

**Price Risk Management in the Dairy Industry**  
Patty Davis,  
Dairy Hedging Specialist Morgan Grain/Allendale

Continued herd expansion and increased cow productivity have pushed recent milk prices to 20-year lows. Class III price for the first half of this year averaged \$9.56, well below the cost of production for most dairies. With the new milk pricing system, dairymen are also seeing a change in their mailbox prices. The monthly basis (producer price differential plus locator adjustment) will be more consistent from month to month and remain in a narrower range, probably \$1.25 to \$2.20 for most locations in Colorado. Low prices have not slowed expansion; inventories of cheese keep growing even though the class III price has been lower than \$10.00 seven out of the past eight months.

Herd expansion and increased cow productivity are probably due to several factors. The low cost of feed grains and ingredients, increased use of BST, a shift in the dairy industry demographically, economics of size, and mixed market signals from the old BFP pricing system. Some western states continue double digit expansion. Five thousand cow dairies have become common place. The economic cost of producing 100 pounds of milk in the west is much lower than other parts of the United States. Larger dairies can survive with lower profit margins and, in my opinion, have no trouble adding additional cows when profit margins decrease in order to meet a targeted return on the investment they have in their facilities.

With these uncertainties facing the dairy industry, understanding and establishing a sound price risk management program is a very important management decision. It must be based on financial analysis and evaluated to determine if business risk associated with price volatility is eliminated. Hedging or the use of derivative markets (futures and options) to forward price or set a floor price on future milk production can eliminate risk in certain circumstances. Understanding the derivatives market takes time but futures and options are financial tools that can add stability to your dairy business if used correctly.

Choosing the appropriate commodities broker is important to this process. Brokers that use speculative positions to increase profits can add risk to your dairy business instead of eliminating it. Determining speculative positions which require the market to move in a specific direction to pay off are very risky. I have analyzed some positions that ended up being a 2 to 1 loss toward the class III price. Always ask your broker to place a floor or have set a minimum price and if spreadsheets or graphs showing profit potential have passed compliance regulations with their clearinghouse.