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Dairy Policy Watch 2012

By

John Newton*
Cameron Thraen#

*AEDE Ph.D. graduate student and #OSUE State Specialist, Dairy Markets and Policy
Agricultural, Environmental and Development Economics
The Ohio State University thraen.1@osu.edu

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Key Features of the Dairy Title of the Agricultural Reform, Food, and Jobs Act of 2012¹

The following key information has been generated by simulating the milk marketings of 5,000 representative farms over the time period 2006-2012. Representative farms were structured to include herd demographics, seasonal production patterns, and farm growth rates common to farms found in Mideast portions of the U.S. Portions of the 2012 margins were estimated using Chicago Mercantile Exchange futures prices. All of the provisions contained in the U.S. Senate version of the DMPP and DMSP have been implemented over this period.

Key Factors from an evaluation of the Dairy Margin Protection Program

1. The outcome for the margin calculation depends on which National Agricultural Statistics Service (NASS) all-milk, corn, and alfalfa hay prices are used by the Secretary of Agriculture: (1) NASS preliminary prices, (2) NASS revised prices, or (3) NASS final agricultural prices. As the prices are revised the calculated dairy producer margin are subject to change; however, **the Senate language does not indicate which prices will be used nor does it include language or provisions that allow for margin revisions.**
2. Margin payments will be received as a bi-monthly payment not a monthly payment. These are Jan-Feb, Mar-Apr, May-Jun, Jul-Aug, Sep-Oct, and Nov-Dec such that margins are calculated only six times per year. **Payment relief from low margins will not occur if the two-month average does not fall below the predetermined margin trigger, however payment reductions from the stabilization program may apply.**

¹ These points reflect the production, prices, and market conditions over the period 2006-2012. The information in this paper is intended to simulate what would have taken place over this historical period and is not intended as a forecast of prices and market conditions in the future.

3. The margin payments for both the “free” and supplemental coverage plans are based on historical farm production. **For a farm operation that has an ambitious growth plan** using historical milk production to compute future margin payments may **result in indemnities that do not adequately reflect realized farm losses, adversely impacting farm budgeting, planning and profitability.**
4. The current Senate proposal does not include an adjustment for local basis (prices reflecting local market conditions) in the all-milk or feed components of the margin. **As a result, it is possible for each producer to experience margin levels that are not the same as the estimated margins calculated by USDA.**
5. For the margin protection program, the premium amount is subsidized differently based on elected coverage levels. For the 2006-2012 period analyzed the subsidy schedule indicated that higher coverage levels shifted the burden of the premium payment from the taxpayer to the producer (e.g. For the \$4.00 basic coverage 69% of the indemnities were funded from taxpayer dollars. For the \$7.50 supplemental coverage level less than 15% of the indemnities were funded using taxpayer dollars.). These results suggest that a producer should elect coverage levels where the government subsidy is maximized (see figure 1) based on expected future margins. **This finding contradicts current industry policy analyst’s beliefs. Industry experts have used the “dip” observed in the marginal changes in premium costs to justify producer coverage levels of \$7.50 (see figure 2). This would be a costly error.**
6. Since premiums are separated into two different tiers (tier 1 for the first 4 million lbs. of annual production history (APH) milk marketings and tier 2 for APH milk marketings greater than 4 million lbs.) the subsidy can be analyzed based on the tier schedule. The results indicate that for tier 2 producers the amount of government support decreased after the free basic coverage (which is subsidized at levels near 90%), while for tier 1 producers the subsidy level peaked at approximately 83% for the \$6.00 coverage level (see figure 1). **For both producer categories coverage levels above \$6.50 would have dramatically reduced government support.**
7. For every producer farm included in the analysis the premiums associated with the \$8.00 coverage level exceeded the indemnities collected from the margin program. On an annual basis the \$8.00 coverage level can provide disaster coverage, but **extended periods of premium payments without a significant indemnity (as was the case in 2006-2008 and 2010-2011) result in net financial losses.**
8. For very small producers (e.g. marketing less than 10,000 pounds per month) the administrative fees of \$100 per year exceeded the indemnity payout for the “free” basic coverage of \$4.00 per cwt. For producers in this category supplemental coverage would have been necessary to avoid net financial losses from participation.
9. The premium return on the indemnity and administrative fees varied dramatically based on the size of the farm operation. The results indicate that because administrative fees are capped at \$2,500 per farm the **economic returns in the event of significantly low margins (such was the case in 2009) disproportionately favor larger producers. Returns to the “free” basic coverage for producers in tier 2 were nearly 3 times as high as the returns to producers in tier 1 (see figure 1).**

10. It is advantageous for a producer to elect a coverage schedule on an annual basis that will maximize the government support and economic returns based on the expectation of future margins. **Continuous use of the same coverage schedule over an extended period of time may create the potential for economic losses from participation in the program.**

Key Factors from an evaluation of the Dairy Market Stabilization Program

1. The stabilization base is selected annually by the producer and is either: (1) the average marketings of the three months immediately preceding the announcement of the stabilization program, or (2) the milk marketings from the same month in the preceding year. The degree of the dairy market stabilization penalty is dependent on the producers elected stabilization base. The stabilization base is subject to seasonal production patterns and the number of days in a marketing month. **For example, the spring flush and number of days in February may significantly impact stabilization base and penalty calculations depending on the producer's base election.**
2. Seasonal changes in milk production and the number of milk production days may result in stabilization bases that exceed actual marketings when the dairy market stabilization program is announced by the Secretary. When the base exceeds actual marketings a producer is not subject to payment reductions. **For this analysis, 12% of producer farms were not impacted during periods when the dairy market stabilization was in effect due to seasonal and monthly changes in milk marketings.**
3. **Suspension of the DMSP depends on how "world" prices are defined by the Secretary.** If the Secretary uses international prices for cheddar and 1.25% skim milk powder a designation must be made among using the "high", "low", or "average" reported price. If the "low" price is used it is easier for the stabilization program to be suspended by the Secretary. Accordingly, if the "high" price is used it is more difficult to meet the suspension triggers defined by the Secretary. As recently as June 2012, the range in international prices between the "high" and "low" reported prices was \$1,000 per metric ton of cheddar cheese. **The wide range in observed international prices complicates the characterization of a "world commodity price" and could have dramatic implications for when the stabilization program is in effect.**

Final Note

Should the U.S. Senate bill, in the current form, form the basis for the margin and stabilization programs for U.S. dairy farms, it is important to recognize that the decision to elect to participate in this program will be a complex process involving a number of options. Dairy farmers should seek the assistance of their local extension economist or consultant to sort out their unique marketing strategy before making a decision.

Figure 1. Percent of Government Subsidy and Return on Premiums by Tier (2006-2012)

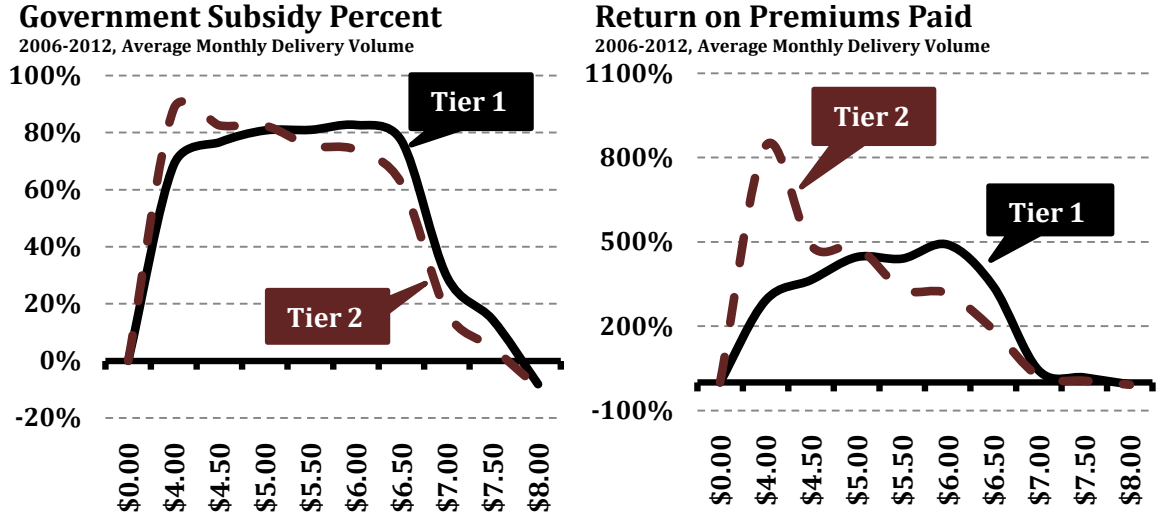


Figure 2. Marginal Change in Supplemental Coverage Premium (\$/cwt)

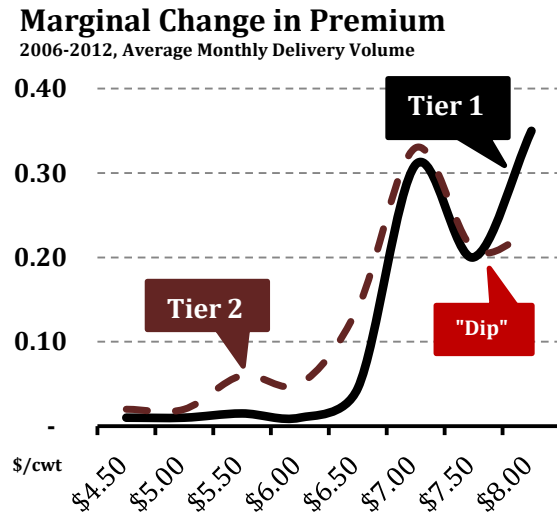
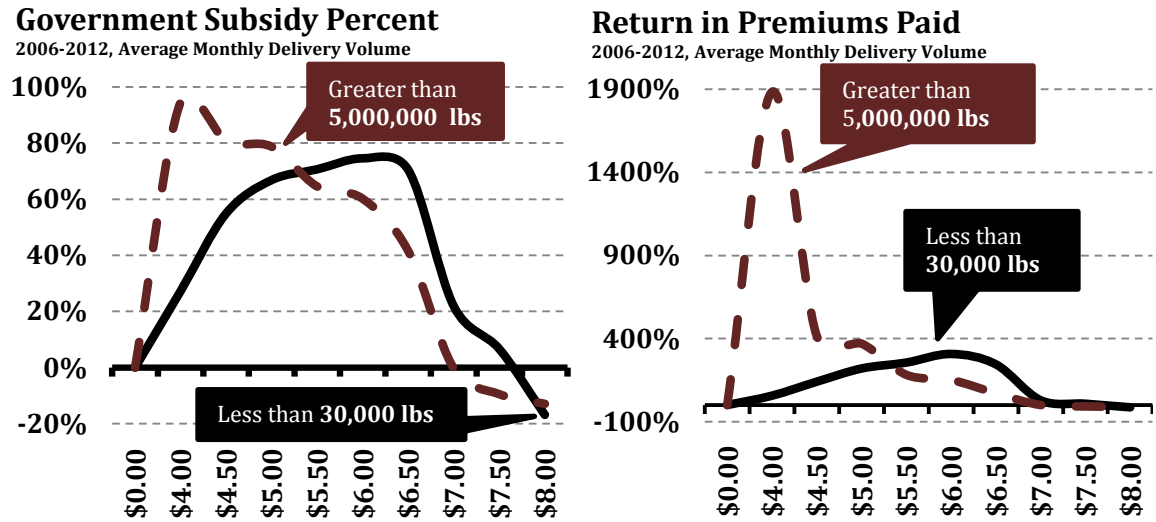


Figure 3. Percent of Government Subsidy and Return on Premiums by Milk Volume (2006-2012)



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