The State of Dairy: California in transition

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The March 12, 2018, issue of Progressive Dairyman *features our annual regional snapshots of "the state of dairy" around the U.S. Expanded reports for individual regions are highlighted in this online series.*

Rob Vandenheuvel, vice president of industry and member relations with California Dairies Inc. (CDI), said the nation's largest dairy state is in transition – a painful transition others may face going forward.

"For a lot of years, we were in a full growth mode – 4 to 5 percent year-over-year growth, new dairies being built," Vandenheuvel said.

That growth was not sustainable forever, especially with limited resources, water being a key one in California. Since 2009, the economic times, combined with other, more profitable uses of land such as almonds and other tree crops, and the high regulatory costs, have put California's dairy industry in a state of decline.

"Whereas before, when we were an industry looking to build our next plant to make sure we had a home for the milk we were producing, now, we're about generating the most value from every pound we're producing," he said.

Plants are moving away from commodity products into value-add products, so they can generate more dollars per hundredweight (cwt) of milk. That process means older, less efficient assets must be phased out, and CDI will close its Los Banos manufacturing facility in mid-March, exiting the cream cheese and Neufchatel business.

"That's a painful process as you go through it," he said. "It's not a fun process, but it's a important process."

Vandenheuvel said he believes other parts of the country have more favorable water, feed and regulatory environments. As a result, he's seeing the "old" California model being replicated in the rest of the U.S. – with milk production growing beyond processing capacity.

"We're watching from afar, and we've seen that play act out," he said. "Hopefully, they can figure out a way to balance supply with demand, because it's not fun when you have significant amounts of milk with no home."

California is still the largest dairy state, producing 40 billion pounds of milk per year.

"Looking into the future, we will continue to be a big dairy state, but I don't think we'll be a growth area," Vandenheuvel said. "The shift has gone from making the most milk to making the most money. Hopefully, we will be a profitable area. That's where we have to be."

Other dairy regions of the country will have to come to that realization.

"If we learned anything from the 2014 Farm Bill, the U.S. dairy industry is not ready for a national supply management or market management strategy," he said.

Vandenheuvel said he doesn't think that's changed for the 2018 Farm Bill.

"If you take the national effort off the table, you need to take a regional approach," he said. "That includes looking at base programs on a regional or cooperative-by-cooperative level."

Challenges abound

Simon Vander Woude, Vander Woude Dairy, Merced, California, said the mood among fellow producers is a mix of concern and uncertainty. Many of those concerns relate to state regulations covering water and fuel taxes. Milk prices for most producers are below the cost of production.

So, even as it transitions, California dairy producers face plenty of challenges, and water remains a primary concern, according to Leland Kootstra, CPA with Frazer LLP, a full-service accounting firm serving dairy operations in California, Arizona, Idaho, New Mexico, Washington and Oregon.

Additional water regulations are due to come into effect in the next couple of years, and lenders are hesitant to lend on ground without two water sources (surface and ground). The transition to tree crops continues, which may also have a lasting effect on the availability of forages.

A major challenge, of course, is the milk price. California producers are bracing for sub-$13-per-cwt mailbox prices in early 2018, and some are considering exit strategies. Annie AcMoody, director of economic analysis with Western United Dairymen, describes California dairy producers as worried.

"The long-term prospects of strong dairy demand globally sounds encouraging, but there is little left equity to burn through for many operations," she said. "The last three years of low prices have been exhausting to weather for many."

Despite the price increase last year, margins remained negative. For the period 2015-17, the average loss to California dairies was $2.29 per cwt of milk produced, she said.

With negative margins forcing some producers out of business and incentivizing others to diversify into nuts and other tree crops, California milk production has been on the decline for three years, and 2017 production – the lowest since 2009 – was down 6 percent from the state's production peak in 2014.

The slowdown makes the state unique among major milk-producing areas – it has excess processing capacity and has some looking for milk. Although CDI announced a plant closure, Valley Milk's commercial operations officially began in Turlock in February 2018.

"With the declining milk production, plants had to start paying premiums to attract milk. While this has been helpful, it has not been enough to close the gap between the price of milk and the cost of producing milk in California," AcMoody said.

One bright spot has been feed prices. According to California Department of Food and Agriculture data, the average feed cost in the state has been declining, down from $11.51 per cwt in 2013 to $8.75 per cwt through the first three quarters of 2017. So far, 2018 prices seem to be close to 2017 levels.

The economic dynamics will likely lead to further consolidation. "There are plenty of producers with strong financials who will be looking to double down and take advantage of the depressed markets," Koostra said.

One uncertainty is the process to create a California Federal Milk Marketing Order (FMMO). (Read "USDA hedging bet on California FMMO delay.")

It wouldn't be California without pressures from labor and environmental regulations, adding financial and time costs for both implementation and monitoring. With rising minimum wages and increased regulations, labor costs demand a higher percentage of the budget and management's time, Koostra said.

And, as California continues to pioneer many environmental changes, it causes implementation challenges for livestock production. "Excessive reporting and the need to work with consultants to ensure compliance add to the financial burden placed on dairies," AcMoody said.

"While the majority of operations will be operating at a loss in 2018, with the availability of excess processing capacity, the expected arrival of the FMMO and ability to easily export product, California may once again be competitive and attractive relative to the rest of the country," Koostra said. "We will need to get global inventories back in line with demand. In addition, we need to continue to be innovative with developing more value-added products that the consumer wants."

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