Others argue that the government formula is not attached to the trading at the CME but rather from data collected by USDA's National Agricultural Statistics Service (NASS). In fact, the NASS survey, which began in 1997 after the University of Wisconsin study, is merely a thinly-disguised smokescreen to cover cash trading's impact.

Plants surveyed by NASS quote the daily CME price to buyers. NASS surveys the plants when the order is completed. Therefore, the only difference between the CME in the NASS price is time, usually seven to ten days.

The argument that farm milk price determines supply and demand of milk falls apart when the actual data is considered.



Although a great deal of variation (many ups and downs) has occurred in farm milk price, the actual linear trend of milk price is flat. The powerful players in dairy have converted what would seem to be a variable into a predictable over time. Farm milk price, in nominal dollars, never changes.

Any time conditions of oligopoly (financial power concentrated in the hands of a few player) exist, planning and predictability become all-important to the powerful few.

In reality, the correlation of farm milk price to milk production from 1997 through 2006 is -.2072. If the law of supply and demand were at work, the correlation would be high and the number would be positive.

Milk production does have a correlation, oddly enough, to the value of Los Angeles real estate. That statistical correlation is .7212, which is a very strong correlation, for the same 1997 through 2006 period.

There has been a very sound reason for this connection. Many California dairy farms historically located on the edge of Los Angeles. As Los Angeles expanded the value of this real estate rose dramatically. In recent years, IRS tax

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code 1031 allowed those dairy farmers who sold their dairies for huge amounts, to count that as no gain, provided they went back into the dairy (or like) business in a relatively short period of time.

In other words, our national dairy policy has been based upon the external input of capital from pricy Southern California real estate. Expansion in four Western states occurred regardless of milk price. Projecting the trend out forever seems doubtful. Existing California home sales have crashed in California according to DQNews.com. For Riverside County, the average price for January 2008 fell by -20.17% compared with January 2007. Default notices for Riverside County increased in the last quarter of 2007 by 118.9% compared with the last quarter of 2006.

While production may increase for bit longer in the West, the real estate bubble may indeed, have broken. Additionally, inputs for Western dairies have increased dramatically. California cost of production, according to USDA data has risen 23% since 2003.

## Current

To continue a national system based on formerly inflated real estate value, dubious future water supplies, and cheap oil, a system which benefited only the powerful few, is ridiculous.

There is a public interest in a dispersed, resilient food supply, including dairy. To accomplish that goal a new pricing system is a necessary part. To obtain a new milk pricing system, we – all Americans – need an honest USDA ... and politicians who are informed rather than merely influenced.

Dairy farmers need to face the fact that there is no future in more of the same. There are no such things as “Free Trade” or “level playing fields”. Dairy farm numbers have been reduced to the point where actual farmers have no political power and most of those who claim to represent them have been fused with those who exploit them (example: DFA & Dean Foods).

Both the public and dairy farmers need to understand the problem does not lie in coming up with a plan, no matter how well thought out the plan might be. The powerful have managed to shape the discussion in a manner which assures their hold on power. Those with a vested interest in the status quo, have more than a foot in the door. The problem lies in the restoration of a balance of power.