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The changing cheese-milk price relationship

The old 10¢ 'make allowance' doesn't hold anymore

For many years, it was easy to translate cheese prices into milk prices and vice versa.

Under the old M-W and BFP methods, the milk price was roughly 10 times the block cheese price, minus a dollar to account for the cost of converting the milk into cheese. So \$1.20 cheese meant \$11.00 milk, \$1.30 cheese meant \$12.00 milk, and so on.

From 1985 to 1997, the average "manufacturing allowance" on blocks was 10.5¢. However, since 1998, the spread between CME blocks and the Class III price has ballooned to 15.0¢ (see chart on page 2). That means the same \$1.20 cheese now equates to \$10.50 milk

and \$1.30 cheese now equates to \$11.50 milk.

Why has the cheese-milk price relationship changed? In short, because of recent modifications in the way the milk price is calculated.

The old M-W price was derived from a competitive price survey in a highly competitive region; cheese plants in Minnesota and Wisconsin have historically paid aggressively to retain producers and keep vats running at capacity. Even when the cheese market was weak, competition for milk in the Upper Midwest forced plants to pay up. When the BFP came on in May 1995 and formulas were used to calculate the milk price, it was still adjusted each month by a competitive pay price.

The Class III price, which entered the scene in January 2000, does not have a competitive price component. It's strictly a mathematical equation, computing the value of milk from the market value of the cheese, butter and whey that can be made from it.

Further, those product prices are based on national conditions, not regional. Over the last decade, supply conditions in the Western region have had a much greater effect on cheese prices.

Federal Order reform added some additional tweaks that changed that cheese-milk price relationship. Now the Class III milk price includes the value of barrels, which typically run lower than the

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KEN'S CORNER



*by Ken Meyers
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While the relationship between the cheese price and the Class III milk price has changed

over the last five years as described above, we should point out that these are minimum prices only.

Plants in predominantly Class III areas – the Upper Midwest more than Idaho – continue to pay large premiums above the minimum price for volume, quality, components, etc.

It's also worth noting that while the Class III has declined, the Class I price has been enhanced through the invention of the "higher-of," which allows Class I prices to be derived from either the cheese price OR the butter price, whichever is higher each month.

Under the old M-W and BFP systems, the Class I price was driven strictly by the cheese price.

Beyond that, on page 2 of this month's issue, we provide a heads-up on the butter market. We urge USDA to open up DEIP for butter sooner, rather than later. The quicker we can get the butter market back into balance – and DEIP will certainly help – the healthier the entire dairy complex will be. □

Slippage

Milk, cheese and butter production have been slow to contract, while demand has been slow to recover. That's keeping prices in the doldrums longer than many of us expected.

First quarter Class III futures have plunged more than a dollar since Dec. 3, and contracts covering the whole year have fallen more than 75¢. A few weeks ago we were talking about milk possi-

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
JAN	1.1475	1.1015	9.80	1.0821	10.10
FEB	1.1725	1.2025	9.85	1.0900	9.90
MAR	1.1925	1.2225	10.25	1.1200	10.00
APR	1.2075	1.2375	10.60	1.1800	10.15
MAY	1.2300	1.2600	10.75	1.1950	10.45
JUN	1.3000	1.3300	11.40	1.2200	10.55

* Block, barrel and butter are monthly averages of CME prices.

bly hitting \$14 in the fall; now even \$13 looks questionable.

We still expect a recovery in

prices in the second half of the year. But it's taking longer to get there than originally thought. □

Cheese-milk relationship ...

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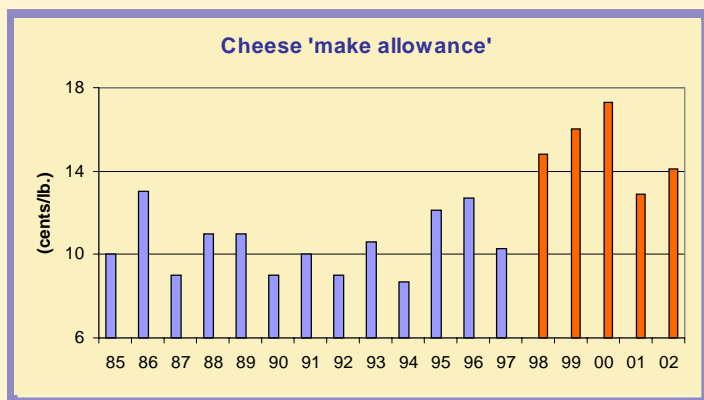
value of blocks and count more heavily in the survey. (Since 1999, barrels have made up 61% of the survey, blocks 39%.) At times, that drags on the milk price, too.

In addition, the current system includes the value of whey powder, which boosts the milk price some years and reduces it in others. Every cent change in the price of whey results in a 6¢ change in the

Class III price. In 2001, the NASS survey whey price averaged 27¢, a 8.4¢ increase from the prior year. That tacked 50¢ onto the Class III price. In 2002, the whey price fell back 7.3¢, striking 44¢ from the Class III price.

Changes to the system have altered the traditional relationships that plants and producers had come to rely on. But in truth, the old adage of subtracting a dollar to cover manufacturing costs was

understating the actual conversion costs of milk into cheese. Plant audits conducted in California each year reveal a margin of 16.5¢. Therefore, the recent average 15¢ margin more closely reflects today's realities. □



The spread between blocks-times-10 and the milk price has widened significantly over the last five years. The spread averaged 10.5¢ from 1985-97, but has averaged 15.0¢ from 1998 to today.

Butter DEIP could be unlocked

When butter moved to CCC for the first time in eight years last week, it gave USDA the impetus it needed to use DEIP to relieve the industry of some excess butterfat. The United States is allowed to subsidize 46.5 million lbs. of butterfat each year under WTO limits. So far this fiscal year, USDA has allocated 29.1 million lbs., but it has yet to invite exporters to apply for bonuses.

With commercial butter stocks at 156.9 million lbs. on Dec. 31 – more than five times the year-end average of the preceding five years – movement under DEIP could bring the market closer to balance in a hurry.

USDA has been reluctant to use DEIP for butter in recent years given the tightness of the domestic market. Over the last four years, the United States has exported just 3.8 million lbs. of butter per year. □

