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The Dairy Herd Buyout Program

WHO SHOULD PARTICIPATE?

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The "Milk Production Termination Program", more often called the "Dairy Herd Buyout Program", is a voluntary program where milk producers decide for themselves whether or not to participate. Many factors influence the personal and economic desirability of participating in the program. The purpose of this publication is to provide you information regarding program perspective, features, and factors to consider; and to provide you aids in developing strategies and bid prices.

Program Perspective

The goal is to reduce U.S. milk production by at least 12 billion pounds in 18 months. The program is aimed at getting resources (cows, facilities, people) completely out of the dairy business.

Dairy farming technology is changing rapidly. It is likely to be dramatically different in five years. Retooling and starting over could be expensive. Therefore, this program is likely to appeal most to people who are considering getting out for good.

Some producers should view this program as a golden opportunity. These include:

1. those about to retire with no family members to take over the farm, and no buyers ready to take over the farm as a complete unit;

2. those facing foreclosure or bankruptcy may find program participation an honorable and convenient way out of business; and

3. those who recently started milking cows and now regret it, may find participation facilitates an occupation change.

Program Features

Milk producers that decide to participate start the process by contacting their local ASCS office to: 1) provide certification of their milk sales; 2) establish composition of their dairy herd; and 3) submit a bid. Milk sales must be certified no later than February 28, 1986 and bids must be submitted by March 7, 1986. If your bid is accepted, you have contracted to terminate milk production for five years. The program contains the following features:

Credit: The authors of this series of publications found the publications developed by the "National Dairy Herd Extension Program Committee" very helpful in preparing these materials.

This archival publication may not reflect current scientific knowledge or recommendations.
Current information available from University of Minnesota Extension: http://www.extension.umn.edu.

1. You agree to sell your cows, heifers and female calves either for slaughter or export. Cattle must be disposed of before the end of the period indicated in the contract, namely: April 1, 1986 - August 31, 1986
September 1, 1986 - February 28, 1987
March 1, 1987 - August 31, 1987

   Note: Slaughter of unbred heifers and calves under contract in period 1 may be delayed to September 30, 1986 -- if the third period is selected, there will be a 17-month period in which to dispose of the total herd.

2. You agree not to own or lease dairy cattle with others.

3. You agree not to rent/lease/sell the dairy facilities you own, lease or rent to another milk producer for 5 years.

4. In return, you will receive payment based on your bid (dollars per hundredweight milk) times your "base milk sales". Your base is the hundredweight milk sold during the lower of two periods, namely: a) July 1, 1984 - June 30, 1985, or b) January 1, 1985 - December 31, 1985.

No credit is given for any increase in herd size, more milk per cow, or participation in the earlier "dairy diversion" program. Furthermore, a reduction in the size and composition of your dairy herd since January 1, 1986 may result in a reduced contract base.

How Many Bids?

There are rules, established by ASCS, as to when cattle may be slaughtered. The program regulations require that no more cattle be slaughtered during period 2 (Sep. 1, 1986 - Feb. 28, 1987) than in period 1 (April through August, 1986) or period 3 (March through August, 1987). Up to 3 bids may be submitted before March 7, 1986 (one for each period). The bids need not be the same; no more than one bid shall be accepted since acceptance by the ASCS becomes final and you are obliged to fulfill the contract.

Placing a bid in all 3 periods likely increase your chances of having a bid accepted. The cut-off (highest bid accepted) may very significantly between periods.

Eligibility

To enter a bid, a producer must have been in business on January 1, 1985, and still be selling milk at the time the bid is submitted. Furthermore, since the marketing base is determined to be the lesser of total sales during 2 marketing periods, it is imperative for the producer to have been in business on July 1, 1984.

Payment Options

Two options are available, namely:

Option 1. No payment in year 1; up to 85% in year 2; 3 equal payments of the remainder in years 3, 4 and 5. Note: the premise is that income from the sale of cattle is sufficient for year 1; the entire income could be spread evenly (25%/year) over the remaining 4 years.

Option 2. Up to 80% of total in year 1; equal payments of the remainder in years 2, 3, 4 and 5. Note: Option 2, if you desire, permits 5 equal annual payments (20%/year).

TAX NOTE: Payment option 1 fits well with liquidation periods 1 and 3. Conversely, payment option 2 fits very well with the 2nd liquidation option (Sept. - Feb.) because that spans two tax years allowing most cattle to be sold in calendar year 1986 and then taking a larger payment upon sale of remaining head in early 1987.

The first year's payment will be made immediately after proof is presented to ASCS that all animals were slaughtered within the contract period. The day this certification is completed becomes the Anniversary Date. Subsequent payments will be made at yearly intervals.

The penalty for proven contract violations may be severe, consisting of repayment of the entire payment made, plus interest. False statements regarding the number of cattle involved at the time of bidding could result in a $5,000 penalty per animal involved.

A Dozen Factors To Consider

Milk producers must carefully consider all the implications of participating in this program and disposing of their dairy herd. Many factors will influence the decision. The first four are paramount to most producers; the remainder may apply in specific cases. These same factors will influence the bid price necessary to entice producers to quit milking cows.

1. **Time left to retirement.** If you planned to retire soon anyway, if there are no family members to take over the farm, and if the farm unit is too small to likely be taken over as a complete unit, then by all means give this program serious consideration. The longer it is to your planned retirement, the higher the bid becomes to justify participation.

2. **Expected annual earnings from the dairy herd.** This is influenced most by:

   a) Level of milk production--more milk per cow usually results in a larger gross margin; thus, a higher bid price is required.

   b) Income over variable expenses--when annual expenditures for purchased goods are low, earnings are increased. These items include costs for: 1) hauling milk, 2) health and veterinary fees, 3) breeding cows, 4) fuel, utility, insurance and repairs, 5) supplies, 6) purchased feed, and 7) labor hired. The lower these expenses--the greater the margin--the higher the bid necessary.

   Note: Cost of producing home-grown feeds doesn't impact here, because low production costs will also result in an increased profit margin for alternative enterprises such as cash cropping or raising other livestock.

   c) Cows per full-time equivalent--when family labor is efficiently and fully employed, profit margins are generally increased, depending on the level of milk production achieved. The more labor efficient you are in dairying, the higher the bid required.

3. **Alternative earning opportunities for your labor and facilities.** A major decision will be how to use operator and family labor if dairying is stopped. If off-farm employment allowing you to make as much as you did milking cows is available, the bid might cover only the loss in net worth.

Producers with no non-farm alternatives and only limited markets for other farm products will need to make relatively high bids.

4. **Historical base vs. expected production.** Many producers will find their total milk marketings have changed significantly since the base period. If average production expected in the next 5 years is considerably above the base milk sales certified, a relatively high bid will be needed.

5. **Sales value of breeding stock.** The value of cows sold for dairy has dropped significantly over what it was only a few months ago. Still, the sales value of premium quality cows and youngstock remains considerably above what you will net if cattle are sold for slaughter. The greater the value of your cattle, the higher the bid required -- unless you can arrange for export sales of your high producing cows at good prices.

6. **Reduced value of your dairy farm.** Farm values have already dropped significantly. But in some locations, the inability to dairy on that farm for 5 years will result in a still lower value. If you feel the sales value of the farm (or its rental value during the next five years) is lowered, you should increase the bid accordingly.

7. **Consider the lender.** If you borrow money, it is likely your assets, including cows, equipment and feed, are tied up as collateral for the loans. They might be collateral for real estate mortgages, chattel mortgages, security agreements, or contracts. Lenders will probably insist that proceeds from the program be assigned first to loan payments. If the loans aren't completely repaid by the projected proceeds, will you be able to arrange adjusted loan servicing schedules that will match your newly projected cash flows?

8. **Consider income tax implications.** Participation in the program will require a massive sale of capital assets in the form of livestock and equipment, and perhaps machinery or land. This could create some unusual (and undesirable) income tax consequences unless carefully planned with your tax advisor. For example, a single taxpayer with over 100 cows would likely have enough capital gains income ($30,000) if all the cows are sold in the same year so as to trigger the alternative minimum tax. The alternative minimum tax for those who file jointly is a $40,000 limit -- more like 150 cows at current slaughter prices. Breeding animals on the farm for more than 24 months qualifies as long term capital; only 40% of these gains are taxable under the 1985 tax laws. Any capital asset sold for less than its adjusted basis would create a loss. This capital loss would offset some of the capital gains reported that year. Recently purchased cows, machinery, and buildings would, if sold, probably result in capital losses.

   The gain in capital assets is the difference between the price received and the adjusted basis of the assets. For livestock born on the farm, the adjusted basis is zero.

   The gain on dairy livestock held on the farm for less than 24 months is short-term gain; and <u>all</u> of it is added to taxable income. Therefore, herds with a large number of younger animals may want to spread their sales over two tax years. This can be done with a bid accepted in either the 2nd or 3rd bidding period. Also, carefully consider which payment pattern you want in light of probable tax loads -- as well as the time value of money (earlier payments will save/earn more interest.

   Other factors in the tax laws to be considered include: a) your farmer's status might be jeopardized, requiring quarterly estimates to be filed;

and b) operating losses from previous years and unused investment tax credits may become important. IT IS VITAL YOUR TAX ACCOUNTANT HAVE INPUT IN THIS DECISION.

9. **Cost of re-entry into the dairy business.** There will be a cost for re-entry into the dairy business. At the least, this would mean purchasing a herd of cows and replacement heifers at a price probably much higher than cows are selling for today. Therefore, if you wish to get back into business after 5 years, your bid will have to be increased.

10. **Selection of method of payment.** Not all monies will be paid to you immediately after the cattle are sold. Any dollars due that are paid later in the program will be worth less than if paid immediately since no interest will be added to delayed payments. Thus, you may want to consider bidding higher if a significant portion of the total payment is delayed until years 3, 4 and 5 for income tax purposes.

11. **Expectation about other bidders.** Dairying has frequently been compared to a poker game. In this context, the "dairy herd buyout program" might be considered the last hand of the night. The action of other players will influence your results. Your bid isn't required to reflect the cards held (the break-even situation on your farm). A producer with a strong hand (a low break-even bid) who decides to pass (not bid) could influence whether your bid is accepted--as could one who overbids his hand (bids far above his break-even).

12. **Geographical limitations.** There may (or may not) be limitations on the number of bids accepted in any geographical region (state). If such limitations do exist, your competition will be the milk producers within your geographic region. The biggest difference between regions is the profitability of alternatives to dairying. Producers with alternatives nearly as profitable as dairying will often be able to submit relatively low bids.

Determining Bid Price

A thorough financial analysis should be done to decide what level of bid you want to make, if any, bid for program participation. Besides this publication, three other worksheets using partial and/or complete farm budgeting approaches are available from your "County Agricultural Extension Agent". All are entitled, The Dairy Herd Buyout Program--How Much To Bid?

Publ. FM-524 No. 2 of a series. A worksheet to be completed by hand with some helpful suggestions for the inputs needed in this worksheet as well as in the computerized decision aid.

Publ. FM-525 No. 3 of a series. A computerized decision analysis utilizing Super-Calc III. This folder contains an input sheet for you to complete prior to accessing the computer.

Publ. FM-526 No. 4 of a series. A computerized decision analysis utilizing the FINLRB (Financial Long Range Budgeting) approach. This procedure, while more complete than the others, requires data on the total farm business and requires as many as 4 hours to complete.

What follows is a "Thumb Rule" approach to calculating a minimum price bid for participation in the Dairy Herd Buyout program. Its purpose is to perform a preliminary screening thereby eliminating situations where a more complete and accurate approach may not be justified. This approach contains many hidden assumptions; no claims are made regarding its accuracy. In the opinion of the authors, if the bid price derived in the following 10 lines is less than $20.00/cwt milk, spending additional time doing a more complete analysis may be justified for someone interested in submitting a bid. No one knows where the bid cut-off point will fall, but if bids approach $20.00/cwt the costs of diversion become quite high. If you use these thumb rules, refer to the "HELP AIDS" section that follows.

THUMB RULES FOR CALCULATING BID PRICE

			$/cwt	Your farm $/cwt
1.	9,000 lb milk/cow base		0.00	____
2.	For each additional 1,000 lb milk	add	2.00	____
3.	For each percentage point base is below anticipated level of milk produced	add	.12	____
4.	For each year (up to 6) producer would have continued dairying beyond 1 year	add	.60	____
5.	For each $1,000 loss in value of farm	add	.22	____
6.	For each 10 percentage points in your marginal tax net (to cover tax shelter aspect of cull cow sales)	add	.08	____
7.	Other		____	____
8.		TOTAL =	____	____
9.	For each $1,000 off-farm income	subtract	.58	____
10.		BID PRICE	____	____

HELP AIDS

Lines

1 & 2. Anticipated pounds milk/cow. Many producers who complete either of the computer analyses described earlier will find their estimated annual gross margin from dairying to be very small, or even negative, if they are marketing less than 10,000 lb milk/cow containing below 4.0% fat. Based on studies completed previously, these values are suggested:

Lbs of milk/cow	9,000	11,000	13,000	15,000	17,000	19,000
Bid price factor, add	$0	$4.00	$8.00	$12.00	$16.00	$18.00

3. Historical base vs. anticipated production. When "base milk" marketed is significantly below anticipated herd milk production, the bid must be increased accordingly as follows:

Expected production (% of base)	90%	100%	110%	120%
Base correction factor, add	-$1.20	$0.00	$1.20	$2.40

Lines

4. **Time left to retirement.** If you planned to retire this year anyway, the only reason to increase the bid price over that needed to recoup your expected loss in net worth from selling cattle as slaughter animals would be as an "insult" factor. But monies added to the bid to account for your loss in dairy earnings because of early retirement is justified (see below):

Years to retirement	1	2	3	4	5
Bid price factor, add	$0.00	$0.60	$1.20	$1.80	$2.40

5. **Loss in value of farm.** Depending on the type of farming in your region, and the relative profitability of alternative enterprises, not every farm will suffer a loss in value if you enter the dairy herd buyout program. However, if you feel your farm will drop in value, refer to the following:

Expected loss in value of farm, excluding dairy cattle	$10,000	$20,000	$30,000	$40,000
Bid price factor, add	$2.20	$4.40	$6.60	$8.80

6. **Income Tax Adjustment.** Dairying has a tax shelter component in the sale of cull cows since 60% of such sales are not taxed (capital gains exclusion). If cows sell for $400, the untaxed portion is $240. Given an annual culling rate of 33%, this is a tax shelter of $80 per cow. The value of this tax shelter varies with Marginal Tax Rate, as follows:

Marginal Tax Rate	15	20	25	30	35
Bid price factor, add	.11	.15	.20	.26	.33

9. **Alternative earning opportunities.** If you aren't ready to retire, and feel there is little opportunity for alternative employment, you may want to be fully compensated for your loss in dairy earnings. On the other hand, if the employment potential off-farm is good and you have no special desire to continue dairying, or you are willing to put a value on your newly found leisure time, then consider the following:

Annual return to off-farm employment, or alternative use of facilities, or value of leisure	$5,000	$10,000	$15,000	$20,000
Bid price correction factor, subtract	$2.90	$5.80	$8.70	$11.60

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Lines

7. Other factors to consider.

A. **Auction price vs. slaughter value of livestock.** If the difference between your anticipated value of livestock and current slaughter value is approximately as shown, no further adjustment is required. However, if your estimated difference far exceeds that shown at your level of production, then include an adjustment in this section:

Lbs of milk/cow/year	10,000	12,000	14,000	16,000	18,000
Sales value minus slaughter value (including 1 young animal/cow), difference in $'s/cow	$90	$240	$380	$540	$680

B. **Escapable expenses per cow sold.** If your estimated totals per cow vary significantly from that shown below at your level of milk production, then include an adjustment in this section:

Income and Escapable Expenses Per Cow

Lbs of milk/cow/yr	10,000	12,000	14,000	16,000	18,000
Value of milk, @ $10.75/cwt	$1075	$1290	$1505	$1720	$1935
Normal Cull Sales	180	190	200	210	220
Total Sales Per Cow	1255	1480	1705	1930	2155
Dairy Related Variable Expenses	441	479	517	555	593
Value of Home Grown Feeds	612	632	652	672	692
Interest on Livestock (cull value)	78	78	78	78	78
	1131	1189	1247	1305	1363
Income above Feed and Cash Expenses, per cow	$ 124	$ 291	$ 458	$ 625	$ 792

NOTE: The appropriate figure immediately above applies to Line J in FM-524.

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DAIRY RELATED VARIABLE EXPENSES PER COW, Excludes Home-Grown Feeds

Lbs of milk/cow/yr	10,000	12,000	14,000	16,000	18,000
Values of Purchased Feed	$150	$165	$180	$195	$210
Milk Hauling	35	42	49	56	63
Cattle Hauling	8	8	8	8	8
Health & Veterinary	34	40	46	52	58
Breeding	20	24	28	32	36
Dairy Fuel	23	25	27	29	31
Dairy Utilities	55	57	59	61	63
Dairy Repairs	40	40	40	40	40
Dairy Supplies	56	58	60	62	64
Dairy Insurance	10	10	10	10	10
Hired Labor for Dairy	10	10	10	10	10
Other Costs	0	0	0	0	0
Total Dairy Related Variable Expense	$441	$479	$517	$555	$593

NOTE: The appropriate figure immediately above **applies to the bottom of the input worksheet in Publication FM-525.**