

Price Risk Management: Determining Marketing Strategies

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If your goal is to manage price risk, then you must start with understanding your cost of production. You must accurately account for your cost of production, before you can determine if you are hedging at a profit or a loss. Your lender, farm consultant, or University Extension Service is capable of helping you determine your breakeven point. Your cost should include both your variable cost and fixed cost. Variable cost would include feed, labor, fuel, utilities, animal health expenses, etc. Your fixed cost would include interest, depreciation, taxes, etc. Since breakeven points are producer specific, using average cost for producers in your area or producers of similar size is of no value.

You also need to have a complete understanding of your basis. The price that you are being quoted when you are dealing in the futures market is the Class III price. Although Class III is an important part of your pay price, it is not equivalent to your mailbox pay price. The simplified basis (federal order blend minus Class III) for eastern Colorado for the first quarter of 2000 is \$1.89. To calculate your basis, take the pay price listed on your milk stub. If you are a DFA Mountain Area Council (MAC) producer this is located under your pay price calculations and includes component payments, PPD for both base and over-base milk and both Market Administrator and cooperative quality bonuses and/or deducts. From your pay price you will need to subtract the 10-cent administrative deduct, 15-cent advertising, 10-cent equity deduct (if applicable) and your haul and stop charge costs. From this number subtract the Class III price; you have now established your basis. Due to changes in the federal order system, I would recommend that you calculate your basis since January 2000, and keep a 12-month record of your basis. By going through this calculation, you will establish your average net basis at your test and quality.

Month	Your Mailbox Pay Price	Class II Price	Your Basis
January	-	\$10.05 =	
February	-	\$ 9.54 =	
March	-	\$ 9.54 =	
April	-	\$ 9.41 =	

Forward Contracts: The use of forward contracts has been limited based on their availability and the prices being offered. Cheese companies such as Kraft, Glanbia, Beatrice and DFA have offered fixed prices for up to 12 months. These have been offered on a limited basis and were typically in the \$11.60/cwt. to \$12.00/cwt. range. There is a long-term forward contract between Columbia River Processing Inc., a subsidiary of Tillamook County Creamery of Oregon, and 6 producers who have agreed to supply a new cheese plant with milk for \$12.50/cwt. for 5 years once the plant is up and running in 2001. The details of any forward contract need to be examined carefully for issues that could potentially reduce their value, such as required component and quality standards. You will be hearing more about the use of forward contracts with the release of the USDA proposed pilot program. The forward contracting program submitted by USDA has stirred a debate between processors and dairy producer organizations on what should and should not be allowed.

Futures Contracts: The use of the futures market for managing the risk associated with the volatility in the pricing of raw milk and dairy products is relatively new to the dairy industry. The vast majority of milk is priced in the cash market, with currently just over 1% of the national

production being priced in the futures market. Milk futures are traded on two commodity exchanges; they are (1) the Chicago Mercantile Exchange (CME) that offers 200,000 lb. milk contracts and (2) the New York Board of Trade (NYBT) that offers both 100,000 lb. and 200,000 lb. milk contracts. These exchanges are free and open marketplaces that set and enforce trading rules and insure the financial integrity of the marketplace. The exchanges are regulated by the federal government through the Commodity Futures Trading Commission (CFTC). Contracts are based on the following Class III component values: 3.5% butterfat, 3.2% protein, 5.69% other solids. There are sellers and buyers. A seller generally believes the price is too high and wishes to "hedge" against a drop in price. A buyer believes that the price is too low, so he "hedges" against an increase in price. Prices move up and down in the futures market on a daily basis as they seek a balance between sellers and buyers. Some of the factors that influence the prices quoted on the futures market are supply and demand, political factors such as trade agreements and government, and private reports that impact agriculture such as supplies of finished dairy products, size of the national milk herd, crop conditions, future chances of drought, etc.

If you wish to trade in the futures market, you need to find a commodities broker, or if you are a DFA member, you can contract directly through DFA's forward contracting service. The future market contracts should be viewed as a tool to assist a producer in locking in a profit margin in his/her dairy operation; there are several different strategies a producer could utilize. For example:

- Prices on the futures market are as low as you have determined they will get, you feel there is only up market potential. You decide you will stay in the cash market.
- You can have several different price levels at which you are willing to contract milk, you contract a portion as each level is attained. DFA members can contract with as little as 20,000 lbs.
- You have determined that you want to attain a certain average price for the next 12 or so months. You make your contracts when the average Class III prices, of those months, plus your calculated basis achieves your price goals.

There are numerous ways in which you can establish a marketing strategy. They should all begin with surrounding yourself with quality market information. Then you will be making a decision based on the best facts available to you at the time you implemented your marketing strategy and it won't be based on emotion of the moment.

As stated earlier, volatility or extreme price swings in the marketplace has created the opportunity to use the futures market as a "price risk management" tool. There is also volatility in the futures market that can be seen if we examine the October 1999 futures. In January 1999, it traded in the \$13.50 range. In April and May 1999, it was trading between \$12.75 and \$13.00 and in August 1999, it traded as high as \$17.63. The October BFP (Class III) settled at \$11.49. If you did not use the futures market, your milk price was based on the \$11.49. As can be seen, with the proper marketing strategy the futures markets volatility can create pricing opportunities.