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A Better Way

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Some tweaks and more regular offerings, say ag economists, would make LGM-Dairy a better risk management strategy.

With fixes, LGM-Dairy could prove a useful tool

While more than 4,800 Livestock Gross Margin for Dairy Cattle (LGM-Dairy) policies have been written since 2008 and nearly 2,500 have been utilized, it's a program that is rife with problems.

First and foremost, the contracts have been offered only sporadically since USDA began subsidizing premiums in December 2010. The volume of milk covered has been very low—less than 1% of annual national milk production prior to the subsidies and 2.5% since the subsidies were offered.

Subsidy funding is refreshed every October, the beginning of the federal fiscal year. When those subsidies run out, however, USDA must stop offering contracts—at any price (see below).

Payouts have been meager. Dairy farmers received about $1.8 million in indemnity payments from fiscal year 2008 to 2012. But they paid $25 million in premiums. USDA further subsidized premiums with an additional $21 million and another $10 million in direct payments to insurers for administrative and operating costs.

In other words, participating dairy farmers received just 4% back in indemnities paid and less than 2% of the total cost of the program. In contrast, crop farmers received indemnities equal to an average of 70% of their premiums between 2008 and 2011. If income over-feed-cost (IOFC) margins were good, that level of indemnity payout might not be surprising. After all, you don't buy fire insurance hoping that it will pay off.

But remember, the period covered is August 2008 through September 2012. "For those 50 months, the number of months a producer could execute a contract is 22," says Andy Novakovic, a dairy economist with Cornell University. "However, 20 of the 22 months during which a producer could buy coverage were among the worst margin performance months for dairy farmers in the last 80 years."

The implication: It would be easy to expect that indemnity payments would represent a higher percentage of the total cost of the program. By the same token, dairy farmers were constrained by the number of months they could execute a contract, and it's unknown which months coverage was taken within each contract.

Despite this disappointing performance, dairy economists who participated in a recent research project say LGM-Dairy could still prove to be a useful tool. Working on the project were Marin Bozic of the University of Minnesota; John Newton and Cameron Thraen of The Ohio StateUniversity; and Brian Gould of the University of Wisconsin.

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In fact, if the program had been offered on a monthly basis and producers bought contracts in a disciplined manner, dairy farms that grow most of their feed would have cruised through 2009 with barely a scratch. Farms that purchase all of their feed could have eliminated nearly 50% of their IOFC shortfall, Bozic says.

The key is to buy insurance early, often and regularly. Once milk prices fall or feed prices jump, locking in a favorable margin in the near term is virtually impossible.

The economists looked at a number of scenarios:

- Buying monthly, covering 10% of production.
- Buying monthly; purchasing the first, second and third months of available coverage; and covering 33% of production in each of those months.
- Buying monthly; purchasing the eighth, ninth and tenth months of available coverage; and covering 33% of production in each of those months.

Which strategy works best is tied to the behavior of the futures markets. The research shows that nine to 12 months prior to the present, IOFC margins trade in a fairly narrow band of $6 to $8 per cwt. But as time moves forward, the eventual IOFC margins can be as low as $2 to as high as $16 per cwt.

To avoid those $2 lows, producers should buy insurance nine to 12 months out. The strategy then becomes to buy a third of your production in each of those months. "If a producer had done that in 2008, his IOFC margin for 2009 would have been higher than the average of the past 12 years," Bozic says.

There are years, of course, when the IOFC margin is $16 per cwt. In those cases, the margin insurance would not have paid off and the producer would have been out the insurance premium.

"LGM-Dairy is not a profit center—it's insurance," Bozic says. "But it can take the volatility out of income over feed cost—and that's important, especially if you're in expansion mode and can't afford those huge losses."

The same margin spread occurs in the futures market, and producers could theoretically get the same protection there. The problem is cost.

Hedging exposes producers to margin calls, and buying options also gets expensive, with far-off puts commanding premiums of $1 per cwt. or more. One could execute a fence strategy—buying puts and selling calls on the milk side and doing the opposite in the corn and soybean markets—but it would become incredibly complex. Plus, it might be difficult to execute eight to 10 months out when contract volumes are low.

For now, the bigger issue is whether LGM-Dairy can be fixed. "LGM-Dairy is useful and it can be made to work," Bozic says. "But it has to be offered on a regular, monthly basis. And even if it has to be offered at full, unsubsidized prices, it should still be offered."

USDA's Hands Are Tied

It's not that USDA's Risk Management Agency (RMA) doesn't want to offer LGM-Dairy monthly or at unsubsidized premiums when the funding for subsidies runs out. The law simply doesn't allow it.

The Federal Crop Insurance Act limits the livestock insurance portion to $20 million annually—see Section 523(b)(10)(C). That covers both premium subsidies and payments to insurers for administrative and operating costs.

"Even if RMA offered LGM-Dairy unsubsidized, it is not in a position to require or suggest that approved insurance providers and agents sell or service livestock policies without compensation for services rendered," says Kimberly Smith-Brown, RMA's director of public affairs.

"Additionally, producers would then have to decide whether to purchase LGM-Dairy without the Federal Crop Insurance Corporation paying a portion of the premium," she says. "Prior to adding a producer subsidy to LGM-Dairy, participation was very low."

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