
Dairy Policy Brief #6: Dairy Farm Revenue Insurance

What is the Program?

With increased volatility in both feed costs and milk prices, there is increased dairy producer interest in government-sponsored and -subsidized gross margin (income over feed cost) insurance. A private dairy revenue insurance program already exists. *Livestock Gross Margin for Dairy* (LGM-Dairy) is a program administered by USDA's Risk Management Agency. The program pays an indemnity at the end of the insurance period equal to the difference, if positive, between the gross margin expected at producer sign-up and the gross margin actually experienced. The LGM-Dairy program contains no producer premium subsidies—it is self-financed in that the farm-specific premiums are set at the expected indemnity level. However, there is a direct payment made to insurance providers to cover administrative and overhead costs. LGM-Dairy uses futures and options prices to determine the expected gross margins that are used in the above indemnity calculation. Some of the elements of LGM-Dairy and experience with the program have relevance in the design of other government-administered dairy revenue insurance programs that might be considered.

What are the Issues?

- **Level of Gross Margin Guarantee.** Depending on the level of gross margin guaranteed and market conditions, the premiums and thus program cost of a subsidized program could be significant. Moreover, given the substantial differences in feeding regimes across the U.S. and non-feed costs of production across farms of differing size, a “one margin fits all” approach may not solve the income variability problems of a large number of producers. Under the LGM-Dairy program farm specific margins are able to be chosen to meet producer-specific needs and cost constraints. This increases flexibility but also increases administrative costs.
- **Determination of Expected and Actual Returns.** In designing gross revenue insurance, one of the more difficult aspects that must be addressed is how to calculate anticipated and actual milk revenue and feeds costs. How these values are determined affects the costs of the program and the degree to which the program is able to reduce dairy farm gross revenue variability for individual farms.
- **Insurance Contract Flexibility.** Producers differ in their risk management needs. These differences can be defined in terms of length of planning horizon, degree of risk accommodation and the ability to pay insurance premiums. In implementing any revenue insurance program there are tradeoffs between program flexibility and administrative ease.
- **Indemnity Period.** Gross margin indemnity can cover monthly, quarterly or other insurance contract time periods. LGM-Dairy uses a 10-month indemnity period. Producers would prefer a monthly settlement rather than considering margins over several months. But monthly indemnity determination would significantly increase program administrative and premium costs given increased monthly risk.
- **Program Complexity.** The LGM-Dairy program is considered complex by some, and has been criticized for being hard for producers to understand and use. Any broader subsidized program will likely suffer from the same criticism—gross margin insurance is a new concept and requires much more producer involvement than existing dairy programs like MILC. Consequently, a broadened program will need to be accompanied by an aggressive producer education effort to help ensure a successful outcome.