Myth busters – California dairy edition

When I started working for the California dairy industry, a wise dairyman once told me: if you want to find 10 different opinions on a topic quite rapidly, put 10 dairy producers in the same room. I can't say that it's always the case, but at times it has sure felt that way. Various perspectives can be a good thing, but it's also important to keep facts in mind. There are a lot of components to the complex California dairy system, so this series will attempt to clarify common misconceptions. In light of all the upcoming decisions that will face California dairy producers, WUD wants to ensure producers have access to all the information they need.

True or False: Pooling of milk is no longer used in California.

False. Pooling, or the sharing of revenues among producers, is still in place today. To understand why it exists, it is useful to take a step back and look at the factors that contributed to the creation of the Milk Pooling Plan in 1969. Milk pricing regulations in California have a long history; back in the 1930's, processors were required to pay milk according to minimum class prices. Class 1 commanded the highest price while other manufacturing uses generated lower prices. This meant that producers would receive a milk price based on where they shipped their milk and what that plant processed.

If Joe shipped to a Class 1 plant, he would receive a different price than his neighbor Tony who shipped to a cheese plant. With this scenario, it is easy to imagine that Joe's financial welfare was likely doing better than Tony's. Emails may not have existed back then to spread news, but coffee shops did. And over time, this pricing discrepancy for selling a very similar product became a source of frustration for many producers when they realized through discussions how much money their neighbor was making. Therefore, it is also easy to imagine that Tony would feel that he also deserved a share of this more lucrative Class 1 market.

Maybe one day Tony would go over to the Class 1 plant and say: "listen, I know you're paying Joe $10 for his milk. I'm only getting $7 for my milk, so I'd be happy to take $9 from you. That way, we're both better off". Processors quickly realized they had the upper hand in this game – they may have been required to pay this hypothetical $10 (because of minimum prices), but they could make producers agree to excessive hauling charges or other concessions to make up the difference and keep more money in their pockets. I wasn't there during those days, but I can just picture a processor saying, a la Corleone: "I'm going to make him an offer he can't refuse."

A lot of producers all fighting for few class 1 contracts made for a weak bargaining position and pitted them against one another. This growing frustration combined with a lack of long-term commitments from either party led to disorderly market conditions. Clearly, something had to be done to equalize the playing field between producers and processors.

That is when pooling discussions began to take place. In 1967, the legislature passed the Gonsalves Milk Pooling Act and two years later the Milk Pooling Plan became operational. Processors were still required to pay minimum class prices but it changed the way producers were paid. Instead of getting a pay check directly from their creamery, producers were now paid a price reflective of the poolwide utilization of all classes. In short, they were now mostly indifferent what their milk got processed into. And Joe and Tony could go back to their peaceful coffee shops conversations without having to worry about undercutting each other.

True or False: Regular quota is tied to Class 1

False – at least today. As we mentioned last week, the implementation of the pooling program allowed for producers to be paid an equal minimum price. While the Gonsalves Milk Pooling Act was passed by the legislature, a producer referendum is ultimately what allowed for the implementation of the Milk Pooling Act in 1969. If you were a producer shipping to a cheese plant, you likely were in favor of the change toward pooling of revenues. If you had managed to ship milk to a Class 1 plant, you likely weren't too much in favor of this change because it probably meant a pay cut. To ensure a fair transition to the pooling program, pool quota was allocated to producers at the time based on each producer's historic production and Class 1 usage. Therefore, when quota was issued, one could say it was tied to milk that had been going to Class 1. However, it is no longer the case today. Because quota is a tradeable asset, it has changed hands many times since 1969 and is not tied anymore to original Class 1 contract holders like it did 45 years ago. Today, quota holders are required to ship milk to a pool plant or cooperative association at least every 60 days. If they don't, quota reverts to the pool or CDFA.

One distinction needs to be made regarding producer-handlers' quota. That quota, referred to as exempt quota, means something different to those that own it. There are four large PHs left in California (referred to as type 70), each owning some exempt quota. PH are dairy producers who also own a fluid milk processing facility. Their exempt quota allows them to avoid participating in the pool. Put another way, on the exempt quota volumes, the processing side of their operation is allowed to pay the producer side the Class 1 price directly without accounting to the California pool.

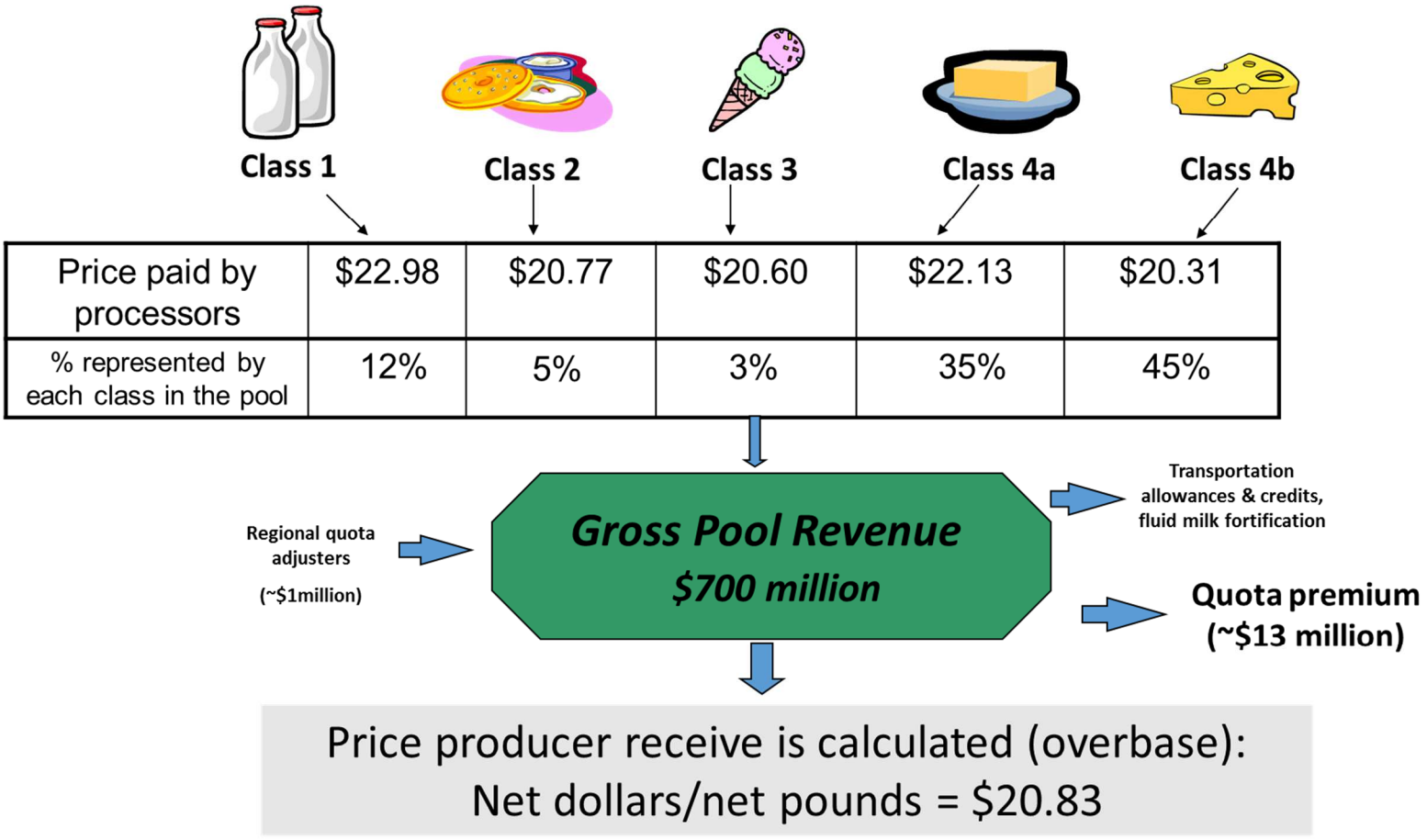
The aforementioned referendum may have left you wondering: what does it take for a referendum to go through? Two thresholds will need to be met: 1) at least 51% of producers must vote 2) 65 percent or more of total producers producing 51 percent or more of milk; or 51 percent or more of total producers producing 65 percent or more of milk must vote yes. This is a very timely question since CDFA is working on the details of a stand-alone quota program and its implementation will rely on the results of a producers' referendum.

True or False: Pooling needs quota to function properly

False. Quota is a very valuable asset that has proven to be an effective investment to keep some dairies' cash flow positive. But the operation of the pooling plan – where processors pay minimum prices for the milk they process into a pool and those total revenues are then redistributed equally among producers – technically does not require quota's existence. In fact, quota is currently a draw from the California milk pool; a step that happens after pool monies have been calculated.

To simplify the complex system, please refer to the chart below. In the hypothetical price scenario below, Class 1 processors paid $22.98/cwt for the milk they purchased, Class 2 processors paid $20.77/cwt, and so on and so forth. The class price paid is then multiplied with volume purchased in that class and all is combined into a "pool". One can think of it as a weighted average of all the class prices; this is why the percentage in each class important. For example, since Class 1 typically commands the highest price, it is to California producers' advantage to try to increase its percentage (which is part of CMAB's mission). All those monies go into the box labeled "gross pool revenue" in the chart below. Before prices to producers are calculated, quota premiums are set aside. That is, that $1.70/cwt owed to

quota holders is subtracted from the gross pool revenue. On average, that amounts to close to $13milllion each month. Interestingly, regional quota adjusters (RQAS, that amount that results in most quota holders getting less than $1.70/cwt) are calculated as an addition to the pool. Once the appropriate money has been taken out of the pool (other deductions from the pool include transportation allowances and fortification allowances), the overbase price is calculated. It is published by CDFA on a standardized basis (3.5% fat, 8.7% SNF), so if your milk composition is higher than these percentages, the overbase price on your milk check would be higher than the published price.



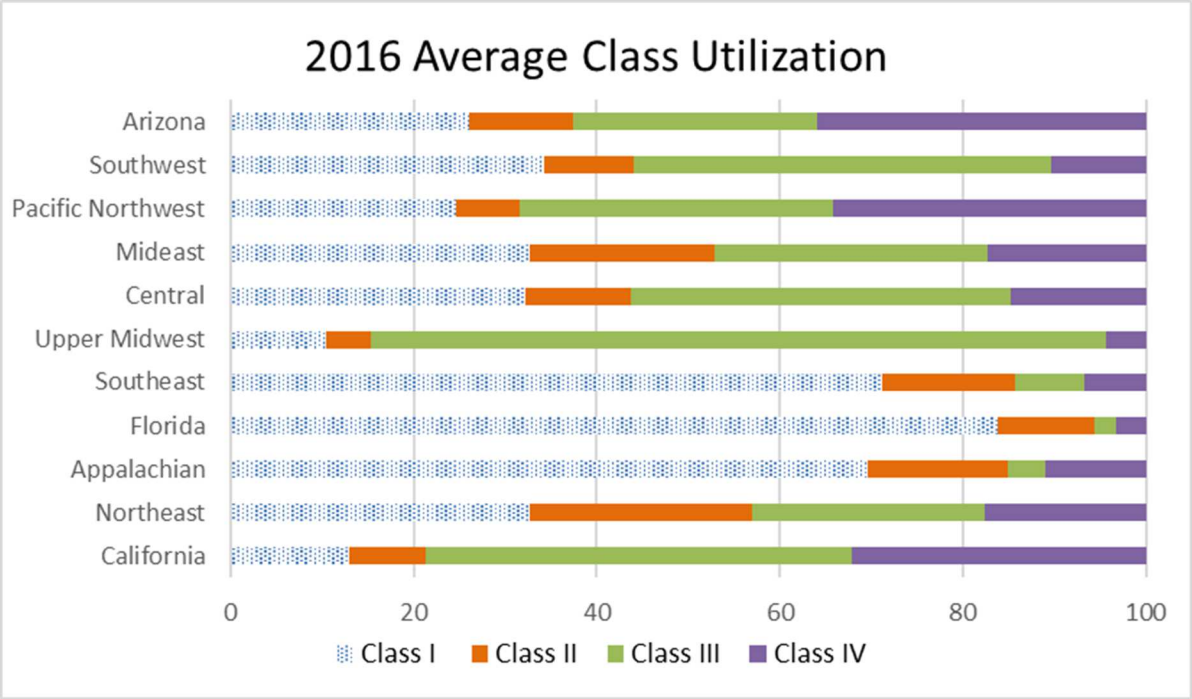
True or False: Every pooled milk producer in California is currently funding the quota program

True. Whether your milk goes to a cheese plant or a yogurt plant, whether you own quota or not, whether you're a Giants or Dodgers fan: if you see an overbase price on your milk check, you are contributing to funding the quota program in the state. To give a simplified explanation of how the math works, the pool total is first calculated by adding together processed volumes of class 1 times Class 1 prices, Class 2 volumes times Class 2 prices, Class 3 volumes times Class 3 prices, Class 4a volumes times Class 4a prices and Class 4b volumes times Class 4b prices. From that total, monies required to pay quota holders are set aside. That amounts to close to $13 million and varies little from month to month. Because that $13 million effectively reduces the amount of money left in the pool, it reduces the overbase price received by everybody. Because some quota holders are subject to regional quota adjusters, they are required to pay back a portion of their quota revenue (approximately 1 million) into the pool. Effectively, this reduces the $13 million quota cost down to around $12 million. On average (it depends on the size of the pool each month), the cost to fund the quota program taken out of the overbase price is around $0.36/cwt. Therefore, every pooled milk producer in California is contributing to funding the quota program. Pooled milk represents approximately 95% of all the milk produced in California. Examples of non-pooled milk includes milk produced in California but shipped out of state, Grade B milk, Grade A milk delivered to non-pool plants and producer-handlers exempt milk.

True or False: California's milk pricing formulas are the only reason prices in the state tend to be the lowest in the country

True and False. On one hand, it is true that California's pricing formulas generate on average less returns for producers than the formulas in Federal Milk Marketing Orders. While the formulas may look similar, they utilize different manufacturing cost allowances, different yields and different price series. On the other hand, it is false that pricing formulas are the only reason for the discrepancy. As producer prices are the weighted average of all the dairy products processed in the state, the make-up of that product mix has a big impact on the price. For example, in California Class 1 represents approximately 12% of all the milk in the pool. Class 1 typically commands the highest price. Therefore, the higher the percentage of Class 1, the higher we could expect the average pooled milk price to be. For example, the official overbase price for May was $14.76/cwt. This assumes a Class 1 percentage in the pool of 12.6% and Class 4a of 32.1%. If the utilization were swapped (Class 1 utilization of 32% and Class 4a of 12.6%) the overbase would jump to approximately $15.24/cwt. The utilization of each class of milk varies widely across the U.S., contributing to the regional differences in average blend prices.

The chart below shows the break down for each FMMO areas and for California. A high Class I utilization is a factor in higher prices; for example, Florida with its 84% Class I utilization experienced the highest mailbox price ($17.24/cwt) in 2016 while California's was $14.72/cwt. But it is not the only factor. The price difference between Class III and IV can impact a region's price heavily depending on utilization percentages. Premiums and discounts can also be a factor. For example, if milk is in short supply in a certain area, processors may have an incentive to pay higher premiums to attract milk to their plant. In FMMOs, if there is too much milk, some processors may be paying under the class price.



In short, the pricing formulas in California are certainly one thing to blame for California's typically lower-than-everybody-else price average. It is however, not the only factor contributing to it.