

# QRC Executive Summary

August 9, 2007

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**The Quota Review Committee's Goal is to provide a recommendation on three milk pool Quota options to CDFA Secretary A.G. Kawamura on or about August 1, 2007.**

*The three options are: (1) quota unchanged; (2) modify quota; (3) retire quota.*



## QRC QUOTA Recommendation to: Secretary A.G. Kawamura

- ❑ **Quota unchanged:** this is the QRC recommendation is based on our evaluation. The QRC had less than a required super majority vote (8 of 11) to recommend retirement.
  - Quota Unchanged: 6 votes
  - Retire Quota (annuity method or sunset): 5 votes
  
- ❑ **Modify Quota: *not a viable option (unanimous)***
  
- ❑ Recommended communication to Dairy Industry. Present written communication via the CDFA Dairy Review, a concise summary of the QRC decision, rationale, and discussion of the process. The detailed support documents showing: (1) the QRC members conclusions from the August 9, 2007 meeting; (2) research and analysis presented in the July 27, 2007; should be made available through the CDFA website.

*These conclusions were based on extensive discussion and evaluation by members of the QRC with outstanding analytical and technical support from CDFA over the course of six meetings, May 23 through August 9, 2007.*

- 1. The original purpose of Quota was to stabilize the pooling system.** Quota is a fixed \$1.70 spread (vs. variable) based on a 15 year average, again to stabilize the industry. Under the current formula any increase in class price revenue goes to the pool (shared by all quota and overbase producers). Under the former variable spread class 1 price increases went exclusively to quota holders.
- 2. Historically there has there has been a positive ROI and payback for having quota.** The duration of payback and ROI is based on the purchase price or basis of quota. Calendar 2007 examples at current milk prices demonstrate a return of 12 to 14% and a payback period of 7 to 8 years. Quota is recognized as an investment asset by financial institutions in evaluating the overall Producer operations.
- 3. Approximate Market value of quota :** June 2007: 2,192,000lbs SNF (daily) x \$492lb (average price of quota) = \$1,078,000,000. (averages for July \$496 and August \$495).
- 4. Compared to the old system, quota can have a positive or negative affect on pool revenue.** Some producers have low to no quota and are dissatisfied with the \$1.70 spread. Approximately \$11,500,000 (net of RQA) per month is allocated from the pool to quota holders and is not available for distribution to non-quota production (2007 numbers).

5. **Quota could just “go away” (retired) with no value to quota holders.** Although it is unlikely that quota would go away with no value in the “near future” (e.g. the next 5 years).
6. **Quota helps protect the pool.** If we (dairy producers) move to a referendum to change one aspect of quota/pooling, everything may be up for evaluation.
7. **Legislatively, it is technically possible to eliminate quota and retain pooling.**
8. **Quota adds complexity to our pricing structure** increasing the difficulty to understand the system.
9. **Changing the quota/pooling system** to mirror federal milk marketing orders would improve chances of passing federal legislation to pool class 1 milk from out-of-state sources.
10. **Without annual growth in class 1 and 2 milk utilization there is no more quota that can be issued.**

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**1. Change Regional Quota Adjusters (RQAs):**

- a. Eliminate RQAs (no change in \$1.70 quota differential) = 1 (QRC votes)
- b. Variable RQA (with a fixed spread) (based on class 1, 2, 3; process will need clarity on what will the overbase price be drawn on) = 1
- c. Eliminate RQAs but spread cost across quota holders = pool neutral = 111
- d. RQAs unchanged = 111111

**2. Go back to pre 1994 variable spread between Quota and Overbase. Only Quota holders would get higher\lower Class 1, 2, 3 values.**

- a. **NOT** a viable option: 111111111 (QRC votes)
- b. This **IS** a viable option: 11

3. **Reinvigorate** Quota . Add more value by reconstructing Pool by expanding Classes of Milk. Include and reissue Quota.
  4. **Double** Quota but cut fixed differential in half from \$1.70 to \$0.85
  5. **Redistribute Quota** to ALL producers
  6. **Producer/Distributors** - Calculate value of milk that is covered by Exempt Quota, compare to historical levels. **Consider including it in Pool.**
  7. **Freeze the Overbase** going into the Quota Pool. Link Quota Pool only to Class 1, 2, and 3.
  8. **Raise the fixed differential** from \$1.70 to a higher level to encourage investment in Quota.
- NOT** viable options (3. through 8. above): 1111111111
  - These **ARE** viable options (3.-8. above): 0

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**Any retirement of quota requires legislative approval.**

**1. Self-funding annuity method:**

- a. The cash flow requirements of using an installment payout method would not require a debt instrument.
- b. The way the math could work is paying out quota on a fixed rate of return (say 6%) with the quota (\$1.70) differential no longer be paid. The differential would be used to retire quota; "\$11.5 million" per month will pay off \$1 billion in 10 years @ a rate of 5%. All producers would likely receive the Pool Blend Price.

**2. Sunset on quota:**

- a. Quota would continue for a 'period certain' (for example 8 or 10 years), then retired with no additional value paid to quota holders.
- b. During this period certain, quota would operate the same as at present. Quota holders would continue to have the \$1.70 spread and quota could still be bought and sold at prevailing market rates.

**3. Single Payout method (revenue bond funding). This is the preferred option for the quota holders but not financially viable to the pool.**

- a. Lump sum payment to holders of quota @ 100% of market value (for example \$492 SNF lb).
- b. The method requires a debt instrument. All producers would receive the Pool Blend Price.
- c. Typical factors and costs in underwriting a revenue bond (using 100% of market value):
  - ☐ Underwriting costs: 2 to 5% of issuance - \$22,000,000 to \$50,000,000;
  - ☐ Underwriting risk factors: Payment certain? Guaranteed through state taxing authority? Guarantee there will be no change in the Pool; e.g. going to a Federal Order? How is the payment stream guaranteed to the bond holder?
  - ☐ Interest rates reflect risk = greater the risk, higher the rate and shorter the term. For example the lowest risk instruments (AAA+):
    - August 8, 2007 U.S. Treasury 10 year @ 4.81%; 30 year @ 4.96%.
    - High risk corporate bonds (< B- rated) of 10 to 20 years ('junk') are in the range of 9 to 11%.
  - ☐ Issuers can also provide a shorter term but still use a 20 year amortization. For example finance the entire bond in 2008 for \$1,090,000,000 @ 9% with a 5 year balloon. Ergo in 2013 the bond would require new financing.

## QRC Conclusions

### Option 3: Retire Quota 3 of 3

#### 3. Single Payout method (continued):

d. Below is a table using a total issuance amount of \$1,090,000,000. Most likely scenario would be rates of 9 to 10 %.

	Years			
Rate	5	10	15	20
0%	18,171,014	9,085,507	6,057,005	4,542,753
5%	20,574,567	11,563,907	8,621,713	7,195,239
6%	21,077,796	12,104,130	9,200,240	7,810,967
7%	21,588,471	12,658,852	9,799,572	8,452,780
8%	22,106,558	13,227,872	10,419,100	9,119,378
9%	22,632,021	13,810,963	11,058,151	9,809,360
10%	23,164,820	11,715,998	14,407,877	10,521,253

Amount based on 2,215,977 SNF Quota pounds at \$492 per pound. Monthly payment to repay \$1,090,260,811 loan.

e. Possible Scenario: a Quota retirement bond could be underwritten with a 5 to 10 year term @9 or 10% approximately \$11,500,000 to quota holders today. This means an additional withdrawal of \$2,300,000 (20% higher) to \$11,500,000 (double from today).

f. Translating some of these **costs per CWT**:

5yrs at 10% approximately \$0.6278 CWT

10yrs at 10% approximately \$0.3139 CWT

