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Dairy Policy – How MILC changes the Dairy Support Price...

Where's the beef - as in \$\$\$'s?

By now we are all familiar with the provisions in the 2002 Farm Security and Rural Investment Act that deal directly with dairy and dairy prices. The program that I will address in this update is the counter-cyclical payment program, or as it is officially labeled, the 'Milk Income Loss Contract' or MILC. The original program terminated with the end of fiscal year 2005, and was extended through August 2007. The payment mechanism included in this program is well known by now, but what is not well understood is the impact of this program on the long standing Federal Dairy Price Support program (DPSP). Whether intended or not, the MILC program has created a sliding DPSP price, with smaller producers gaining the most and larger producers the least by way of price support. In this policy update I will explain the impact of the MILC on the effective DPSP.

A Look at the Effective Price Support

First, consider the MILC Program. As for the actual payment calculation this is easy. The current program requires that each eligible dairy producer be paid 34 percent of the difference between a fixed \$16.94 and the announced Class I milk price for the Boston Class I market. This amount is to be calculated each and every month, beginning with the start of the Federal fiscal year, which is October. Cumulative producer milk shipments up to 24 thousand hundredweight per program year qualify for these monthly payments. Producers can select the start month, but once this is selected, the cumulative shipment accounting also starts and payments accrue until the 2.4 million pound maximum is reached.

You can find a complete table of payment rates plus a weekly projection payment rates on the OhioDairyWeb 2007 website: <http://aede.osu.edu/programs/ohiodairy/> . You will also find an Excel Workbook that you can download and use with your farm production numbers to calculate the value of the payment program to your operation and the best month each FY to start your program payments.

There is one aspect of this program that I would like to bring to your attention however. Many producers in Ohio and the rest of the Mideast Federal Order produce far more milk than the 2.4 million pound upper limit placed on eligible milk shipments by the program. The question that I am repeatedly asked by dairy farmers, small and large alike, deals

with the impact of this program on effective support price available to each producer. Put another way, has the MILC program had any impact on the current support price program, which was also extended by the 2002 FSRIA? The answer to this question is absolutely! Allow me to explain.

First, we all know, or should know, that the Federal Dairy Price Support Program keeps in place a minimum floor price for Class III milk at \$9.90 for milk testing 3.67% fat. This is a voluntary program in that the Commodity Credit Corporation (CCC) makes available to the cheese, butter and nonfat dry milk industry, the option of selling these products to the CCC at purchase prices that will allow the cheese, butter and powder plants to pay their dairy shippers the \$9.90 floor price. Current CCC purchase prices for dairy commodities are show in the following Table 1.

Table 1. Current CCC Dairy Support Prices

Bulk Block Cheddar Cheese**:	\$1.1314	
Bulk Barrel Cheddar Cheese***:	\$1.1014	
Bulk Butter:	\$0.8548 Effective Nov. 15, 2002*:	\$1.0500
Bulk Non-Fortified NFD****:	\$0.9000 Effective Nov. 15, 2002 *:	\$0.8000
Bulk Fortified NFD****:	\$0.9100 Effective Nov. 15, 2002*:	\$0.8100
Processed Cheese (5 lb. loaf, per lb):	\$1.1839	
Processed Cheese (2 lb loaf, per lb):	\$1.2239	
Print Butter (consumer sized):	\$0.8848 Effective Nov. 15, 2002:	\$1.085
Instant NFD (consumer sized):	\$1.0575 Effective Nov. 15, 2002*:	\$0.9100

Participating in the DPSP program is voluntary. Those who own and hold these products do not have to sell to the CCC at these prices. For a variety of reasons (good ones I might add) that I will not go into at this time, our recent experience is that the industry is reluctant, with the exception of the nonfat dry milk industry, to sell at the announced support prices. The effect of this reluctance is that we can and have observed the announced Class III milk price (the price that receives the support floor) far below the 'official' support price. In November of 2000 the Class III price dropped to \$8.57 on very weak cheese prices and relatively modest butter prices. During the period July of 2002 through June of 2003, the announced Class III price was below the DPSP all but one month.

Nominal versus Real Support Price

Another important fact about the DPSP is that it is fixed at \$9.90 per hundredweight and not indexed for inflation in production input prices. The \$9.90 is a nominal price and the real price is something quite different. Using the USDA National Agricultural Statistical Service Livestock Sector Producer Price Index for production inputs, with a base of 1990-92=100, both the nominal and the real DPSP, over the period 1988:1 to 2006:8 are shown in the following Chart 1. What is striking is the real value of support, the safety net, is only \$6.70, far below the nominal \$9.90! Over the 1990 – 2006 period, the real DPSP has been declining at a rate of 2.7% per year.

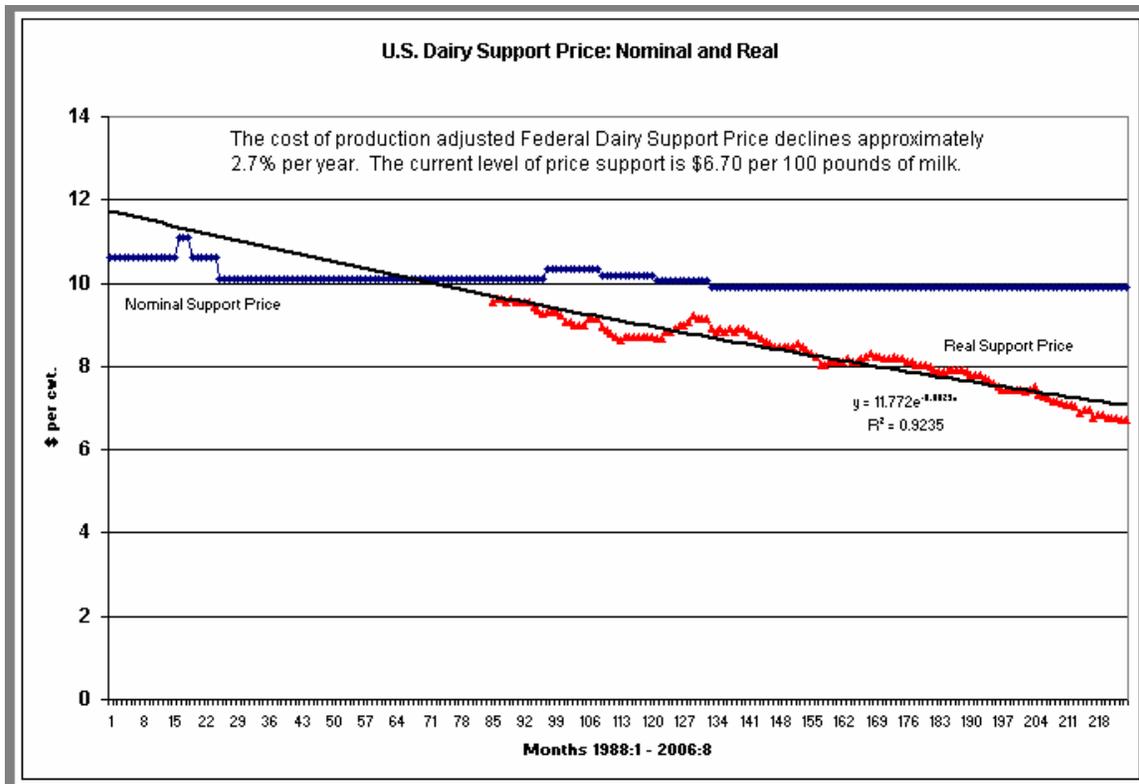


Chart 1. Nominal and Real DPS.

The DPSP and MILC

Ok, now that we know that the CCC pay prices are not hard and fast prices, we also know that there is some low level of cheese, butter and nonfat dry milk prices that would move these products to the CCC for price support purposes. I have selected these to be \$1.02 per pound for cheese, \$0.90 per pound for butter, and \$0.80 per pound for nonfat dry milk. Dry Whey, while not a support commodity, is priced at 18 cents per pound. If the markets were really weak and stayed that way for an extended period of time product would have to move to the CCC and the assumption is that it would move at these prices. If we use these prices as the effective floor for the purpose of determining where the bottom to the milk price resides we come up with approximately \$8.70 per cwt. as the nominal Class III milk support price at 3.5% fat.

If milk prices were to sink to this level, what would the nominal counter-cyclical payment be under the MILC? This can be calculated and it is \$10.40 per hundredweight. So, for the dairy producer meeting the minimum of 2.4 million pounds milk shipped per fiscal year, the effective support price under the program is no longer the official \$9.90 but an effective \$10.40 for the Class III part of the milk check. There is of course additional dollars from the federal order revenue pool if the milk is pooled on a federal order. Now the question becomes what happens to this effective support price as the level of milk production increases beyond the 2.4 million pounds? Clearly, the counter-cyclical payment applies only to this first 24 thousand hundredweight and the remainder must receive support at the effective rate of \$8.70. I have put together a table that shows the level of effective support per hundredweight by the number of cows milked over a 365-day program year. I have assumed an average daily production of 65 pounds per cow.

Table 2. Calculated Effective Federal Milk Support Price by Size of Operation

Cows	100	200	400	700	1000	1500	2000	2500	3000
ESP #	10.40	9.55	9.13	8.94	8.87	8.81	8.79	8.77	8.76
ESP *	7.07	6.50	6.21	6.08	6.03	6.00	5.98	5.96	5.96
Cwt (1,000)	24	48	96	168	240	360	480	600	720

ESP # nominal dollars and ESP* real dollars, per hundredweight.

As you can see from the numbers in the table 2, and chart 2, the effective support price, both nominal and real, declines rather sharply from the base herd size of 100 cows. As the percent of milk shipped not covered by the program increases the effective support price declines toward the \$8.70 level. The MILC program has achieved a diminishing support level for U.S. dairy producers based on production level. When dairy commodity prices are very low and would trigger CCC purchases, the more milk a producer ships to the market the lower the overall level of price support protection available to that producer!

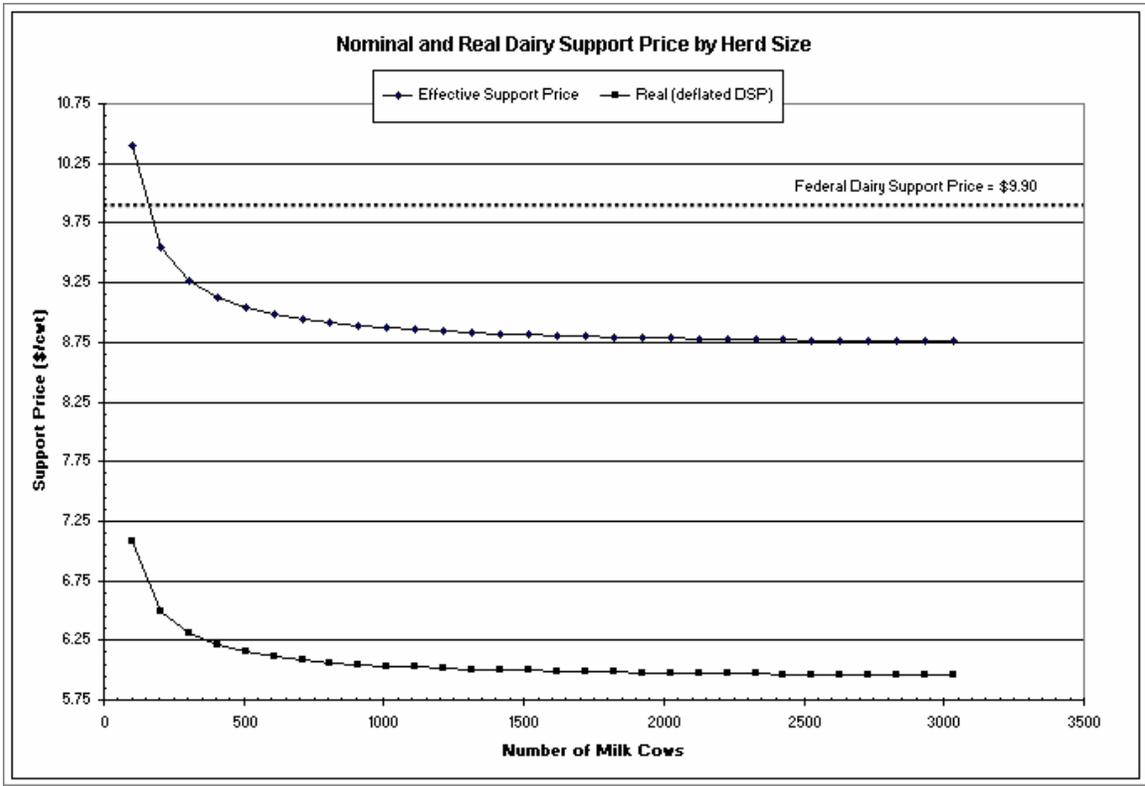


Chart 2. DPSP, ESP#, and ESP* by Herd Size.

Now you can see why many of our larger producers are concerned about the overall production impact of this payment program. If, over the life of the program, or an extended program in the 2007 farm legislation, there is enough of a production stimulus to expand milk production this could depress market prices toward the effective support level and the larger producer receives less assistance. Is this bad? Not necessarily. It can be argued that taxpayer-funded help programs should be targeted more directly

toward the smaller producer and that the larger producer achieves a level of self-help indirectly through scale economies, which result in lower production costs, and size economies which result from greater market bargaining power in purchasing inputs or negotiating volume or quality premiums. They do not need nor necessarily want a higher level of program support in the form of taxpayer assistance.

Now to one last point about the potential long-term impact of the counter-cyclical payment program. Does the program, in some subtle manner, lower the support provided to the larger producer over the life of the program? Absolutely not at all. The effective support price floor is about \$8.70 for these producers without the program. With the program in place this effective floor is raised for all but the very largest producers. The smaller producer, the ones who will see their effective support floor increase in the event of excess production and low market prices are the ones who could be hurt the most financially when the program expires in 2007.

I have read a number of analyses of the long-term impact of these payments and the conclusions range from no significant production increase to the opposite. If these additional funds are used to reduce debt and increase capital expenditures that improve the quality of milk and the economic prosperity on our medium and small-scale dairy farms then I would not be concerned about the production impacts. If instead, these dollars are used to expand the milking herd and milk production to take advantage of receiving full program payments then this could create long-term price problems.

Cameron Thraen

A handwritten signature in black ink, appearing to read "Cam Thraen". The signature is fluid and cursive, with a prominent loop at the end.