Cooperatives Working Together (CWT) Program

Before You Submit a Bid for the CWT Herd Buyout Program[1]

The Cooperatives Working Together (CWT) Herd Retirement or “buyout” program is a new voluntary initiative of the National Milk Producers Federation to strengthen and stabilize farm milk prices. This new program is intended to increase milk prices by reducing milk production by 540 million pounds via whole-herd retirement. Producers participate by submitting a bid by **August 22, 2003**. If the bid is accepted by the program administrators, producers will be notified by mid September. Within the following month, the successful bidders will have a field auditor come and tag the cows. The cattle of the selected bidders must be sold to a packing company, and moved directly from the farm to a slaughter house. Dairy cattle cannot be sent to a sale barn or cattle auction house, only to a packing house. Documentation of the sale to slaughter must be sent to CWT prior to payment by CWT. Details of the program, including forms for bidding and a bidding worksheet, can be found at http://www.cwt.coop/.

Bids are presented on per hundredweight basis relative to milk sales in a base history period. A similar Federal program (the Milk Production Termination Program) occurred about twenty years ago. Under that Federal program, successful bids were below $22.50 per cwt. However, this new program is funded directly by producers and has a different production target. Therefore, producers should not necessarily rely on that experience as a guide for bidding in the CWT program. As with any bidding program, the higher the bid is, the lower the probability is that it will be accepted. So the producer may want to know what they should bid.

However, before determining what to bid, producers need to be asking themselves, do I even need to bid? To help do this, producers will want to look at their goals and priorities and those of the family. Goals may include necessary family income levels, time for leisure activities or other lifestyle priorities. However, all of these goals may not be achievable by remaining in dairy farming. A key question you need to ask yourself is “What are you planning to do or likely to do if you do not participate in the CWT buyout program?” Will you continue dairy farming or sell out anyway? If you plan to sell out anyway how soon would you sell? Therefore, the second step is to assess the financial status and recent performance of the dairy farm business. It is a sad fact that over 40% of the nation’s dairy farmers have sold their cows and left dairy farming over the past 10 years, and this trend is likely to continue. In Louisiana, almost 25% of the dairy farms went out of business between 1999 and 2002. Can your dairy farm survive? If so, will the farm allow you to achieve your most important goals? If the answer is no, it is time to consider all the alternatives, including submitting a bid under the CWT herd retirement program.

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One approach to bidding is to try to determine the maximum bid that will be accepted. Clearly, interested producers would prefer to receive the largest possible payments, but since CWT is a new program, no reliable information is available about the number of likely bids or the range of bid prices. Therefore, producers seeking to identify that "maximum acceptable bid" must rely on intuition and guesswork: a high-risk approach, to say the least.

The second approach involves calculating a breakeven bid as the first part of any strategy in bidding. A breakeven bid is the amount necessary to offset the costs of participating in the program. This bid represents a minimum bid because a producer has no incentive to submit a bid that would leave him or her worse off than if he or she stayed out of the program. Therefore, calculating a breakeven bid is a defensive strategy designed to protect a producer from financial losses. However, it is a logical place to begin developing a bid because breakeven bids will vary widely from farm to farm.

1. The bid must compensate the producer for the difference between the slaughter value of the milking and dry cows and their value if sold as working dairy animals. One way to assess the dairy value of a herd is to use the services of a qualified auctioneer or cattle buyer. The value of the herd for slaughter will depend on the cull cow price. In either case, a producer would receive the sale value less the cost of the sale and any taxes due. The lump sum difference divided by the number of hundredweights of milk in the base period will give the bid amount needed to breakeven. The CWT website has an on-line calculator to help producers determine this value www.cwt.coop

2. The bid must compensate the producer for any loss of income net of any cost savings. A producer may decide to retire, to switch to non-dairy farming enterprises, or to re-enter dairy farming at some future date. Each alternative will produce a different level of income. The producer will need to estimate the investment, income, and operating costs associated with a switch to non-dairy farming or re-establishing a dairy herd. If these projections show a reduction in income relative to the current dairy operation, the bid must offset this.

3. A third, more conservative, approach that producers may wish to consider involves a careful evaluation of the family goals and priorities and the clear identification of the distinct alternatives available to the family. Different bids, should they be accepted, may allow the family to achieve different alternatives and different goals. These distinct financial alternatives may involve different occupations, income levels, asset ownership, and debt load, or cash flow feasibility. Cash flow considerations may be important in addition to the economic costs discussed above. Debt load and family living needs may also factor into the bid calculation if the income projections are not sufficient to achieve important family goals, such as the survival of the farm.

The following examples illustrate this approach.

Example 1: A producer's debts exceed the estimated market value of his assets, and he is unable to service his debts. The family members are distressed at the prospect of bankruptcy and the associated stigma. Also, they are strongly attached to their home. They define two alternatives:

1. They project that they could avoid bankruptcy if a bid of $4/100 lb. cwt above their breakeven bid was accepted and all property sold, including their home. Any lower bid is not attractive because they still would be forced to file bankruptcy.

2. A bid of $6/100 lb. cwt above breakeven would allow them to keep their home and avoid bankruptcy, but all remaining assets still would be sold. They are willing to forego any higher bids to increase their chances of having a bid accepted. The family must still decide which of the two bids to submit, but this decision may well be manageable because it involves two clearly defined alternatives.

Example 2: A producer has two distinct nondairy alternatives: to take a better paying non-farm job or to remain on the farm with an inadequate and more variable net income. The producer has a strong preference for the farming option and estimates that a bid of $5/100 lb. cwt. over his breakeven bid would make it financially feasible. He is willing to forego a higher bid to increase his chances of having his bid accepted.

Example 3: A producer estimates that a bid of $3/100 lb. cwt over his breakeven bid is needed to retire the farm debt and prevent the sale of his farm because his nondairy income from crops can provide for family living needs but cannot service any farm debt. He is willing to gamble that he can keep the entire farm and will forego a higher bid to increase the chance that his bid will be accepted.

In each example the specific goals and alternatives provide break points in the range of possible bids. These may provide producers and their families with some more clearly defined choices that make the bidding decision more manageable. This approach has some similarities to forward contracting for a commodity such as corn or hogs to lock in a profit even though the chance for a higher profit is given up.

A bid might be fine-tuned by the use of a common strategy in retail marketing such that prices are set at $9.95 instead of $10.00. Gasoline prices, for example, are typically set using this approach ($1.399 not $1.40 per gallon). If a producer expects a significant number of round figure bids, for example, bids in whole dollar or half-dollar amounts, he or she would increase the chance of having a bid accepted by submitting one that is slightly less than a round figure.

In conclusion, producers need to carefully evaluate their goals, financial condition, and alternatives. It is important that a breakeven bid be estimated as accurately as possible, partly to protect the producer from financial losses and partly as a base from which to estimate bids that are attractive to that producer.

Before Making a CWT Whole-Herd Buyout Bid Consider These[2]

1. For you and your family, how important are these and other things?

   - Cash income
   - Financial security now
   - Financial security in retirement
   - Keeping the farm in the family
   - Passing the farm along to family
   - My occupation as a dairy farmer or farmer
   - Off-farm employment opportunities
   - Pride and status in community
   - Time for leisure activities

2. What are your plans for your dairy farm?

   - Will you continue dairy farming? If so, how might you change you current operation in light of this CWT program, if at all?
   - Will you participate in this CWT program?
   - Are you planning to sell out anyway (regardless of the CWT program), at some later date? How soon?

3. What is the financial condition of your business (near term and long term)?

   - Examine net farm income for the past few years and projections for the next few
   - Examine changes in debts and assets over the past few years from your balance sheets and current statement of assets and liabilities
   - Examine cash flow summaries for the last few years and projections for the next few, including business operating income and expenses, capital purchases and sales, new loans and loan payments, non-farm income and *(especially)* family living expenses.
   - Answer this question, "Can the financial condition of my farm be improved by increased efficiency, sale of specific farm assets, generating off-farm or non-farm income, restructuring debt or declaring bankruptcy?"

4. If you stop producing milk, what are your alternatives and which of these is best for you?

   - Estimated net income from farming alternatives or alternatives to farming
   - What are the off-farm employment opportunities in or near your community? What jobs are you qualified for or willing to do? What do

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they pay? If not already working, what jobs are available for other family members?
- How much could the sale of farm assets bring (less any sales commission and taxes)? If you liquidate these assets, will the proceeds be sufficient to pay off any farm debt? How much money will remain to invest or start up a new business? If you plan to invest any net proceeds, where will you invested it and at what rate of return?

5. If you participated in this CWT program what the potential economic costs?

   - If the cattle are sold for slaughter (not for dairy purposes) what are the expected losses in income? What profit are you giving up by going out of the dairy business?
   - What might be expected losses (or gains) from changes in cattle prices if you wait to sell you dairy cattle at a different time? (Recall that market prices for cattle may fall if many dairy cattle are sold for slaughter at one time in your region).
   - What loss (or gain) in net income do you expect if net income from dairying is higher (or lower) than net income from the next best alternative, including cash income and non-cash earnings from land appreciation?
   - If you plan to re-enter dairying at some point in the future, what are the costs for starting a new dairy herd, including the cost of cattle and net income losses during the rebuilding period?

6. What are the tax consequences of participating in the CWT program?

   - You need to talk to your tax counselor or accountant on the tax consequences of a successful bid and the choice of a payment option. This is especially critical given the recent changes in tax laws.
   - How will the CWT payments be taxed (as ordinary income or compensation for the loss of value from the sale of cows (business property)?
   - Is income from the sale of raised cows and heifers over 2-years old eligible for capital gain treatment?
   - Is income from the sale of purchased cows, machinery, and equipment liable for depreciation recapture or capital gains treatment (depending on the tax basis (cost))?
   - If land is sold for more than the basis (cost), is the difference taxable as capital gains?
   - Is the sale of young stock, feed, and rent received taxed as ordinary income?
   - Do you have carryover of investment tax credit and net operating losses available to offset part or all of the tax liability?
   - Can you do income averaging and installment sales of non-dairy assets to reduce total tax liability?

7. What about your lien holders and major creditors?

    - You must consult lien holders and major creditors before submitting a bid if secured property will be sold.
    - You may wish to discuss with them how the sale proceeds and program payments are to be used. You may need to restructure any remaining debt so that the payment schedule fits a different income pattern.

8. What should you consider when developing a bidding strategy?

    - What do you need to cover the relevant economic costs of entering the program compared to the best alternative? Anything above this breakeven bid will benefit you financially. A starting point for determining you breakeven bid would be the bid sheet provided at the CWT website www.cwt.coop Notice, however, this worksheet calculates only the financial costs of liquidating you dairy and not your economic costs.
    - Because this is a unique program, there is very little information to help you estimate the upper limit on an acceptable bid.
    - Examine your situation and determine what the effects of different bids (scenarios) might be. How big would the bid need to be to pay off the farm debt? How large would it need to be to prevent bankruptcy?
    - Avoid even numbers when bidding. Prices of $9.99 not $10.00 are used at most stores. If a bid is close to the maximum using a similar approach might make it more competitive.