Dairy Options Pilot Program (DOPP) and Dairy Livestock Gross Margin (LGM)

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Overview

- Dairy Options Pilot Program (DOPP)
  - Background
  - Operation
  - Participation
  - Results and Conclusions
- Dairy Livestock Gross Margin (LGM)
  - Background
  - How it works (sales and end of insurance period process)
  - Challenges

DOPP Background

- Origination :
  - 1996 FAIR Act authorized pilot programs to evaluate farmers' use of futures and options.
  - Milk determined by RMA to be a good market candidate.
  - Put options determined by RMA to be a good vehicle..
    - Initially BFP milk
    - Later Class III and IV
  - Devised primarily as an education and a "learn by doing" tool.
- Subsidies:
  - 80% of put option premium
  - Up to $30 of broker commissions per round-trip transaction

DOPP Operations

- Participants
  - Operate a dairy farm in a participating county; document production of at least 100,000 pound over past six months; be eligible for programs under FAIR Act; sign DOPP contract and attend training (does not obligate to buy puts).
- Brokers
  - Sign a DOPP agreement; be in good standing with National Futures Association and not debarred; have minimum IT capacity.
- Transactions
  - Quantities purchased (100K min – 600K max); puts purchased within 4 months of training; held until 1 month prior to expiration.
- Types of puts
  - Contract month (2-12 months forward); at least $0.10 "out of money"

DOPP Participation

- Four Rounds
  - Round I – 38 counties in 7 states (early 1999)
  - Expanded to Round IV – 300 counties in 40 states (late 2002)
  - Funding was NOT re-authorized after 2002.
- Producers
  - 6,359 completed training (<10% of all eligible)
  - 1,354 of those trained (21%) purchased options
  - WI, MN, and PA accounted for 2/3 of DOPP participation
  - Evidence that activity in dairy marketing clubs increased.
- Trading Activity
  - Little activity when milk prices near support level (most common)
  - Significant activity during part of Round III, when prices were high but falling.

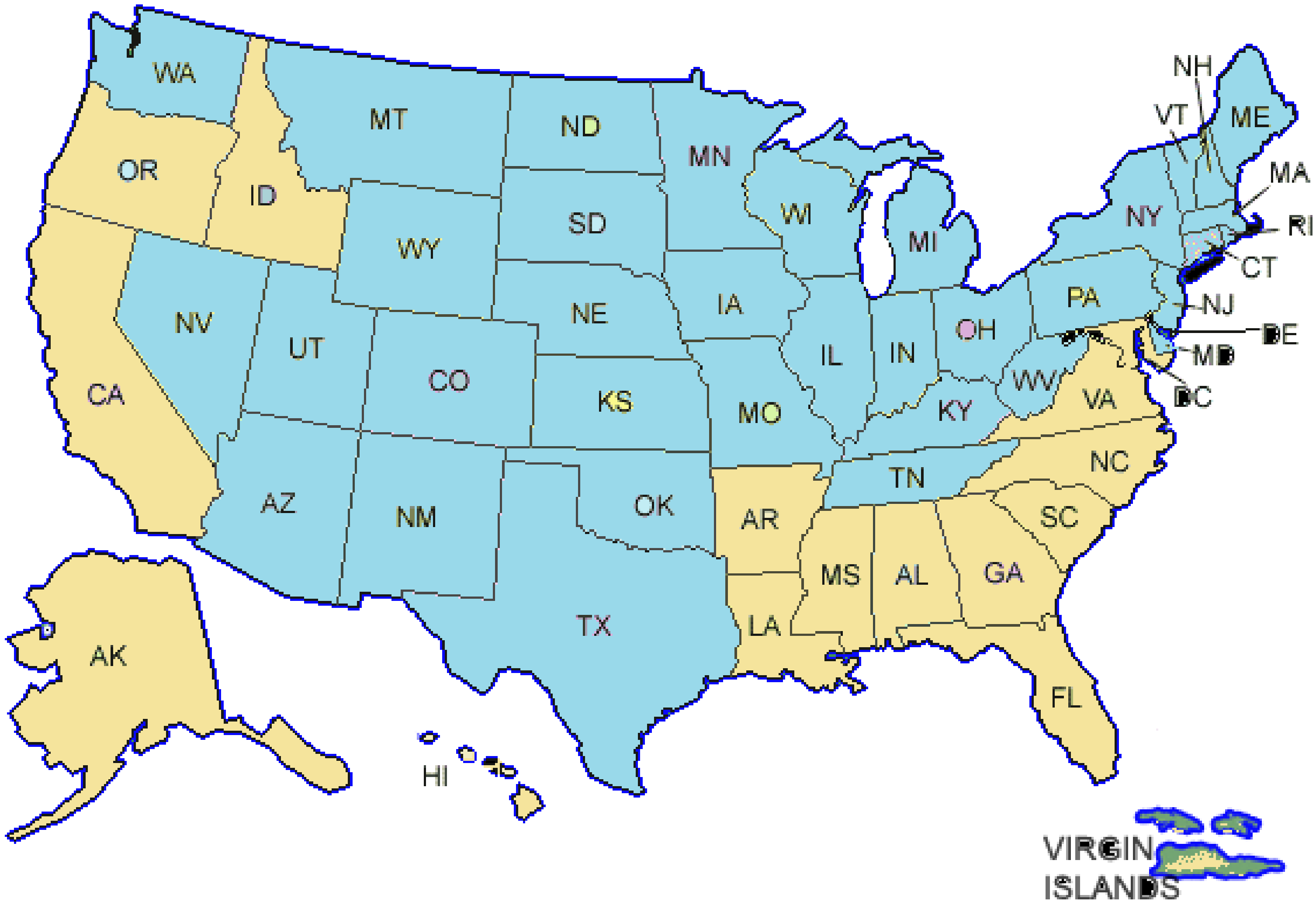
DOPP Results and Conclusions

- DOPP operated during a time of interest in market-based solutions.
- Allowed producers to hedge at prices above price supports.
- Limitations
  - Able to stabilize returns, but over a relatively short time period.
  - Significant barriers:
    - Education
    - Complexity of markets
    - Basis risk
- Little impact on production and prices

Dairy LGM – Background

- Livestock Gross Margin for Dairy Cattle (LGM-Dairy) approved by the Federal Crop Insurance Corporation Board of Directors in July 2007 and subsequently expanded March 2009
- Submitted by Iowa Agricultural Insurance Innovations (IAII) as a 508(h) submission
- IAII owns and maintains LGM-Dairy
- Offered for sale monthly, beginning on the last business Friday of the month and ending at 8 pm CST the following day

LGM-Dairy Availability



Dairy LGM – How it Works

- Insures difference between the price received for Class III milk (output) and the cost of corn and soybean meal (inputs)
- Producers select amount of corn and soybean meal to feed each month or use predetermined default feed values
- Price discovery is determined using futures settlement prices at the Chicago Mercantile Exchange Group (all prices used in LGM Dairy are market based prices)
- Dollar denominated deductible ($0-$1.50 in $.10 increments)

Dairy LGM – How it Works (cont.)

- Producers may signup 12 times per year and don't have to figure mix of options

- Can be tailored to any size farm

- Does not protect margins in the long term

Dairy LGM – Sales Process

- Sales begin when Expected Gross Margins are posted till 9am the following day on the third-to-last business day of the month.
- Premium is due at time application is signed.
- Limited to 240,000 cwt. per contract and year.

Dairy LGM - End of Insurance Period

- Insurance provider notifies producer within 10 days after Actual Gross Margins are released of probable loss.

- Producer has 15 days to submit Actual Marketing Report and sales receipts.
  - Must have sold at least 75% of target marketings.
  - Indemnity will be reduced by the percentage by which the total of actual marketings fall below 75%.

Dairy LGM – Challenges

- Sales Period
  - About 16 to 18 hours,
  - Up-front payment, and
  - Get it right the first time.

- Errors
  - Corrections allowed if no change to premium or liability.

- Actual Marketings
  - Not used for indemnity.
  - Verify 75% of target marketings.
  - Need sales receipts for indemnity payments.

Dairy LGM – Summary of Business

- 2009 Reinsurance Year
  - 40 policies earning premium
  - 401,680 cwt. milk
  - $4,715,858 in liability

- 2010 Reinsurance Year to date
  - 92 policies earning premium
  - 1,382,870 cwt. milk
  - $18,301,516 in liability

(As of 3/18/2010)

Dairy LGM Summary

- Privately developed insurance product approved and operated by the Federal Crop Insurance Corporation.
- Creates an option-type based on difference between:
  - Revenue from Class III milk
  - Input costs: Corn and Soybean Meal
- Sales process
  - Offered once a month (After trading on last Friday of month)
  - Procedures for selecting feed mix and establishing coverage
- End of Insurance Period process
  - Procedures for collecting an indemnity
- Challenges

For more Information

- RMA
  - www.rma.usda.gov

- DOPP
  - Economic Research Service, “The Dairy Options Pilot Program and Risk Management in Dairy: A Report to the Risk Management Agency, USDA;” July 28, 2004, Monte Vandeveer.

- Dairy LGM
  - Dairy LGM Frequently Asked Questions:

    http://www.rma.usda.gov/help/faq/lgmdairy.html