# Program on Dairy Markets and Policy Information Letter Series

## MILC Sign-up, LGM-Dairy, and Planning for the October 2011 to September 2012 Fiscal Year

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Introduction

The federal fiscal year begins on 1 October. On this date, many USDA programs require new sign ups. Some will have new rules take effect. Federal appropriations may be changed and effect how much money is available for a program. This letter provides a few updates and reminders about some programs that dairy farmers should review or consider this month.

MILC

Dairy farmers are required to fill out a simple, 1-page form to identify the month of the year in which they want to begin their eligibility to receive MILC payments. If MILC payments are triggered before that month, they will not receive a payment. Once a payment is triggered on or after the selected start month, then eligibility is continuous until the end of the marketing year (September) or the payment marketings limit is reached, whichever comes first.

The form, CCC-580, is available from a local Farm Services Agency (FSA) office. Producers who anticipate or know that their annual marketings will exceed the "payment pounds" limitation of 2,985,000 pounds per operation are allowed to specify the month in which they want their eligibility or participation to begin. They can request a different starting month in each fiscal year and they can change the starting month in any given year provided they do so before the 14th of the preceding month. Thus, if a producer specified October as the starting month and she wants to change it to a later month, she must formally notify FSA by no later than 14 September. If more than one producer is associated with a dairy operation, each one must agree to the same starting month or to the same change in a starting month.

A producer may choose a starting month for whatever reason makes sense to them. One likely reason is try to allocate the allowed 2.985 million pounds to the months during

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which the producer thinks the payment rate will be the highest. Needless to say, this involves some guesswork, but monthly payment rates can vary considerably during extended periods when the program triggers.

According to the instructions appended to CCC-580,

> *If the starting month selected by the dairy operation is never modified from the initial selection, the selected month will remain the same for each fiscal year throughout the duration of the contract [through FY12]. That is, once a {starting} month is chosen for a fiscal year, the corresponding month will be the start month for the subsequent fiscal years unless affirmatively changed by the operation.*

Hence, if a producer choose October last year and didn't do anything previously to pick a different month for FY2011-12, then October 2011 will be considered their start month for that fiscal year. The same would be true if they previously picked November, February or any other month.

Now is a good time to think about which month in the coming fiscal year a producer would like to begin his eligibility for MILC payments. Again, this only applies to producers whose annual farm marketings are near or greater than the 2.985 million pound payment limit. As a general rule, the more milk an operation produces, the more important it is to give careful thought to the selection of starting month.

<u>Dairy Market Outlook</u>

As mentioned above, the selection of start month for producers who will only be eligible for payments on a portion of their annual milk marketings is most logically dependent on estimating the months in which the payment rate is likely to be the highest. The payment rate is 45% of the difference between the actual Boston Zone Class I price under the Northeast Federal Milk Marketing Order for a given month and the MILC trigger price of $16.94 plus any applicable adjustment for high feed costs[1]. The trigger for "high" feed prices is $7.35 per cwt of 16% mixed dairy feed ration, as announced by the National Agricultural Statistics Service (NASS) in their monthly publication *Agricultural Prices*.

For comparative purposes, since October 2006 (the last 5 years), the announced value of 16% dairy ration mix has ranged from $5.37 (in 2006) to $11.66 (in 2011). The average monthly value for the summer months of 2011 has been $11.16 to $11.66.

There is no futures market for 16% mixed dairy ration, but there is for corn and soybean meal. Both markets have been generally rising but unsettled as buyers and sellers try to sort out the implications of a wet spring and delayed or prevented plantings in some areas, drought in other areas, adverse late summer weather in other areas, recent spikes in international demand, and so on. Settlement prices in early September indicate corn prices rising to $7.80 by next summer. Soybeans and SBM have been subject to similar fluctuations in conditions and expectations. Settlement prices for SBM rise towards $390 per ton next summer, at present. Every producer must decide for himself what to make of these market opinions, but it is wise to give it some thought. Current corn prices are about $2 a bushel above their five-

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[1] On September 1, 2012, the payment rate is scheduled to be reduced from the current 45% to 34% of the difference.

year average, as are soybeans. Of course, market conditions will continue to evolve as we proceed to harvest and market expectations will continue to fluctuate. There is no guarantee that feed prices will continue to increase, just as there is no guarantee that they won't. Whether prices move up or down from current opinions, the coming fiscal year will be characterized by feed prices that are high by any measure. As is typically true, they are likely to be seasonally highest next summer as post 2011 harvest inventories dwindle. However, a weak harvest relative to current high demand could cause corn prices to spike early.

In contrast, future milk prices are not high by any historical comparison. The recent Class III futures markets shows price slipping from an August value near $22 per cwt to less than $18 by January and an average for the remainder of 2012 around $17. The Class IV price shows a similar pattern but slips about $1 lower. If these numbers held, it would portend a Boston Class I price in the $20 range. Table 1 shows the estimates of the Class I price, the prices used to calculate a ration value and expected MILC payments based on those estimates.

Table 1. Actual and Estimated Prices and MILC Payments.[2]

| Month | Class I | Corn | Soybeans | Hay | Ration | Trigger | MILC Payment |
|---|---|---|---|---|---|---|---|
| Jun-2011 | **$23.57** | **$6.38** | **$13.20** | **$180.00** | **$11.26** | **$21.00** | **$0.00** |
| Jul-2011 | **$24.28** | **$6.32** | **$13.20** | **$189.00** | **$11.39** | **$21.13** | **$0.00** |
| Aug-2011 | **$24.68** | **$6.62** | **$12.90** | **$191.00** | **$11.66** | **$21.41** | **$0.00** |
| Sep-2011 | **$25.03** | $6.79 | $13.86 | $208.00 | $12.29 | $22.06 | $0.00 |
| Oct-2011 | $23.18 | $6.96 | $13.86 | $207.00 | $12.43 | $22.21 | $0.00 |
| Nov-2011 | $21.84 | $7.12 | $13.87 | $214.00 | $12.72 | $22.51 | $0.30 |
| Dec-2011 | $21.50 | $7.29 | $13.98 | $218.00 | $12.97 | $22.77 | $0.57 |
| Jan-2012 | $21.44 | $7.34 | $14.10 | $221.00 | $13.09 | $22.89 | $0.65 |
| Feb-2012 | $20.77 | $7.38 | $14.10 | $225.00 | $13.22 | $23.03 | $1.02 |
| Mar-2012 | $20.54 | $7.43 | $14.10 | $229.00 | $13.34 | $23.15 | $1.17 |
| Apr-2012 | $20.52 | $7.47 | $14.12 | $230.00 | $13.40 | $23.21 | $1.21 |
| May-2012 | $20.23 | $7.51 | $14.14 | $231.00 | $13.46 | $23.28 | $1.37 |
| Jun-2012 | $20.23 | $7.51 | $14.23 | $232.00 | $13.49 | $23.31 | $1.38 |
| Jul-2012 | $20.26 | $7.51 | $14.33 | $232.00 | $13.51 | $23.33 | $1.38 |
| Aug-2012 | $20.37 | $7.19 | $14.23 | $233.00 | $13.22 | $23.03 | $1.19 |
| Sep-2012 | $20.47 | $6.88 | $13.85 | $234.00 | $12.91 | $22.71 | $0.76 |
| Oct-2012 | $20.54 | $6.73 | $13.71 | $233.00 | $12.74 | $22.53 | $0.68 |
| Nov-2012 | $20.43 | $6.59 | $13.56 | $226.00 | $12.44 | $22.22 | $0.61 |
| Dec-2012 | $20.50 | $6.45 | $13.64 | $219.00 | $12.18 | $21.95 | $0.49 |

Based on the futures market prices as of the first week in September, 2011, there is a high probability of MILC payments beginning with November production and reaching peak payments during the summer of 2012.

[2] The Boston Class I price is estimated from the CME Class III and IV futures markets settlement prices as of 9/6/11. The ration values are estimated from CBOT futures market settlement prices for corn and soybeans as of 9/6/11.

LGM-Dairy

LGM-Dairy is essentially a bundled hedging (option) tool that allows farmers to simultaneously establish future positions on milk, corn, and SBM. Farmers insure against the risk that actual Income Over Feed Costs is less than the insured level. The insured level is established based on average futures market settlement prices on three days at the end of each month. The actual level is not the producer's actual but the amount calculated using the CME settlement prices for Class III milk, corn, and SBM in the covered month(s). Farmers can insure a variable amount of milk, up to 24 million pounds per insurance period and they may elect a deductible of up to $1.50 as a way to reduce their premium charge.

Two very significant changes were made to LGM-Dairy in 2010. The first was to change the collection of the premium from "up-front" to "at the expiration" of the contract. This change continues until RMA announces otherwise.

The second change was to allocate internal RMA funding to subsidize the cost of LGM-Dairy to the user. This subsidy is subject to change at the beginning of each fiscal year.

In authorizing LGM-Dairy and other risk management tools for livestock producers, Congress directed $20 million per year to subsidize or otherwise enable the use of these tools. The money can only be used for livestock products but LGM-Dairy is not the only product. Thus, the Federal Crop Insurance Corporation must decide annually how to divvy up that pie. Although this creates some uncertainty about how much will go to LGM-Dairy, the $20 million itself is not uncertain. This amount is identified as "mandatory" funding. Hence, it is not subject to the annual appropriations process and cannot be changed by Congress without changing the underlying authorizing legislation. That means this amount is available annually through September 2012.

When USDA allocates funding for this purpose, out of the $20 million, it budgets on the basis of how many dollars per contract and how many contracts during the year. The expenditure per contract is given, but the number of contracts is a guess. In 2010, the use of the subsidized contracts overwhelmed USDA projections such that within 3 months USDA had to terminate the LGM-Dairy program for the year. Moreover, reverting to farmers paying the full value of the premium was not an option. This is because the charge for "delivery" on the contracts is separate from the premium charge. In exhausting the $20 million budget, USDA was unable to pay the delivery fees, even if farmers paid the full premium.

The new fiscal year allows USDA to start anew with the LGM-Dairy contract. At this point, no announcement has been made on what assistance may be offered for LGM-Dairy or any of the other livestock risk management products. It is virtually certain that some kind of subsidy will be offered, but it is entirely unclear what that will be.

Many analysts are assuming that the funding for FY12 will be quickly exhausted, perhaps even more quickly than it was for FY11. That is quite hard to assess without knowing what kinds of Income Over Feed Costs will be available when the sign-up is opened on 28 October. If current prices, more or less, remain on the CME, the available margins will not be terribly appealing.

What kind of protection opportunities will be available in October or any future month is hard to guess given the vagaries and fluctuations of futures markets. It will be wise to keep a weather eye out as these conditions evolve. There will no doubt be attractive buy opportunities at some point. If predictions prove true that USDA premium subsidies will be quickly exhausted, then it is possible that LGM-D will once again become dormant. This does not negate the fact that each producer must assess whether the protection levels that are available are sufficient to warrant purchasing a contract at whatever price. It is also wise to keep in mind other options that may be available for managing output and/or input price risk.

Dairy Producer Margin Protection Program (DPMPP)

The Dairy Producer Margin Protection Program was developed by the National Milk Producers Federation as part of its package of dairy policy changes known as Foundation for the Future. In July, Congressman Collin Peterson circulated a "discussion draft" of a bill that legislatively embodies FFTF, with a few modifications.

The essence of DPMPP is that it would replace the Dairy Product Price Support Program and, more importantly, MILC with a new plan that has some resemblance to LGM-D but which is also quite different in some important aspects.

Like LGM-D, DPMPP would be based on gross returns from milk sales in excess of feed costs. The particular calculation developed for DPMPP, however, is quite different, even though the concept is the same. DPMPP would use USDA reported prices for All Milk, corn, soybean meal and alfalfa hay. Even more significantly, the DPMPP is fundamentally an insurance product, not a hedging product. LGM-D is tied to futures market prices. Producers can only "lock in" an Income Over Feed Costs that is the result of whatever the CME has available for futures market prices on three days of a month. This could be a very favorable margin or not. DPMPP allows producers to pick a margin level ranging from a minimum of $4 per cwt to $8 per cwt OR the average margin forecasted by USDA, whichever is lower. The $4 coverage is available to producers at no charge. A premium is charged for higher levels of coverage, which are offered in 50¢ increments. The premium rises from 1.5¢ for $4.50 to 92.2¢ for $8. The amount of milk that a producer can cover is limited by a percentage of their milk marketings historical base.

Or at least that is the proposal. Any or all of these parameters could change. And, of course, there is no guarantee that this bill will actually become law in any form.

While it is certainly premature to around a proposed bill, it is tempting to second-guess what will happen and when it might happen. Although there is nothing in the current proposal that excludes LGM-D if DPMPP is passed, it is reasonable to wonder whether USDA would actively support two such similar programs. It is not in USDA power to unilaterally terminate LGM-D, but continued support for premium subsidies could be discontinued unilaterally.

We do not recommend trying to second guess the outcome of dairy policy legislation, but it does make sense to add this to your list of things to monitor in the next several months.