March 31, 2008

MCT COMPASS

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Production vs. Capacity

U.S. dairy farmers have long enjoyed the opportunity to increase milk production without any constraints or penalties. That is until recently. The largest dairy cooperatives in California—California Dairies, Land O' Lakes, and Dairy Farmers of America—have implemented supply management plans that basically cap their members milk deliveries at last year's level.

Milk produced above last year's level is likely to receive a significantly lower price that reflects: the cost of transporting that milk to a processing plant outside of California; the value of milk sold to calf ranches; or the cost of disposal. It is estimated that more than 1.0 million pounds of milk each day are being dumped in California. That equates to about 3 million pounds of cheese or powder per month that is not being produced.

California's capacity challenges are due to unfettered growth in milk production and a slowdown in capacity growth. At least three companies, Land O' Lakes, Hilmar Cheese, and Leprino Foods, added significant additional cheese production capacity in California in the early 2000s.

By the end of 2007, the Corona cheese plant, which could process up to 5.0 million pounds of milk per day, closed. It was hoped that this closure would be offset by the addition of a new powder plant that was scheduled to come online. Unfortunately, the new start-up was slower than expected and milk production growth greater than anticipated.

Another factor that is likely contributing to the disorderly marketing of milk within California is the state's milk pricing regulations. Unlike the rest of the United States, cooperative-owned milk marketed within California must receive the corresponding regulated California class milk price. For example, the March 2008 California 4b (cheese milk) price is \$16.94/cwt. A California dairy cooperative is not allowed to sell that milk to another California processor for less than \$16.94/cwt. But that milk can be sold to an out-of-state processor for less.

Within the rest of the United States, milk trades for less than the

Continued on page 2

KEN'S CORNER

by Ken Meyers
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The slowdown in the California dairy sector opens the door for other regions to recapture market share. Clearly, additional new cheese capacity in the Southwest and Idaho is well positioned to grow.

But let's not overlook the Upper Midwest. Milk production there has been growing the past couple of years after a couple of decades of decline. Many dairy manufacturing facilities have operated on 5- or 6-day schedules.

Thus, the capacity is available if milk can be procured at competitive prices. MCT

Lower stocks...

Milk production is increasing seasonally across the United States and dairy product production is strong. Despite strong milk production, the dairy product markets for the most part are steady. With American cheese stocks trailing the prior year by 8.3%, there does not appear to be any significant downside in the CME cheese markets. Export opportunities should continue to buoy the butter and powder markets.

MCT Forecast

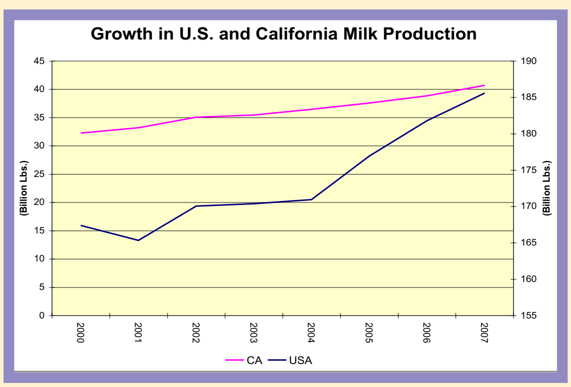
	Block*	Barrel*	Butter*	Whey**	NFDM**	Class III	Class IV
Mar	1.8234	1.7980	1.3454	0.2450	1.257	18.00	14.25
Apr	1.7950	1.7650	1.3650	0.2650	1.294	16.75	14.95
May	1.7600	1.7350	1.3900	0.2700	1.315	16.55	15.25
Jun	1.7250	1.7000	1.4200	0.3150	1.320	16.60	15.30
Jul	1.7500	1.7250	1.4450	0.3250	1.360	16.60	15.80
Aug	1.8000	1.7750	1.4750	0.3450	1.390	17.10	16.20

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

Regulatory quagmire...

Continued from page 1

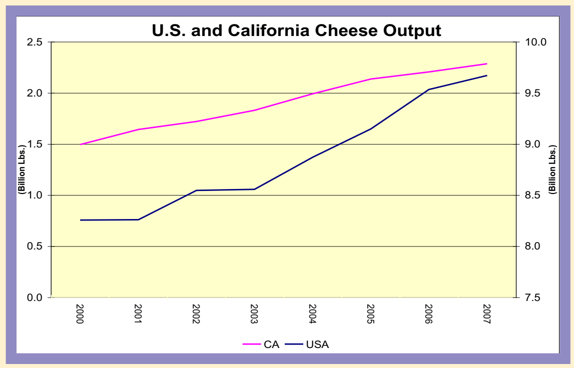
class price during periods of surplus production and holidays. Discounting milk provides an incentive for processors to make the adjustments for handling additional milk volumes. During periods of peak milk production, it is not unusual for milk to be discounted from $2.00 to $5.00/cwt. (or more) less than class. The level of discount varies by region and often represents the cost to transport milk to the nearest processing plant with capacity.



Source: MCT Dairies, Inc.

The slowdown, or a cap in California milk and dairy product production, is likely to have a significant impact on the U.S. dairy sector. California accounts for 21% of U.S. milk production. Since 2000, U.S. milk production has increased by 18.2 billion pounds. California milk production has increased by 8.4 billion pounds, which accounts for about 46% of the total gain in U.S. milk production during this period. Likewise, U.S. cheese production increased 1.4 billion pounds from 2000 to 2007. California's cheese production increased by 789.3 million pounds, which is about 55% of the total gain in U.S. cheese production during this period.

California has long been the dominant producer of milk powders in the United States. The state accounts for more than half of all dried milk powders produced here and is a significant exporter of dry products.



Source: MCT Dairies, Inc.

Without changes in the California milk pricing system or additional plant capacity coming online, the California dairy sector appears to be at a stalemate. Since California has been the dominant growth engine in the U.S. dairy sector over the past decade, the question remains will there be a corresponding slowdown in the U.S. dairy sector, or will other regions enhance their production capabilities to make up for the Golden State's slowdown? **MCT**

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