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MCT COMPASS

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The Big Squeeze

This is certainly not the season for complaining, but cheese makers have been getting the squeeze and some think it's time for a change. Economists Ed Jesse and Brian Gould from the University of Wisconsin spent the past several months looking at what has been happening to cheese makers' margins, including the impact from rising energy costs, and the results are eye opening.

A cheese maker's gross margin is basically sales revenue per hundredweight of milk that is run through the plant minus the cost of 100 pounds of raw milk. Revenue is based off the various products a plant produces, such as cheese, whey, and butter. Due to federal order milk pricing regulations, cheese makers are allowed what's called a make allowance to help cover their manufacturing costs. This margin is fixed and is determined by the government using a series of formulas. In turn, cheese plants are required to pay dairy producers federal order minimum prices, thus they cannot recoup additional unexpected expenses by negotiating a lower price with their suppliers.

When manufacturing costs rise substantially, like they recently have from climbing energy costs, fixed margins can quickly become insufficient. The current squeeze certainly is not the sole result of rising energy costs, but they are bringing the issue into clearer focus. For example, manufacturers of dried dairy products are trying to recoup costs by charging their customers more in the form of energy surcharges. These energy surcharges are being wrapped into the product prices reported by both *Dairy Market News* and NASS, which in turn, raises the cost of Class IV milk. Because manufacturers of nonfat dry milk are producer-owned operations, the higher milk price at first glance looks like it would be welcomed. However, this avenue quickly becomes inefficient because it makes U.S. products less competitive on world markets.

For cheese makers, the situation is even worse because in today's highly competitive market, they are not afforded the luxury of tacking on an energy surcharge to

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KEN'S CORNER

by Ken Meyers
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Rather than inundating USDA with a laundry list of contentious issues surrounding the manufacturing milk price formulae, including everything from butterfat recovery to yields, the dairy industry has selected a single issue, stagnant make allowances, to appeal for change. The narrow scope of the hearing provides an opportunity for the dairy industry, producers and processors alike, to present a cohesive and unified position. That is something that rarely happens. In addition, it strips USDA of the opportunity to "give" on make allowances only to "take" on moisture adjustments, with the ultimate impact being status quo in the per hundredweight prices.

If the single-issue make allowance hearing proves successful, a precedent may be set for a more successful policy changing model than throwing everything into the policy debate and hoping for something to stick. MCT

Lead in to the blues

Dairy product prices are expected to trade within a narrow range through January. The February blues make these markets more unpredictable. Strong feature activity could bolster domestic demand, and expanding the varietal cheeses for export through the CWT program may enhance export demand. Without growth in both domestic and export demand, surplus milk production could push dairy products prices to near the $1.30 per pound level. MCT

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV
Nov	1.3760	1.3340	13.30	1.4265	12.90
Dec	1.3900	1.3575	13.20	1.4125	12.85
Jan	1.3800	1.3475	12.95	1.3650	12.40
Feb	1.3500	1.3200	12.80	1.3750	12.20
Mar	1.3300	1.3000	12.40	1.4000	12.20
Apr	1.3000	1.2700	12.15	1.4500	12.40

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

The problem of fixed...

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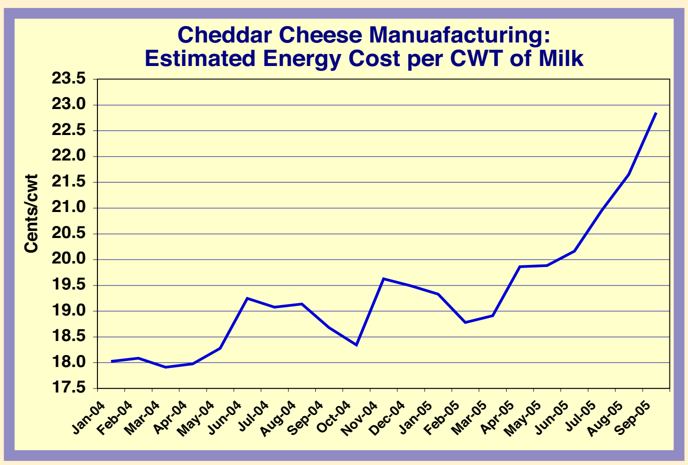
their final product in an attempt to recoup additional expenses. Cheese plants that charge their customers more risk losing them to a plant that decides to eat the additional cost. In addition, adding a fuel surcharge would immediately be translated into a higher cheese price and thus a higher Class III price, raising the cost of a plant's largest input, thus creating the opposite effect and further narrowing the gross margin.

According to the University of Wisconsin study, fixed make allowances, like those currently in use, become more of a problem when the manufacturing cost assumptions used in the formulas become outdated, which is exactly what is happening today because the assumed energy costs in the make allowances are substantially lower than today's real costs. Using a variety of formulas, Jesse and Gould estimated that energy costs associated with cheese making have increased by about a third, or 13 cents per hundredweight of milk since 2003, an additional cost that cannot be recouped by just passing on an energy surcharge to the end user.

The economists conclude that fixed margins for cheese makers, like those provided by the current make allowances, are fine as long as they assure reasonable profitability, promote efficiency, and encourage competition for cheese at price levels that are above the federal order minimums. On the other hand, fixed margins become a serious problem when they encourage disinvestment in cheese making by consistently yielding sub-par returns, like they do in today's current squeeze.

The National Cheese Institute has proposed reverting back to the make allowance formulas of five years ago and including an automatic adjuster to cover volatility in energy costs. This proposal is also one of three proposals submitted by Agri-Mark, whose total proposal is supported by producer groups nationwide. On Nov. 15, USDA announced that it will hold an emergency public hearing limited to the make allowance issue. Watch for more details on the hearing in upcoming issues of the *Federal Register*. MCT



Energy costs for cheese makers have risen dramaticaly since early 2004. Source: University of Wisconsin.

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