California Producers Scared: Milk Prices Lag Behind Soaring Costs

by Pete Hardin

Over the past couple decades, California dairy producers generally swaggered through dairy price downturns, figuring that sooner or later, enough Midwest and Northeast dairy farmers would quit milking cows … and thus correct any U.S. milk "surplus" problems.

And besides, California's dairy lenders were almost always understanding about extending operating loans through low milk price cycles.

The "Golden State" was deemed a model of modern dairy production efficiency … until perhaps early 2006 … when, across the board, costs, milk prices and weather all started going in the wrong direction in tandem. California's paradigm has changed. The era of "Cheap Grain" has ended. Current production costs are climbing. Most frustratingly, California dairy producers are failing to see "current" values for nonfat dry milk reflected in their milk prices.

Failure to match "current" milk prices to "current" production costs will only perpetuate the negative cycle that has devastated California dairy producers' net cash returns since early 2006.

But after a year and a quarter of relatively low milk prices, California's dairy producers have lost their swagger, their shirts … and in some case, are in danger of losing their farms. Estimates are the average California dairy producer lost between $2.00 and $2.50 per cwt. on all milk production during 2006. Based upon roughly 38 billion lbs. of statewide milk volume—these losses cannibalized roughly $750 to 950 million worth of equity during 2006. Similar poor financial returns milking cows continue for most producers in 2007's first quarter.

After some 15 months of big losses for milk producers, California producers join many other U.S. dairy producers … on their knees, financially. And, unless net cash-flows for the majority of California dairy producers improve dramatically *soon*, a significant number of dairy producers will be pulled under. The ripple effect will financially harm businesses and lenders serving the dairy producer community—just like what's going on in the New England and eastern New York State.

If there's good news in this mess, it's that *finally* some California dairy producers are waking up to milk marketing and milk-pricing inequities that have combined to deny large amounts of needed milk income from their paychecks.

* Many California dairy producers have borrowed heavily to pay bills during 2006. California dairy producers now carry record volumes of payables on their books. Borrowing capacity has been tapped out, in many cases. Lenders must maintain the quality of their loan portfolios. "Better" farm milk prices will be offset by rising grain and hay costs here in early 2007.

* Sources say most of the Production Credit Association loans to dairy farmers in California are severely deteriorated—borrowers are paying "interest only" … at best.

On April 4, when DairyAmerica's Rich Lewis made his prediction of $1.70/lb. nonfat NASS prices by September (2007), DairyAmerica's spot price for nonfat dry milk was $1.80/lb.. Thus, DairyAmerica's top official projects it will take six more months for "tailenders" like the NASS and CDFA price surveys to get to within a dime of current NASS prices! In other words, current milk pricing practices and systems will yield more of the same-old, same-old—unduly low prices—to dairy farmers … in California and throughout the U.S.

* Residential estate values in many parts of the state are sliding backwards—trending down sharper than national indicators in recent years, as California's residential real estate bubble is bursting, in tandem with national trends. California's sliding home real estate values and rising mortgage foreclosure rates have bankers and stock markets equally nervous.

It's a fact: the greatest factor correlating with increased California dairy production growth has been real estate values in Southern California. The real estate mega-bucks that exiting dairy producers have drawn out of Southern California have been reinvested in dairy facilities in the Central Valley, Idaho, New Mexico, and west Texas … to make more milk and avoid Uncle Sam's tax bite on capital gains. Too often in past couple decades, modern dairy palaces constructed with money pulled out of Southern California dairy real estate dollars have been structured on the western mega-dairy model dependant on cheap grain prices.

Grain, hay & by-products costs way up!

The California dairy production model … indeed, western, factory-style dairying … has been based on artificially cheap grain costs. During the past year, higher grain costs, particularly in tandem with low farm milk prices, have churned red ink by the trailer load. Usually, California dairy producers forward-contract some or all of their grain purchases, up to a year in advance. But last year, in the late summer and fall, numerous California dairy producers couldn't believe that the "too high" corn prices would last … so they didn't contract, waiting for corn prices to drop.

Strong demand for corn—both globally and domestically—has sharply escalated dairy production costs in California in the past year, as milk prices stagnated. Stronger export demand for corn, coupled with exploding domestic demand for ethanol production, have driven corn prices sky-high. Recent downturns in corn futures—responding to government estimates of a 15% increase in U.S. corn acreage—must be tempered with weather realities in the Midwest and Plains during the upcoming crop season. Savvy persons should pay attention to the weather, not government reports, about the fate of the 2007 corn crop in the Plains and Midwest.

Meanwhile, term contracts for other feed inputs—like almond hulls—are expiring and current prices are much higher than those of expiring contracts.

In early April 2007, as the first cuttings of new crop alfalfa are being harvested and fed, hay is both tight and expensive. Reports from the Central Valley tell that prices for new crop alfalfa ("no test") start at $195/ton delivered. Better-quality early 2007 cuttings are priced in the $210-$215 range. No carry-over, quality hay was stored on California dairies this past summer and fall, because cash-flows didn't permit the outlay. Dairy-quality alfalfa's high prices and scarce availability comprise one more headache for dairy producers in California right now. In truth, from dairy livestock to beef animals to horses, California probably has too many critters that eat hay.

California's present—and future—squeeze on hay supplies results, in part, from aberrant weather both from spring 2006 and spring 2007.

Last year, intense rainfall plagued California's Central Valley in late winter and spring 2006—delaying normal early cuttings of the all-valuable forage crop. Heavy rains continued into early May last year in many agricultural portions of the state. Early cuttings of alfalfa turned fibrous and molded in the field. Lots of poor-quality hay was harvested. Then, in the second half of July, intense heat scorched the state and was tough on plants, as well as men and beasts.

Weather patterns so far in 2007 have yielded tiny amounts of precipitation in the Central Valley. That moisture shortfall is impacting forage quality of uplands frequently grazed by beef animals. Also, yields on early cuttings of alfalfa may be reduced by low soil moisture levels. Reservoirs serving the Central Valley are reported to be in relatively good shape, although snow pack in the mountains (that feeds the reservoirs) is below normal. In summary: forage availability looms as a critical input for California dairy producers in 2007, from standpoints of both supply and cost.

Many factors have gone wrong simultaneously

High grain prices … high hay prices … low milk prices … tough weather. In tandem, these factors have conspired to create negative cash-flows approaching $1 BILLION for California dairy producers since January 2006.

If that cash-flow hit isn't bad enough, another pedestal of California's dairy industry is tottering: Class 1 (fluid) milk quota. Class 1 quota allows its holders access to the higher-valued fluid milk receipts, through California's state-governed milk pricing program. Those pieces of paper constituting Class 1 quota are valued at just over $1 billion. For the past several decades, ownership of Class 1 quota has been an asset that's held, bought, sold … and borrowed against. These days, though, those "Golden State" Class 1 quotas—repeat, worth $1 billion—are fast losing their aura.

Tremendous growth in California milk production has reduced the total Class 1 utilization down to less than 15%. Equally worrisome: more and more out-of-state milk is "invading" California, either raw form sold to fluid milk plants, or as packaged product. The spring 2006 dairy legislation passed by Washington, D.C. to allegedly penalize producer-handler Hein Hettinga's Sarah Farms operation in Arizona, in fact, is backfiring against the many California sponsors of that law. H.R. 4015, the Milk Regulatory Equity Act of 2005 (so named when it passed the U.S. Congress) created a "no-man's land" in Nevada—an island immune from federal milk order regulation. Major interest is spring in Nevada to build fluid milk facilities and "invade" California with non-regulated fluid milk.

All these factors weigh against the integrity of California's historic dairy regulatory efforts … and the $1 BILLION value of Class 1 quota held by dairy farmers.

The future of Class 1 quota is tenuous, more tenuous than those with vested interests in the stability of California dairy producers' equities would like to admit. A recent report commissioned by the California Milk Advisory Board suggested, among many other items, that a system for "buying out" dairy farmers' Class 1 quota through a system of state-sponsored bonds be created. That suggestion presumes that state legislators pressed for money and time in the difficult days ahead will be sympathetic to the needs of "rich" dairy farmers. Behind the scenes, California dairy producers are starting to worry that their historic support in Sacramento is not as stable as it once was.

Bottom line: Production costs & milk prices

Sustained by relatively "cheap" grain prices over time, California milk production has soared ever higher. Historically, no matter what has happened price-wise, California producers' response has been to make more milk.

Despite low milk prices, high grain prices, and high hay prices, the past month has been no exception to the "make more milk" dictum. Throughout much of March 2007, both Dairy Farmers of America and the National Farmers Organization instructed some members in California to dump milk. Simply put: too much milk output in March 2007 overwhelmed available milk hauling and processing capacity. However … this March 2007 burst of milk volume was spurred, in great part, by unduly dry winter weather that resulted in virtually no weather stresses on milk cows. As higher grain and hay costs impact, March 2007 may go down in history as the last "peak" of California's raw milk gusher.

Since the late 1970s or early 1980s, state government in California has overtly inspired growth and expansion of dairy manufacturing plants, to accommodate all the milk that state producers could generate. California's state dairy policy makers have kowtowed to dairy plant owners' interests, at the expense of producer equity in milk-pricing. Issues such as manufacturing plants' "make-allowances" and transportation credits have repeatedly been decided by the California Department of Food and Agriculture (CDFA) on behalf of dairy process-

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ing and marketing interests. The monthly pool of producer revenue overseen by CDFA has been viewed as a reservoir to tap. And all that tapping has drained producer revenues, while at the same time creating a form of state-sponsored "Socialism" for dairy processors (including producer cooperatives).

The "same-old, same-old" game of subsidizing dairy manufacturing plants has deteriorated into a drain on dairy producers' milk checks.

4a (powder) pricing: DairyAmerica screws up, producers lose big-time

Solutions? There are no quick, easy solutions to the run-up in grain prices and scarce, expensive hay costs. California dairy producers' costs are up … and will likely stay up. Energy cost increases mean that transportation of grain from the Plains and Upper Midwest will climb—adding to total costs of feeding grain on California dairies. California's historic dairy "model" may be outmoded.

Price-wise, like their dairy farming counter-parts elsewhere in the nation, California dairy producers have suffered from a deteriorating share of the gross receipts available from the sale of dairy products.

Like dairy farmers elsewhere, California producers are suffering from what they increasingly perceive as misdeeds in the marketplace by their major cooperatives. And no single issue focuses the milk marketing/pricing issues like the big co-ops' failure to intelligently market dairy protein powders domestically and globally.

U.S. nonfat dry milk powder is based heavily in California. In 2006, California produced over half of all U.S. nonfat dry milk. The major dairy co-ops operating in California—California Dairies, Inc.; Land O'Lakes; and Dairy Farmers of America—all belong to DairyAmerica—the cooperative milk powder marketing agency (*aka* cartel) that foolishly relies on Fonterra—New Zealand's dairy export near-monopoly—as its exclusive export agent. DairyAmerica's failure to wisely market nonfat dry milk during the past year has resulted in continued lowball milk prices to California dairy producers. In late spring 2006, DairyAmerica signed a low-ball dairy export contract with Fonterra. Both domestic and global prices for nonfat dry milk have since sky-rocketed. But DairyAmerica—locked into this low-ball export contract—has continued to under-report current milk powder prices. These lowball prices have translated into lower Class prices in CDFA's system, as well as USDA's. (See the March 20007 issue of *The Milkweed* for volumes of information on milk-powder pricing.)

DairyAmerica's Rich Lewis predicts $1.70/lb. NASS powder price by Sept.

California dairy producers should find interesting a projection made by Rich Lewis of DairyAmerica at an industry meeting in Binghamton, New York on April 4. Lewis estimated that nonfat dry milk prices—as measured through USDA's National Agricultural Statistics Service (NASS)—will climb as up to $1.70/lb. by September … 2007. NASS's milk powder price, like CDFA's calculations for the 4a Class price, lags far behind current market prices for nonfat dry milk.

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CDFA uses milk powder pricing data to set monthly prices for various classes of milk use. Class 1 (fluid), Class 2 (cultured products), and Class 3 (ice cream) all rely on Class 4a values. Thus, if California dairy producers' pricing system had factored in higher values for nonfat dry milk in the past six to eight months, a great portion of the red ink they'd cash-flowed in that period of time would have been alleviated.

Won't get better 'til …

California dairy producers face multiple, serious challenges. Managing higher grain and forage costs is one challenge which may entail tough decisions. California has too many critters that eat forage, period.

But in the pricing and marketing of milk, many opportunities for improvement are present … starting with 4a pricing and the low-ball milk powder prices. In their search for solutions, California dairy producers are slowing grasping the following changed realities:

* Pricing actions by CDFA and the big co-ops have not been in the producers' best interests.

* Making all the milk they can, come what may, is ruinous to producers when collectively practiced.

* Helplessness and ignorance of dairy marketing/pricing cannot continue. Many parties in this industry have become arrogant, fat and lazy … due to the dairy producers' ignorance of events in milk marketing, pricing and policy.

Both in California and across the U.S., overall farm milk price realities will not significantly improve until California dairy farm men and women wake up and do something about the milk pricing and marketing inequities that depress their milk prices.

To survive and prosper in the future environment of higher grain, energy and interest costs, California dairy producers direly need cooperative milk marketing and state milk pricing systems that reflect **current** values of dairy commodities … raising producers' net milk prices. California's major dairy cooperatives all belong to DairyAmerica—the milk powder cartel. Until DairyAmerica's pricing and marketing practices become directed towards the economic betterment of dairy producers, California dairy farmers will continue chasing current milk production costs with outdated milk pricing values.