

Price Risk Management

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Open any dairy related marketing newsletter or magazine and you can find statements such as the following:

"The days that the dairy industry had price predictability are gone and have been replaced with price volatility"

"Supply and demand are determining the price you receive."

"Low dairy prices today are a symptom of a market that is in a correction mode, reacting to an increase in the supply of milk products which is greater than the demand for those products"

"Dairy producers need to be more involved in "price risk management."

All of these statements are self-explanatory with the possible exception of the last one, what does price risk management mean to dairy producers? Many changes have occurred for the Colorado dairy industry this past year. The greatest of them is Federal Milk Order reform, which effectively reduced the Class I utilization from 50 % to 30%. The lowering and the potential future elimination of the support price of milk is having a greater impact on the price you receive than most of us are willing to recognize. Due to the decline in the support price, there has been a reduction in government purchases and, therefore, a reduction in the supply of dairy products held in government warehouses. That inventory of dairy products held by the government acted as a reserve supply for processors. This created a flat price for raw milk and eliminated any price volatility that would have occurred when the supply of milk was short.

From 1980 to 1985 when the government had ample dairy products in storage, the M-W (Class III) price ranged from a low of \$11.08 to a high of \$12.72, a spread of only \$1.64. From 1991 to 1995 that spread jumped to \$2.97 with a low of \$10.02 and a high of \$12.99. From December 1998 to December 1999, the spread jumped to \$7.71 with a low of \$9.63 and a high of \$17.34. As the support price has been reduced and government controlled dairy surpluses have been eliminated, volatility in the marketplace has clearly increased.

Although price volatility may be unnerving, there are tools a dairy producer can use to level out the volatility. If you have a speculator's mindset, you could say price volatility creates opportunity for price enhancement. Presently, there are three price risk management tools being used by producers to protect against price variability: Forward Contracts, Futures Contracts and Put Options. Forward contracts and futures contracts are discussed starting on page 3 and basic terminology necessary to understand the dairy future/options market is reviewed in the insert.