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The Dairy Margin Protection Program: One Year In, Where Do We Stand?

USDA recently opened the sign-up period for the 2017 Dairy Margin Protection Program (MPP). How has it worked to date? The MPP was intended to support dairy producers by allowing them to insure their income-over-feed-cost margins. It is the successor to the Milk Income Loss Contract (MILC) program that paid dairy farmers when the class I price of milk fell below the target of \$16.94/cwt in the Boston market.¹ All participating dairy producers were paid an amount equal to 45 percent of the difference between \$16.94 and the lower market price. Starting in 2008, an adjustment factor was added whenever the dairy feed cost exceeded a threshold of \$7.35/cwt, adding some measure of protection against high feed costs. MILC payments were made on the first 2.985 million pounds of milk production per farm (about 150 cows), limiting the protection to about 30 percent of US milk production.²

The MILC program was replaced by the MPP which took effect in the fall of 2014. There were several changes:

- Producers would now have to share in the risk by paying a type of “insurance premium” for their coverage beyond catastrophic (\$4.00 margin) levels.
- It would allow producers, for a fee, to insure up to an \$8.00 margin between the national milk price received and national feed costs.
- Two tiers of pricing for coverage premiums were established: One for the first four million pounds of production and a higher rate for production beyond that level. This was analogous to the production limitations of MILC. It allowed for larger producers to protect their margins as well, albeit at a higher cost.

MILC was designed to be most effective when milk prices collapsed, as they did in various years, including 2007 and 2009. The MPP was designed to deal with a scenario where the combination of milk prices and high feed costs resulted in weak margins for producers, as occurred in 2012.

There was concern at the start that the MPP could be an expensive program for the federal government. For the five-year period 2008-2012, the MILC program cost \$1.1 billion, due primarily to large payouts in 2009 and 2012. The Congressional Budget Office projected the cost for MILC for 2014-2018 at \$161 million. The changes in dairy programs enacted in the 2014 Farm Bill (replacing MILC with the MPP as well as some other changes) were projected to add as much as \$241 million to that figure.³

Now that we are one year in to the MPP program, how have things gone? Unfortunately, things have become just about as bad as they can possibly get for dairy producers without triggering significant payments. Income-over-feed-cost margins hovered around \$8.00/cwt for most of 2015. This means that producers who had paid premiums received little or no benefit from the program. Margins were low enough to cause significant hardship for many producers, without realizing much “safety net” benefit.

There is significant frustration that the MPP has not generated net payments for producers. However, it is notable that the MILC program, triggered primarily by low milk prices, would not have paid out either over the course of 2015. A notable difference was that the MILC program was free to producers, while those who bought coverage under the MPP had to pay premiums, which in some cases were significant. Table 1 on the following page shows the MPP participation at various coverage levels.

¹ As reported monthly by the Federal Milk Marketing Order Administrator

² Congressional Research Service, *Dairy Policy Proposals in the Next Farm Bill*, October 22, 2013

³ Congressional Research Service, *Dairy Provisions in the 2014 Farm Bill*, September 15, 2014

An analysis of national participation in the MPP indicates that it took in at least \$73 million dollars and paid out only \$708,000. Only producers insured at the \$8.00 level received payments, and even then, the payments were less than what they paid in program costs.

The result is that, contrary to initial cost estimates, the program actually made money for the federal government in 2015, despite being a hard year for dairy producers. This has left many producers disappointed with the program, and the number of farmers who bought coverage for 2016 was far lower than 2015. In 2015, of the 24,748 farms that participated in the MPP, 56 percent chose to buy up to some level of coverage higher than the \$4.00 catastrophic coverage level. For 2016, only 23 percent of farms chose to buy higher coverage levels.⁴ In 2016, the program may provide some benefits to producers who bought coverage at high levels as margins have been running below the \$8.00 trigger for part of the year.

While the MPP has many characteristics of an insurance program, it is actually not a true “insurance” product. It is administered by the USDA Farm Service Agency, rather than a crop insurance carrier. On the actual crop insurance side, there is a program called Livestock Gross Margin-Dairy (LGM) which has delivered better results for some producers. This program is much more flexible and therefore more complex than the MPP. Limited subsidy funding for LGM, however, has limited participation. Nationwide, only about 2,100 producers had LGM policies in 2015. However, the program paid out \$16.7 million on \$12.1 million in farmer premiums paid.⁵ Unfortunately, while LGM may be a better option for some, producers are currently unable to switch from the MPP to LGM for the life of the 2014 farm bill.

We are currently facing a rather unique situation in dairy markets where margins are low, yet not as low as some recent periods such as 2009. Unlike periods of volatility in the recent past (where we saw very high margins at times, followed by dramatic downturns resulting in significant losses), right now prices are close to cost of production for many producers, and look like they will remain there for some time. Most of the current risk management programs available for dairy seem to be designed for severe, yet short-term, downward price spikes, which are more likely to trigger payments rather than an extended cycle of lower margins.

Table 1: U.S. Margin Protection Program Participation, 2015

Level	Number of Pounds Insured (millions)	Number of Farms
\$4.00	87,382	10,888
\$4.50	426	136
\$5.00	5,747	741
\$5.50	2,367	505
\$6.00	24,591	3,828
\$6.50	17,119	6,457
\$7.00	825	502
\$7.50	3,019	1,430
\$8.00	583	261
Totals	142,063	24,748

Sources: Farm Credit East Estimates based on USDA/ Farm Service Agency data.

Table 2: Margin Protection Program Premiums

Margin Level Covered	First 4 Million Pounds 2014-2015	First 4 Million Pounds After 2015	More Than 4 Million Pounds
\$4.00	No Cost	No Cost	No Cost
\$4.50	\$0.008	\$0.010	\$0.020
\$5.00	\$0.019	\$0.025	\$0.040
\$5.50	\$0.030	\$0.040	\$0.100
\$6.00	\$0.041	\$0.055	\$0.155
\$6.50	\$0.068	\$0.090	\$0.290
\$7.00	\$0.163	\$0.217	\$0.830
\$7.50	\$0.225	\$0.300	\$1.060
\$8.00	\$0.475	\$0.475	\$1.360

Sources: National Milk Producers Federation, “Introducing the Dairy Producer Margin Protection Program.” Published August, 2014

⁴ USDA ERS, *Changing Structure, Financial Risks, and Government Policy for the US Dairy Industry*, March 2016

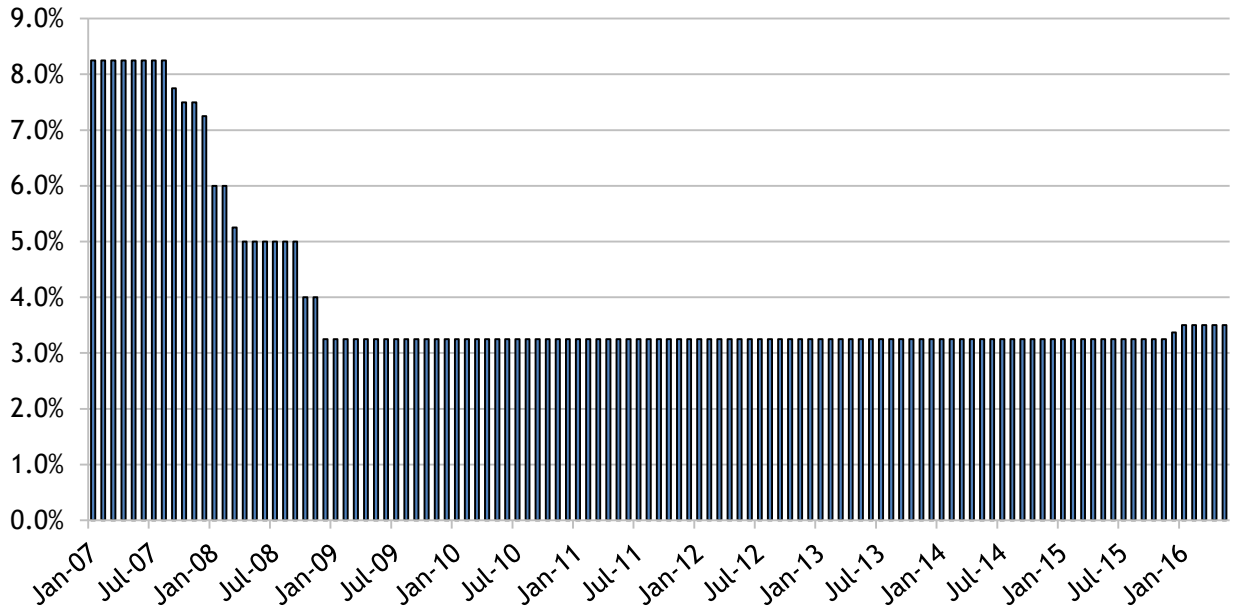
⁵ USDA Risk Management Agency, *Summary of Business*, \$22.3 million in total premiums were paid, including \$10.2 million in subsidy funds

Interest Rate Outlook

Market turmoil following the United Kingdom's historic vote to leave the European Union could give the US Federal Reserve pause as it considers raising interest rates.

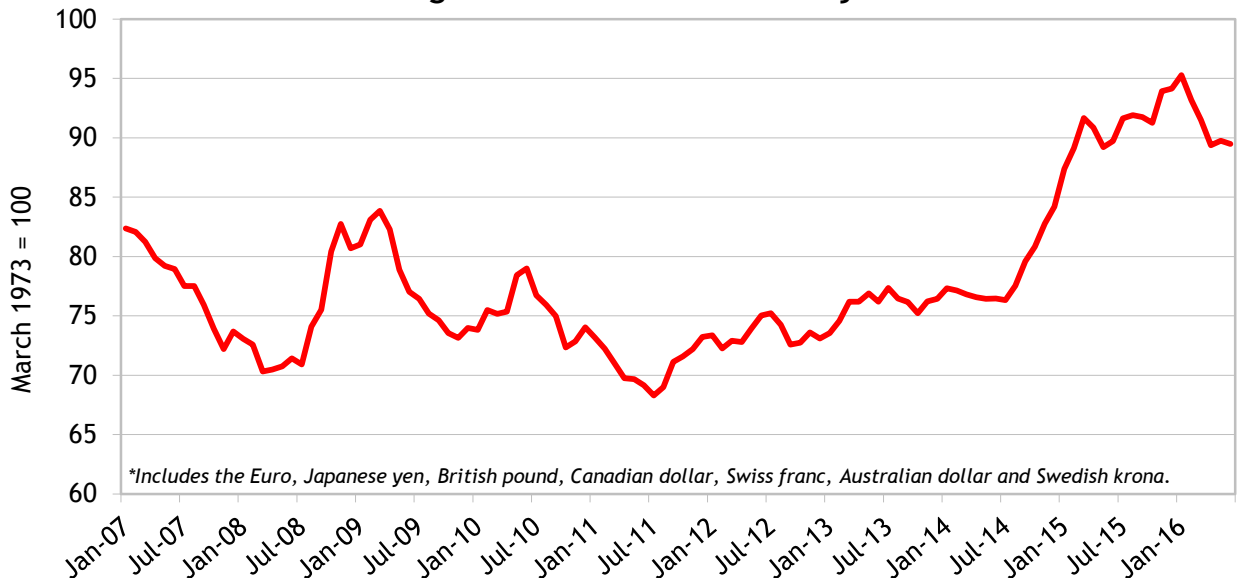
At their June meeting, the Fed's Open Market Committee (FOMC) decided to postpone additional rate increases, given uncertainty in the US labor market and inflation running below the committee's two percent target. According to FOMC's June 15 press release, "the committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

Prime Rate Charged by U.S. Banks



Source: Board of Governors of the Federal Reserve System

U.S. Dollar's Strength Determined Against a Basket of Seven Major Currencies



*Includes the Euro, Japanese yen, British pound, Canadian dollar, Swiss franc, Australian dollar and Swedish krona.

Source: Board of Governors of the Federal Reserve System

Many believe this says that interest rates are indeed expected to rise over the long term, but that any rate increases made by the Fed are likely to be measured and gradual. It is looking highly unlikely that the FOMC will consider a rate increase in their July meeting given the UK's vote to leave the EU, at least until it becomes clearer how this will affect the US markets and broader economy.

Another important development is the sharp rise in the value of the US dollar. The dollar's value had been trending downward since January, but remains high by recent history and rose on the news of the "Brexit" vote. The strengthening dollar could serve as a drag on the US economy by hurting exports and making imported goods cheaper. A decline in global stocks and an investment flight to safe havens like US Treasury bonds, add to this effect. If the Fed raises interest rates, it would put upward pressure on the dollar.

All these factors make the FOMC, traditionally cautious and risk-averse, likely to adopt a "wait-and-see" approach and postpone rate increases. Traders in Fed funds futures contracts put a zero probability of a rate increase in either July or September, and a more modest chance of a rate increase by year-end. The last increase was a quarter-point move in December 2015.

Fixing a portion of variable-rate debt could be a prudent risk management strategy for some borrowers. While rates may be unlikely to rise in the near-term, long-term increases are more likely. Fixing the rate on some or all debt can provide a hedge against future rate increases.

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- H. Jackson Brown, Jr.

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