

BIDDING STRATEGIES FOR THE CWT HERD BUYOUT PROGRAM

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The CWT Herd Reduction (buyout) program is a new industry initiative intended to reduce milk production by 540 million pounds by taking whole herds out of production. A producer can only participate by submitting a bid and having that bid accepted by the program administrators and there are regional limits to participation. Bids are stated on per hundredweight basis relative to milk sales in a base history period. Our only previous experience with this type of program occurred in the mid-1980s with the federal Milk Production Termination Program. Under that program, successful bid ranged from \$3.40 per 100 lb. to over \$1,000! The highest bid accepted was \$22.50. However, this new program has a different production target and funding base, so this experience is an unreliable guide to submitting a bid under the CWT program. All that can be said with certainty is that the higher the bid the lower the chance that it will be accepted. How then can a producer determine his bid?

The beginning point for a producer should be a thoughtful look at his or her goals and priorities, those of other family members as individuals, and those as a family. Goals may include family income targets, time for leisure or other non-farm activities, and lifestyle goals. However, all of these goals may not be achievable by remaining in dairy farming. A key question is "What are you planning to do or likely to do if you do not participate in the 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. Can the farm survive? If so, will the farm allow you to achieve your most important goals? If the answer is not, it is time to consider all the alternatives, including submitting a bid under the CWT herd reduction program.

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 this is a new program, there is no reliable information 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 represents a minimum bid because a producer has no incentive to

submit a bid that would leave that producer 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.

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. Each alternative will produce a different level of income. It will be necessary 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 then the bid must offset this.

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. above their breakeven bid were 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. 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 may well be a manageable decision 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. Over his breakdown 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. over his break-even bid is needed to retire the farm debt and prevent the sale of his farm because his nondairy income barely can provide for family living needs and 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 in order 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 “Odd Pricing.” This is a common strategy in retail marketing such that prices are set at, say, \$9.95 not \$10.00. Gasoline prices are typically set using this approach, e.g., \$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 are advised to evaluate carefully 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.