# The Dairy Security Act of 2011 (H.R. 3062) and the Dairy Provisions of the Rural Economic Farm and Ranch Sustainability and Hunger Act of 2011 (S.1658[1])

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## Introduction

Legislation commonly referred to as a Farm Bill is expected next year, although the current Federal budget process may accelerate this timing. Consideration of the dairy provisions of the Farm Bill comes at a time of frustration by U.S. dairy producers with more than two decades of increasing milk and, more recently, feed price volatility, and concerns about the possibility of a repetition of the very low (negative for some producers) margins of milk over feed costs experienced in 2008 and 2009. In addition, substantial pressure exists for a reduction in overall U. S. government spending (and revenue-raising), including expenditures on agricultural programs. These two factors have influenced the discussion of dairy policy options for the past couple of years.

More recently, a number of dairy policy proposals have been introduced in Congress to reduce milk price fluctuations. Over the last two years, the National Milk Producers Federation has crafted and refined their idea of a plan known as the Foundation for the Future. Colin Peterson (D-MN) incorporated much of those ideas into the draft language of a bill before some modifications and the final language that has been submitted as the Dairy Security Act of 2011 (H.R. 3062, referred to as DSA in this paper). Senator Lugar (R-IN) has also presented a bill known as the Rural Economic Farm and Ranch Sustainability and Hunger Act of 2011 S.1658 and H.R.3111, referred to as REFRESH) to the Senate Committee on Agriculture, Nutrition, and Forestry. The dairy provisions in REFRESH are nearly identical to DSA except where noted in this paper. This paper summarizes the major provisions of these two bills. Two other papers by the authors focus on analyses of market and farm level impacts of the this proposed legislation.

## Overview

The DSA seeks to reduce milk price volatility, replace current safety net programs with milk-feed price margin insurance, require federal milk marketing orders to replace product price formulas for Class III milk with a competitively determined price, and reduce the federal budget exposure for dairy programs in the Farm Bill. The budget savings would be found by repealing three current programs: the Dairy Export Incentive Program (DEIP), the Dairy Product Price Support Program (DPPSP), and the Milk Income Loss Contracts (MILC). The former "safety net" programs, DPPSP and MILC,

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would be replaced with a voluntary insurance program referred to as the Dairy Producer Margin Protection Program (DPMPP). If producers have elected to participate in the program a base level of coverage is provided at no cost. Producers can also buy up to higher levels of protection by paying an annual premium. Indemnities are determined by the difference between milk prices and feed prices referred to as the margin trigger. The same margin calculation would determine whether the Dairy Market Stabilization Program (DMSP) would be activated. If the DMSP is triggered, participating dairy producers would be notified that they would not receive payment for a portion of milk shipped that is above their individual production base.

**The Margin Calculation**

The calculation of the margin is an important part of the DSA. It determines if a participating producer will receive an indemnity under the DPMPP and it determines if the DMSP is triggered. The margin is calculated as the simple difference between the All Milk price and the value of a dairy cow ration. The dairy cow ration is formulated to include alfalfa hay, corn silage, shelled corn and soybean meal. This ration is calculated to support 100 pounds of milk production from an average producing cow and a normal complement of heifers, sick and dry cows in a herd. The value of corn silage is estimated from the current price of shelled corn. The alfalfa hay and corn prices are the preliminary estimates of national prices received by growers in the National Agricultural Statistics Service (NASS) publication called Agricultural Prices which is published toward the end of each month. The U.S. All Milk price is also taken from this publication. Agricultural Prices does not publish a soybean meal value but one is available from another USDA agency—the Agricultural Marketing Service (AMS). AMS publishes a monthly value for Central Illinois 48% soybean meal toward the latter half of each month. The feed cost formula used is:

(1.192 * Corn Price) + (0.0152 * Alfalfa Hay Price) + (0.00817 * Soybean Meal Price)

So, for example, the September 2011 feed price would be calculated as:

(1.192 * 6.69) + (0.0152 * 196) + (0.00817 * 337.16) = 7.97 + 2.98 + 2.75 = $13.70

In September, 2011 the All Milk price was $20.90, so the margin is: $20.90 - $13.70 = $7.20 Historic price calculations for the DSA margin are shown in Figure 1, although it is important to note that the pattern of margins is likely to be diffierent going forward under the proposed legislation.

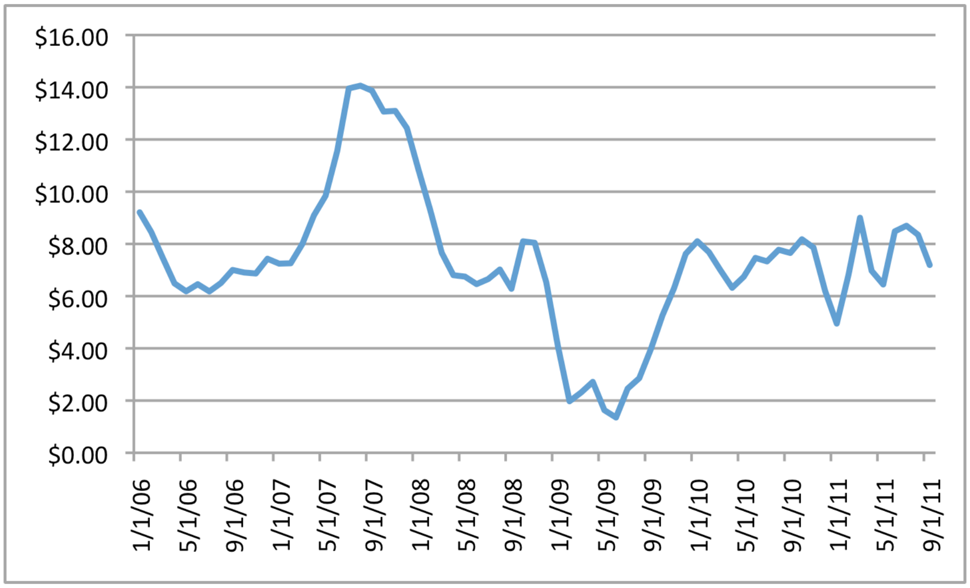


**Figure 1. DSA Margin Calculated with Historic Prices.**

**Dairy Producer Margin Protection Program**

The DPMPP is available to all registered producers with a basic level of protection of a $4.00 margin at no cost. At the time a producer registers, an historic base is determined as the highest annual level of milk production in the previous three calendar years. 80% of the historic base of production will be protected. Producers can also choose to buy up to higher levels of protection in 50 cent increments all the way to an $8.00 margin. The supplemental insurance can cover from 25% to 90% of the historic base of production. Producers can also select a growth option at the time of registration. The growth option will reset the historic base each year to the highest annual level of production including the previous calendar year.

Table 1 shows the premium associated with the increased levels of margin protection. At the time a producer registers, the level of protection and the percent of milk covered must be choosen. This cannot be changed over the life of the Farm Bill. The annual premium payment is paid on 100% of the historic base by January 15th of each year or two payments of 50% each can be paid by January 15th and June 15th of each year. Participating producers will also have an annual administrative fee to be paid. For producers marketing less than 10 million pounds of milk per year, a $100 fee is charged, from 10 to 40 million pounds of milk the fee is $400 and for 40 million pounds or more a $1,000 fee is charged.

Table 1. DSA Premium Costs

| Margin Protected | Premium per cwt. |
|---|---|
| $4.00 | $0.000 |
| $4.50 | $0.015 |
| $5.00 | $0.036 |
| $5.50 | $0.081 |
| $6.00 | $0.155 |
| $6.50 | $0.230 |
| $7.00 | $0.434 |
| $7.50 | $0.590 |
| $8.00 | $0.922 |

The margin calculation for the DPMPP is made 6 times per year. This margin is the average for two-month pairs such as January-February, March-April, etc.

For example, a producer who sells 1,200,000 pounds of milk annually and chooses a $5.50 margin protection level at 75% of his/her production with a growth option. Two years later, his/her production has grown to a new production base of 2,400,000 pounds of milk. If a margin is calculated to average $3.50 for two consecutive months, then an indemnity is triggered and the producer would receive a $0.50 payment (up to the $4 basic level) on 80% of the initial 1,200,000 base (divided by 6 for the two month period) (1,200,000 / 6) * 0.80 * ($0.50/100) = $800. The producer is also paid the supplemental insurance up to the $5.50 coverage level as (2,400,000 / 6) * 0.75 * ($1.50/100) = $4,500 for a total indemnity payment of $5,300 for the two month trigger period. If the next consecutive two-month period has an average margin of $4.50 the producer would not be paid the basic level of protection but would receive an indemnity payment of (2,400,000/6) * 0.75 * ($1.00/100) = $3,000. And if the subsequent consecutive two month period has a calculated average margin of $6.50, then no indemnity is paid.

**Registration and Transfer**

The DPMPP is voluntary but, to participate, existing dairy producers must register for the DPMPP within one year after the bill would be signed into law. This does give producers time to evaluate the impact of the program on their operations before committing to participation. However, once a producer has registered, he/she is committed to participate for the life of the farm bill (usually five years). Producers cannot change the level of margin protected or, if they are purchasing supplemental insurance, they cannot change the percentage of their milk that is covered. The historic production base of the farm can be transfered by sale or lease to another person, or the production base may be transfered to another facility if the operation is relocated. However, the production base and the supplemental level of margin insurance cannot be changed by transfer. A new entrant into milk production can register within 180 days of first milk production for the DPMPP. In that case, annual historic base will be determined by USDA as an extrapolation from the initial production period.

**Dairy Market Stabilization Program**

The DSA also includes the Dairy Market Stabilization Program, which ahs the objective of moderating price volatility. The DMSP is linked to the DPMPP in that if a producer signs up for the margin protection program he/she would be obliged to participate in the DMSP as well. Using the same margin calculations as the DPMPP, participating producers would be obligated to reduce milk marketings 2, 3, or 4 percent from their production base when the margin value is at or below $6 or $5, for two consecutive months or $4 for a single month respectively, or not be paid for the value of the penalty milk shipped. However, the maximum amount of milk not receiving payment would be 6, 7, or 8 percent of *current* marketings, respectively.

In general, the no-payment penalty continues until there are two consecutive months with margins above $6. Under the DSA, the DMSP may be suspended if world prices for cheddar cheese or skim milk powder is 20% higher than U.S. prices for those products under the DSA. The main difference bewteen the dairy providsions under REFRESH and DSA is that conditions for suspension of DMSP. With REFRESH, suspension of the DMSP is linked to the margin. DMSP would be suspended if the NASS product price for cheese or NDM is higher than the Oceania price for two consecutive months and the margin is between $5 and $6, when the NASS price is more than 5% higher and the margin is more than $4 but less than $5, or when the NASS price is 10% higher when the margin is less than $4. In the last five years, thes combination of theseconditions for price relatinships and margins have not been met.

Under the DMSP, a producer can continue to market as much milk as they wish, even though a portion of their milk may be in penalty. Although they would not receive payment for this milk volume, a national board would receive a payment from processors for the penalty milk value. The monies collected from the sale of penalty milk would be used to purchase dairy products for donation to non-commercial channels such as food banks, or for other demand expansion activities.

Under the DSA, participating dairy producers would be able to choose one of two methods for determining their production base for the DMSP by January 15th of each year. This base is different than the historic production base used in the DPMPP. The base would either be 1) the average monthly marketings for the three months preceding the announcement of a trigger event, or 2) the average monthly marketing for the same calendar month in the previous year. Although the monthly margin is calculated in exactly the same way, a trigger event is determined as the average margin for any two consecutive months, such as January-February, February-March, etc.

**Federal Milk Marketing Order Reform**

Both the DSA and REFRESH would require the Secretary of Agriculture to amend federal milk marketing orders to eliminate the use of end-product price formulas and use a competitive pay price to determine a Class III milk price. The method of price determination in all other classes of milk would be unchanged. The Secretary is not required to hold a hearing to take testimony on the altered price discovery mechanism, and only a simple majority of *participating* producers or milk volume is required for passage. Normally, a two-thirds majority is required. Generally, a failed vote on a typical federal order amendment would mean that the entire federal order is voted out. Under the provisions of DSA, a failed vote on the federal order reform means that the current federal orders remain in effect.

**Repeal of Existing Programs**

The political environment in the latter half of 2011 requires any legislation with budget implications to show a reduction in expenditures from Congressional Budget Office scoring. The DSA has demonstrated the needed budget reduction by eliminating three current programs. Authority for the Dairy Export Incentive Program (DEIP) and the Dairy Product Price Support Program (DPPSP) would be repealed. In recent years, these two programs have been very inactive and would have little impact on actual market outcomes. However, from the CBO perspective, their repeal would demonstrate a budget saving. Milk Income Loss Contracts (MILC) would also be repealed. This program has been active in recent years and in 2009 made significant counter-cycical payments to dairy producers.  It is imporant to keep in mind that the scoring of CBO is what matters for the purposes of having legislation meet the current conditions, which are termed "CUT-GO".  That is, any new legislation must show savings from cutting expenditures under current programs, rather than by raising revenues, greater than or equal to the proposed spending on new legislation.

**Summary**

At the time of this writing, there is a great deal of activity in Washington, D.C. to craft legislation that is commonly referred to as the Farm Bill.  Both the House and Senate have very similar versions of dairy provisions that would seek to replace current safety net policies with a voluntary insurance know as the Dairy Producer Margin Protection Program.  Producers who register to participate in the DPMPP would also be obligated to participate in the Dairy Market Stabilization Program.  During times of low milk-feed price margins, the DMSP would not pay producers for a portion of their milk which exceeds a temporary base level of production.  When margin levels have recovered, the DMSP is suspended and a new level of producer base recorded.

Two companion documents can be found at http://dairy.wisc.edu which analyze the potential market and farm-level impacts if the provisions of these bills are enacted in to law.