Milk Producers Council

"Serving the Dairy Industry for more than 60 Years"

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My View on Milk Production Increases

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Part One - From November 7, 2008 Issue

The dairy industry in California continues in its addiction of over-production of milk. Dairy producers seem to have only one clear focus; produce more milk. As costs go up, as milk prices decline, we produce more milk. As coops battle to place milk and milk products, we produce more milk. With 3x milking, rBST, advancing genetics, gender-specific semen, we produce more milk.

In a perfect world, where the milk we supply and the demand for those products remained somewhat in balance, this would be a strong sign of a vibrant and healthy industry. But the reality is, dairymen produce in an unrestrained fashion with no consideration of demand, leaving the industry in a perpetual state of overproduction which causes a myriad of problems, all of which should be unnecessary.

The typical dairyman is a good cow-man; he knows how to produce milk efficiently, and with high quality. As long as he is not on the wrong side of his banker or the dairy inspector, he is king of his domain. His coop puts wheels under his milk every day, his banker tells him what interest rate he pays on loans, the beef market dictates the price he gets for culls, and the California State regulatory system sets his milk price. He is not a milk or milk product marketer, does not need to innovate new desirable products, doesn't need to concern himself with milk sales – his coop will do all that.

Sounds like the epitome of socialism! It's all good and works well, right?

Not even close.

Our crazy "produce more milk!" entitlement mentality, that we can produce ever more milk, no matter what, causes such huge problems that our industry finds itself in a constant state of confusion and tension. Our coops cannot demand higher prices from Buyers, simply because they must get rid of more milk than the market wants. They are in a position of finding "holes", transporting milk over long distances, "selling" milk to calf ranches at cents on the dollar, and disposing of milk in other ways best not to put in print. This places the Buyers in an incredibly strong position.

Further, and worse, even when a coop is able to extract a premium of a few cents, another coop comes along and underbids them, and that premium is lost.

But things may be changing. There has occurred, in recent times, several "sea changes" that must alter the face of the industry; 1. Near effective irrelevance of the support program, 2. Less mid-west smaller dairies, 3. Imposition of production bases by all three major coops in California.

Let's explore them.

Support Program. In 1933, the federal government authorized the creation of the Commodity Credit Corporation (CCC), and in 1949 the CCC was given the responsibility to assure an adequate supply of milk for consumers – the Dairy Price Support Program was born. The CCC is required to buy all nonfat dry milk, butter, and cheese the industry offers to it at predetermined prices. The initial purpose was to remove excess product in the spring and release it in the fall, all in an attempt to flatten out supply. This law was intended to benefit consumers, not producers, and initially it worked as planned. But the dairy industry quickly saw it as a market (read that "loophole") not a market of last resort, especially when President Reagan, in 1981, finally froze the rising support price at $13.49 cwt, because we were generating huge volumes of product to government warehouses. (That $13.49 cwt, by the way, translates into $29.97 cwt in today's dollars!) The industry saw it as an actual market and produced giddily, resulting in the government dumping huge amounts of product in 1983-84, followed by a federal government producer buy-out to reduce production. In the short term, that solved the overproduction problem. Since then, the support price has dropped to $9.90 per cwt making this outlet definitely the last resort and definitely unattractive, especially when our milk prices were well above that price. With feed costs soaring due to the congressional ethanol mandate, that $9.90 per cwt "market" should effectively be closed to us.

Mid-west Dairies. In years past, when we out-produced demand, and milk prices declined, many mid-west dairies, those many thousands of producers with 20-80 cows, just quit, and stayed with farming only. That soon dried up the excess production, and milk prices gained strength, making us once again, okay.

In the last decade, our west coast style of dairying has been exported to Idaho, Texas, New Mexico, and even to the mid-west. Now, when prices decrease, those dairies, being larger and much better capitalized, have much more staying power. Except for last year's "bubble," the milk price does not recover as before. The drops we see are deeper and more sustained and the recoveries are anemic and certainly less dramatic. It seems like it has become a game of the titans seeing who could hemorrhage the longest and still survive. (The polite word for this pattern is "volatility.")

Coop Bases. Apparently, out of sheer frustration with the oceans of milk presented to our California coops, Land O'Lakes, California Dairies, Inc., and Dairy Farmers of America instituted base programs. This was done with little warning and apparently with little forethought, and certainly was not planned in concert with other coops. The only immediate accomplishment was the targeting of those dairies that just happened during that time frame to be in a growth mode, and after a small across-the- board fee, all costs to dispose of excess milk was charged to those "over-base" producers. One Southern California dairy suffered a charge of over $600,000 for the period of March-July, 2008. Because at all times, various dairies are undergoing expansion, the institution of bases at another point in time would have simply targeted other dairies, perhaps different than those punished now. Sort of like musical chairs-when the music stopped, for those without a seat, they got whupped. And hard.

In partial response to the unexpected imposition of bases, many cows were sold to out-of-state producers. Between that, and producers so affected reducing their production, a short term positive response has occurred.

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So why do so many producers have as their primary goal to just produce more milk? The answer lies in the magic of pooling, which was instituted at the same time quota was issued. Pooling of milk is a brilliant, efficient method of valuing and distributing milk in California. Imagine two buckets; one, a large "milk" bucket and the other a large "money" bucket. All milk produced in California is "poured" into the milk bucket. At the bottom of that bucket are 5 faucets. One faucet for each milk usage. Class 1, 2, 3, 4a & 4b. As milk enters the bucket, it loses its producer identification and then, various processors, whether it be for their intended use of bottled milk, cheese, powder, etc., tap into the faucet corresponding to that use. As milk is processed for those various uses, that identifies a value based on our pricing formulas, Class 1 price, cheese, etc. The payment for the corresponding usage value is then "placed" into the money bucket.

At the end of the month, it will have been determined how much milk has been produced and what its value is, strictly according to how and where it was used. That amount of money is then reported as a pool total, which then has deducted from it transportation credits and allowances, the quota payout of $1.70 cwt (less the RQA) according to quota holdings, and what is then left is divided equally according to volume of milk, and milk components to all producers.

This is a wonderful system. It establishes an equitable price to all, allows maximum availability of milk for higher-valued products, and allows a quota producer to ship to a powder plant or a non-quota producer to ship to a Class 1 bottling plant. All very efficient and equitable.

However, for all the positives this system provides, it has a serious flaw. Because all milk is pooled, the common value established by usage and the equitable payout to producers means when a lower value is created by overproduction that devaluation is shared by all producers simply by an across-the-bucket reduction in total proceeds . Stated differently, and simpler, if I produce one extra load of milk, which of course will go to powder (and possibly to the CCC) it will have a value of less than $10 to the pool, but I will receive a blend value of approximately $16.00 cwt for that load. But remember, the income to the pool bucket is about $10.00! That $6.00 loss is shared by all! Stated in again another way, it is in the best interest of every producer to produce as much milk as he can, always, because the lower value for that excess product is borne by everyone. Indeed, the producer who hasn't expanded in recent years is sucking air. So many others have expanded, and that expansion, if it exceeds market demand, by definition has largely gone to lower or lowest value uses. This flaw in an otherwise brilliant system is described best by the two hikers in the forest being chased by a bear. Those two do not need to outrun the bear, one just has to outrun the other! So my and your best business plan is to keep producing more, because the system, as designed, rewards individual growth but punishes producers industry-wide. The negative effect of me producing that "one more load" will be picked up by you.

As a side note, when milk in neighboring states comes into our pool, it enters as Class 1 usage, and receives Class 1 price. The problem with that is each load so delivered displaces a California load which takes that load from Class 1 all the way to the bottom value, reducing our pool total. This financial rape should not happen.

Part Two - From November 14, 2008 Issue

Last week, I wrote that the dairy industry in California continues with its "addiction" to over-produce milk, explained why I thought that was so, pointed out the problems it causes, and made a case for all of us to expect more of the same unless something is done. This week, I'll show examples of some successful programs, and suggest some steps that could start us towards a solution.

A few comments about powder plants. We need them. We need them to balance our production to meet daily, weekly, and seasonal demands of our customers. A problem arises, though, when investments in multi-hundred million dollar plants are made. The coops making those investments want to keep them running full tilt, of course, to return profits or "dividends" to their members. So indirectly, those investments encourage even more production. In a more perfect world, coops would not build those super-sized plants, and would run the ones they have only when a true profit can be made, or when there is a need to clear the market of the normal short-term and seasonal surpluses, and leave them idle otherwise.

That's essentially what United Dairymen of Arizona is doing. They have a base program which pays about a dollar more than overbase milk, and when supply exceeds what UDA can process, a "history base" is put into effect which limits the amount of milk a producer may deliver. By controlling the milk flow to the market with that plan, that plant, when it is idle, may be UDA's biggest contributor to the net profits they have. I can hear the howls of derision and condescending laughter at the possibility of something like that happening in California. But think about it – coops have hundreds of millions of our retain dollars interest free, they are given ample make allowances for processed products, they charge their customers for every service given – they even dip into our money bucket when fuel costs go up. You'd think that keeping a powder plant for back-up purposes is a no-brainer.

So why isn't it? To use a metaphor, a glove will shape itself exactly to the hand that goes into it. That is to say, coop management will do exactly as their boards direct. The boards are made up of dairymen who largely share the "produce more milk!" entitlement mentality, maybe because that's all we've known since our pooling/quota program began 40 years ago. (Those of you who were around back then will remember the projections that were made to help "sell" the pooling legislation: all existing producers would be equalized, meaning all the milk they were producing during the period just prior to pooling, plus normal growth, would receive the quota price within about 14 years, and everyone would live happily ever after.)

Land-O-Lakes and Dairy Farmers of America are nationwide coops. Their corporate planning and board decisions will of course show that influence. A "California solution" will not likely be at the top of their agendas and any positions they take affecting California will be watered down accordingly. California Dairies, Inc. is different. CDI controls 50% of the milk in California. CDI has only California producers as members. By taking a courageous leadership role, CDI could bring L-O-L and DFA to the table. Their combined volume would represent 85% of California's milk, and the right management of that volume could help resolve some of our problems immediately. The total production of all other milk is 15%! Can the tail wag the dog? It shouldn't.

In 1922, the Capper-Volstead Act became law which exempted agriculture from anti-trust restrictions. Stated simply, our coops can legally collude, price fix, develop common marketing plans, and make economic decisions that in any other industry would violate anti-trust laws. Are we doing this? Of course not. Why not? Because we have that "produce more milk" entitlement mentality, and the moment words or statements like "production cuts," "production discipline," or "growth management" are spoken in a group setting, all forward thinking shuts down. The recently instituted base programs in California do little to cap production, and their main effect was to isolate producers who recently expanded or who were in the process of doing so. The problem of our coops not being in a position to achieve milk prices above the state minimums remains.

Look at what Hilmar Cheese has done. All their producer/members are on a production contract. This sets a limit on the amount of milk each member ships to Hilmar. Do Hilmar members expand production? Of course. But in an orderly, as-market-dictates basis, which shields that increase from the vagaries of an over-supplied market. The total volume of all the member contracts is less that what Hilmar's normal needs are and accomplishes the following:

1. Hilmar's members focus on managing what they have, rather than expend energies to see into which cubbyhole they can stuff a few more cows.

2. Hilmar buys milk outside their membership group when needed, in the exact amount it is needed, which in almost all cases is distressed milk, begging for a home.

3. Those who supply Hilmar with their reserve needs receive the minimum price if purchased from producers, and possibly less than minimums if purchased from other plants. With this program, Hilmar never has market-clearing costs. That translates into an extra source of profits for its members.

This results in our production-assaulted coops balancing Hilmar's needs, at no charge and sometimes at a loss. Does that mean that Hilmar management knows more about what is happening than do our coop boards? Or is Hilmar simply using common sense to take advantage of what is going on in the industry?

In the mid-west, Continental Dairy Products, Inc, a producer coop operating in Ohio, Indiana, and Michigan, has strict production control on their producers. They are seldom, if ever, in a position of having to beg a buyer to take more milk. The result is one to two dollars premium, at all times, just because they do not let overproduction overwhelm their ability to market the milk.

The overarching theme here is that overproduction is the single culprit keeping us from operating an orderly, intelligent industry. State minimum prices are exactly that, minimums. Nothing in policy or law keeps coops from setting a higher price. Only the neutering effect of overproduction. To underscore the point, after the government instituted the national buyout about 25 years ago, prices increased. When financial hemorrhaging runs its course and targeted culling removes those 50 pound producers, prices increase. When CWT removes enough cows, prices increase. Hilmar doesn't have disposal or balancing costs; Continental garners a premium because overproduction is not an issue; UDA doesn't flood the market. What is it about these facts we don't comprehend?

So often we hear from fellow producers "let the market control production." Well, it has, and look at what has been happening over and over. It's brutal. It bleeds the strong and kills the weak. When prices return to an acceptable level, the survivors, who are now less strong, recover just in time to face that insane cycle again.

If you own a hardware store across town from mine, and you go broke, I gain sales. That's healthy capitalism. But when my neighbor dairyman goes broke, it has no positive affect on me. Why? Because our heavily regulated industry is joined at the hip by virtue of pooling and a myriad of regulations. We swim or sink together!

There is a truism in the industry: all heifer calves born, are raised. All fresh heifers are milked – either in your barn or mine. Large dairies that have been built do not produce milk, cows produce the milk. If those large dairies add a thousand heifers, that's simply a thousand heifers not being milked at your place or mine.

So what's at the core of the California problem? There are 1,800 dairymen in the state, all working at increasing or maintaining production. Collectively, that creates the unwieldy, seemingly unsolvable overproduction problem we have. If each one of those 1,800 would do a little bit of production control, the problem disappears. How do you eat an elephant? One bite at a time. If only a few producers reduce or control production, and not the rest, those people hurt themselves and only temporarily make it better for the others. We need to do it in concert, and our common point of connection is our coops.

Last year, MPC sponsored a Cornell University study that showed establishing an incentive to manage production increases by producers would likely solve the bust-to-boom-to-bust problem. The study showed that, if individual self-interest could be activated in the right way at the national level, producers would respond. Our goal was to have this "Growth Management Plan" included in the Farm Bill. MPC hit the road and spoke with many dairy groups, in California and elsewhere. The response from producers was total approval and acceptance of the idea, but the industry "leaders," our coops and trade associations, were not interested. And so the problem remains.

So, what would happen if production discipline for California were to be instituted? A whole, brand new world would be open to us. A complete paradigm shift for our coops would be required, which would probably not be welcome, at least initially. Here are some of the things that probably would need to be done to get it started.

1. The first step would be to have California's three major coops jointly look into ways to establish and manage a production discipline program for their members.

2. The committee should consider if production controls only would be sufficient – or if pricing authority would be needed – in effect, a California Marketing Agency In Common.

3. A review should be made of possible changes needed to be made to California's milk statutes to provide maximum operational flexibility for the "CalMac."

4. A study and plan is needed on how to equitably correct or control the current inter-state milk pricing and usage problems that have caused immense losses to California producers and processors.

Getting three major coops together to share costs, prices, problems, and opportunities certainly will not be easy. It wasn't easy for the three coops who now make up CDI to arrive at a solution, but it happened, partly because they each could see real benefits from the result. CDI's leadership at this time in exploring the road to the point where higher milk prices would result in profits, not problems, is an exciting thing to consider. Think about our coops being able to finally market our milk instead of just finding outlets for it. That's the difference between being price makers instead of price takers.

Few have experience with such a scenario (UDA, Hilmar, and Continental, excepted of course). So, a lot must be learned. The suggested steps and studies listed above are the least that is needed to be done. But I'm convinced that we do understand that the core problem is overproduction, and we should understand that it won't be corrected unless there is a consensus to do so. I'm also convinced that our coops (that is, the dairymen on their boards) have the authority and the responsibility to lay plans to improve what is now a virtually unacceptable situation. All we need is for them to agree to do it.

Years ago, California producers voted to "tax" themselves about $.05 cwt on all milk (which has since risen to about $.20 cwt) to reimburse our manufacturing plants for the costs of transporting their products to the mid-western and eastern parts of the country, to compete head-on with local sellers. With the emigration of California producers and west coast style of dairying to states lying to the east of us, plants in those areas are in an increasingly stronger position to supply those markets than we are.

Our future growth market lies to the west – the Pacific Rim countries. We need to develop those markets, because we are closer geographically and have the shipping ports and certainly the milk supply. The growth of the dairy industry to the east has increasingly compromised us on the west coast, and it will take a concerted effort to develop these "new" markets. This requires cooperation between coops, time to develop products wanted by those countries, and production control. That is one of the fundamental responsibilities of coops – to foresee what is needed to match current and future supply with current and future needs. Alternatively, we can choose to do nothing, allow the anti-business, anti-agriculture forces in California to continue to push us to obscurity. Or we can unite to "re-invent" our west coast dairy industry.

We don't need Sacramento. We don't need minimum prices. We don't need the support price program. What we do need is for our coops to function in a manner they are supposed to – but that can't be done without effective and acceptable production controls as a starting point.

We need a call to action. Our coops will do what their members want. Every producer who agrees with some or all of the points in this article should – and must – contact their board member representative and tell him or her what should be done. Here's the key problem that stands in the way of progress: it's when a group or committee is confronted with a new idea, and everybody looks to why it can't, or shouldn't, happen. Challenge your board to address themselves only to how it can be done. If our coops know that we as producers are more than willing to take that small "bite" of production discipline, nothing should stop them from accomplishing a sane, profitable industry. But that will take guts; it will take a willingness to make mistakes and to learn from them. It will take a concerted, united effort – something which is sadly missing in California – to accomplish this. New brooms sweep cleaner than old ones. If the job isn't being done properly, perhaps it's time for a change. But it can be done, it should be done, and it must be done. Status quo is no longer acceptable.

Your views on my views will be greatly appreciated. We would like to hear from you. Please address your comments to mpc@milkproducers.org and reference this article; or give MPC a call at (909) 628-6018.