

DECEMBER 12, 1969  
Baron's

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# Exchanges milking futures

By DAVID DISHREAU

AP Business Writer

Moo-ve over traders. Milk money is taking on a new meaning as two commodity exchanges uncap competing milk futures contracts.

The instruments, to be launched Tuesday on New York's Coffee, Sugar & Cocoa Exchange and Jan. 17 on the Chicago Mercantile Exchange, are designed to help dairy farmers, cheese makers and speculators profit from unsteady milk prices as federal price supports erode.

"It's very difficult for a producer to plan for the future. His stock has some stability to the product market," said Don Wilborn of the National Milk Producers Federation.

For the farmer and the milk seller, OCSB, the milk market, has been a volatile commodity.

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The reduction in the government-guaranteed price moved the \$20 billion milk industry closer to a free market. Prices have rarely dropped as low as \$10.10 since then, mainly fluctuating between \$11 and \$13 per hundredweight in response to supply and demand pressures.

The price volatility has been unsettling for milk producers and cheese, butter and ice-cream makers because it increases their financial risk. In 1969, they approached both the Merco and the OCSB about creating a milk futures market to transfer that risk to speculators.

A futures contract is a promise to buy or sell a commodity — in this case, 50,000 pounds of milk — on a future date at a specified price. Producers and users trade the contracts to lock in prices; speculators trade them in hopes of profiting from price fluctuations.

Neither exchange saw so much future in milk futures six years ago. But the price volatility and the likelihood of further government withdrawal from the market persuaded them to take another look.

Buyers and sellers are both at risk and they will be at more risk when the price support structure drops. "Don't think there's any doubt that support structure will drop," said Jack Cook, senior research analyst at the Merco.

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DAILY NEWSPAPER

LAS VEGAS REVIEW - JOURNAL

Las Vegas, NV

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DECEMBER 12, 1988  
Bacon's

# Exchanges see potential in milk futures

Associated Press

Moo-ve over traders. Milk money is taking on a new meaning as two commodity exchanges uncap competing milk futures contracts.

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unsteady milk prices as federal price supports erode.

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For the Merc and the much smaller OSCE, the milk rivalry reflects the intense search by futures exchanges for niche

markets to exploit.

The exchanges' interest in milk futures stems from the volatility of milk prices since 1980, when the government reduced its milk support price to \$10.10 per hundred pounds after holding it near \$13 for much of the 1980s.

The reduction in the government-guaranteed price moved the \$20 billion milk industry closer to a free market.

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DECEMBER 12, 1995

Bacon's

3155 Milk-futures contracts to be offered

Associated Press

Milk money is taking on a new meaning as two commodity exchanges uncap competing milk-futures contracts.

The instruments, to be launched today on New York's Coffee, Sugar & Cocoa Exchange and Jan. 11 on the Chicago Mercantile Exchange, are designed to help dairy farmers, cheese makers and speculators profit from unsteady milk prices as federal price supports erode.

"This should bring some stability to the producer market," said Thom Wilborn of the National Milk Producers Federation.

For the Merc and the much smaller CSCE, the milk rivalry reflects the futures exchanges' intense search for niche markets to exploit.

"We hope... that the dairy industry will support us," said Jim Howe, head of market development at the CSCE.

The exchanges' interest in milk futures stems from the volatility of milk prices since 1989, when the government reduced its milk support price to \$10.10 per hundred pounds after holding it near \$13 for much of the 1980s.

The reduction in the government-guaranteed price moved the \$20 billion milk industry closer to a free market. Prices have rarely dropped as low as \$10.10 since then, mainly fluctuating between \$11 and \$13 per hundred pounds.

The price volatility has been unsettling for milk producers and cheese, butter and ice-cream makers because it increases their financial risk. In 1989, they approached the Merc and the CSCE about creating a futures market to transfer that risk to speculators.

A futures contract is a promise to buy or sell a commodity — in this case, 50,000 pounds of milk — on a future date at a specified price. Producers and users trade the contracts to lock in prices; speculators trade them in hopes of profiting from price fluctuations.

DECEMBER 12, 1995

3185  
RECORDING

# Starting today, exchanges hope to see futures in milk

**Assigned Prices**  
When we over traders, Milk money is taking on a new meaning as two commodity exchanges incap competing milk futures contracts.

The instruments, to be launched today on New York's Cofee, Sugar & Cocoa Exchange and Jan. 11 on the Chicago Mercantile Exchange, are designed to help dairy farmers, cheese makers and speculators profit from unsteady milk prices as federal price supports erode.

"It's very difficult for a producer to plan for the future. This should bring some stability to the producer market," said Thom Wilborn of the National Milk Producers Federation.

For the mercantile exchange and the much smaller coffee and sugar exchange, the milk rivalry reflects the intense search by futures exchanges for niche markets to exploit.

"We hope, and I think we have reason to believe, that the dairy industry will support us," said Jim Boyce, head of market development at the coffee and sugar exchange.

"The exchanges' interest in milk futures stems from the volatility of milk prices since 1989, when the government reduced its milk support price to \$10.10 for every hundred pounds after holding it near \$13 for much of the 1980s.

The reduction in the government-guaranteed price moved the

\$20 billion milk industry closer to a free market.

Prices have rarely dropped as low as \$10.10 since then, mainly fluctuating between \$11 and \$13 per hundredweight in response to the pressures of supply and demand.

The price volatility has been unsettling for milk producers and cheese, butter and ice cream makers because it increases their financial risk. In 1989, they approached both the mercantile exchange and the coffee and sugar exchange about creating a milk futures market to transfer that risk to speculators.

A futures contract is a promise to buy or sell a commodity

on a future date at a specified price. Producers and users trade the contracts to lock in prices; speculators trade them in hopes of profiting from price fluctuations.

Neither exchange saw so much future in milk futures six years ago. But the price volatility and the likelihood of further government withdrawal from the market persuaded them to try. They hope to attract speculators and sellers are both at risk, and they will be at more risk when the price support structures drop. I don't think there's any doubt the support structures will drop," said Jack Cook, senior research analyst at the mercantile ex-

DECEMBER 12, 1995

**Bureau's**

# Milk Futures Premier Today

*The Associated Press*

Move over traders. Milk money is taking on a new meaning as two commodity exchanges uncap competing milk futures contracts.

The instruments, to be launched today on New York's Coffee, Sugar & Cocoa Exchange and Jan. 11 on the Chicago Mercantile Exchange, are designed to help dairy farmers, cheese makers and speculators profit from unsteady milk prices as federal price supports erode.

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For the Merc and the much smaller CSCE, the milk rivalry reflects the intense search by futures exchanges for niche markets to exploit.

"We hope, and I think we have reason to believe, that the dairy industry will support us," said Jim Bowe, head of market development at the CSCE.

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ers because it increases their financial risk. In 1989, they approached both the Merc and the CSCE about creating a milk futures market to transfer that risk to speculators.

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DECEMBER 12, 1955

Bacon's

## Two exchanges see money to be made in milk futures

By DAVID DISHNEAU  
AP Business Writer

How to profit in the newest commodity market: buy low, sell high and don't lose your milk money.

Two commodity exchanges are wrapping milk futures contracts in a bid to expand their range of products.

The instruments are scheduled for launch today on New York's Coffee, Sugar & Cocoa Exchange and Jan. 11 on the Chicago Mercantile Exchange. They are designed to help dairy farmers, cheese makers and speculators profit from unstable milk prices as federal price supports erode.

"It's very difficult for a producer to plan for the future. This should bring some stability to the producer market," said Thom Wilson of the National Milk Producers Federation.

For the Merc and the much smaller coffee exchange, the milk rivalry reflects the intense search by futures exchanges for niche markets to exploit.

"We hope, and I think we have reason to believe, that the dairy industry will support us," said Jim Bove, head of market development for the coffee exchange.

The exchanges' interest in milk futures stems from the volatility of milk prices since 1949, when the government reduced its milk support price to \$10.10 per hundred pounds after holding it near \$13 for much of the 1930s.

The reduction in the government-guaranteed price moved the \$30 billion milk industry closer to a free market. Prices have rarely

dropped as low as \$10.10 since then, mainly fluctuating between \$11 and \$13 per hundredweight in response to supply and demand pressures.

The price volatility has been unsettling for milk producers and cheese, butter and ice-cream makers because it increases their financial risk. In 1953, they approached both the Merc and the coffee exchange about creating a milk futures market to transfer that risk to speculators.

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Milk exchange saw so much future in milk futures six years ago. But the price volatility and the likelihood of further government withdrawal from the market persuaded them to take another look.

"Buyers and sellers are both at risk, and they will be at more risk when the price support structure drops. I don't think there's any doubt the support structure will drop," said Jack Cook, senior research analyst at the Merc.

If milk futures attract enough makers to create a viable market, one exchange almost certainly will emerge as the dominant marketplace. Eventually, the first exchange to launch a contract wins the race on the Merc — best known for its stock-index currency and livestock contracts — has high hopes.

NOVEMBER 12, 1995  
ECONOMY

# Deregulation could benefit state

## UW dairy economists see market protection

### The futures market can give state dairy farmers an edge in selling milk

MADISON (AP) — Wisconsin dairy economists say a milk futures market set to begin next year will help avert a predicted dairy farmers' panic over the financial sting of liberalized milk prices.

Milk future contracts designed by the Coffee, Sugar & Cocoa Exchange in New York will enable dairy farmers, co-operators and processors to lock in a future price for their milk while giving speculators the chance to bet on the direction of milk prices.

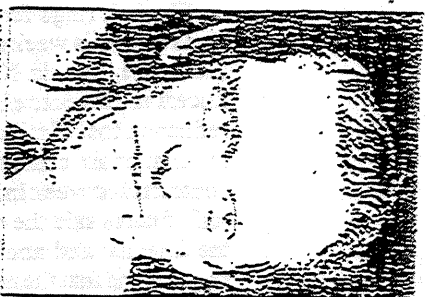
The futures market is set to begin Jan. 24.

A study by three economists shows that the Exchange's contract will offer significant risk protection for upper Midwest dairy farmers and processors, said Kenneth Fontenley, one of two University of Wisconsin-Madison economists who worked on the study.

"Now the dairy industry will have the ability to concentrate more heavily on the producing side of the business," Fontenley said.

Producers in regions under federal marketing orders, which includes Wisconsin, can cut their price risk in half by hedging with futures contracts, the study found.

For example, if a farmer is worried that milk prices will fall, he can lock in a profitable target price by purchasing futures contracts in which a speculative promises to buy at today's higher prices.



ROBERT CHOPIN, a University of Wisconsin dairy economist, sees advantages to the dairy futures market.

If prices plunge by the time the contract matures, the farmer will still make a profit because he will be paid at the contract price by the speculator. If prices rise instead, he will lose money on the futures contract but still make a profit because of the higher cash price for his other milk.

"The idea is you take a position in the futures market that is the opposite of your position in the cash market," Fontenley said. "As long as the two prices move together, any loss in one market is offset by a gain in the other."

Fontenley and colleague Robert Chopin worked on the study with Hector Zapata, a Louisiana State University economist.

The new milk futures contract calls for the delivery of 50,000 pounds of milk to certified sales in Madison. The contract will trade in dollars per hundred pounds of milk.

The Coffee, Sugar and Cocoa Exchange began trading checkerboard and powdered milk futures and options in 1993.

## Also chief sees boost for dairy farmers

### A key to profitability will be marketing all the product that the industry can produce, a co-op exec says

By Mary Mueller  
Special to the Post-Tribune

MADISON — If milk support prices, the Commodity Credit Corp., and federal milk marketing orders disappear because Congress deregulates the dairy industry, there's no need to panic, according to Larry Lemmenes, Aho Dairy Cooperative president and general manager.

"A lot of people are concerned and some are predicting there will be a big loss of jobs," Lemmenes said. "But economic models compiled by dairy economists at the University of Wisconsin suggest that if any one is in a reasonably good position for deregulation, it is the Wisconsin cheese industry. There has been much talk but perhaps we should not be fearful of deregulation."

Lemmenes noted per capita cheese consumption has doubled since 1970 although the rate of increase has slowed in recent years. He said the price supports have not played a role in the cheese market for a number of years, that the CFC is now purchasing only about half the milk that Aho has not sold any product in the CFC in 10 years.

William A. Glass, milk price set by market orders, however, there would be a problem in maintaining the income of dairy farmers where milked milk usage is high, such as the Northeast and Southeast, he said.

"Under deregulation, one alternative is to effectively sell all that you produce. There will be no sale-

ry net," he noted. Aho faces strong cheese price competition from "non-traditional" areas — Idaho, Utah, New Mexico and California.

Aho and other dairy processors can succeed in the long-term by finding "new market relationships with regular rather than one-time or occasional customers, both within the United States and beyond," Lemmenes believes. He hopes that deregulation of the dairy industry would be completed with federal support for exporting products.

A futures market both for cheese and fluid milk could be a valuable tool, particularly if it were used for regulation, Lemmenes said. He hopes futures contracts will become a common practice for both dairy farmers and processing plants but need more traders and more liquidity.

Aho carried out a pilot project for futures pricing of cheese on the Coffee, Sugar and Cocoa Exchange in New York, contracting with members for a price on nearly 11 million pounds of milk during the first year. Futures contracts are also being offered by Swiss Valley Dairy Co-op, based in Iowa, and Danyles Co-op at Syracuse, N.Y., while Land O'Lakes Dairy Foods is considering the idea. The New York market will be offering fluid milk contracts in January and the Chicago Mercantile Exchange might also trade them, Lemmenes noted.

In the first year of forward milk price contracting at Aho, the 43 members who took one or more contracts averaged one cent per hundred above the co-op's cash price for the contract month. But the objective should not be trying to beat or outguess the price for a given month but rather to "cheese price risk" and lock in a profit based on known production costs, he emphasized.

sized.

During the early months of Aho's forward contracting program, which is continuing, all of the contracted prices fell below the co-op's cash price for the month. For the spring and summer of 1995, however, the cash prices were lower than the contracted prices, resulting in close to an overall balance for the year.

The drop in cash prices came because of record low milk component prices for marketing cheese — a direct result of the hot weather during the summer of 1995. "Our plants have never had lower components than in July, August, and early September," Lemmenes explained. "We expected a cheese yield of 10.1 to 12.1 pounds from a hundredweight of milk over a whole year but in August the yield was down to 9.7 pounds. On 110 million pounds of milk a month, that's a loss of 500,000 pounds of cheese."

Low cheese yields explain the high in cash milk prices although the market prices for cheese from June to early October were up by 20 cents per pound, traditionally meaning a \$1.50 to \$2 rise in the milk price, Lemmenes said. He noted a rebound in the components (butterfat and protein) in recent weeks and predicted a fairly strong milk price rise for October, following the 33-cent per hundred jump in September.

Noting the merger of Foremost Farms USA and the Morning Glory Region of Associated Milk Producers, Lemmenes said "we are in the midst of a changing and consolidating industry. We cannot be reactionary or turn back the clock. We must take advantage of changes and new opportunities." Lemmenes expects Foremost and Morning Glory "will concentrate on marketing and they will have more resources for product research and development."

# DAIRY PROFIT

December 11, 1995

Vol. 17, No. 1

## Bell rings for milk futures

The bell rings for trading milk futures and options early this week on the Coffee, Sugar, & Cocoa Exchange, Inc., in New York, offering dairy producers and the entire industry yet one additional risk reduction tool if milk price volatility increases. At the first of six coast-to-coast seminars on the new contracts last week in Madison, Wis., proponents of milk futures said they hoped milk contracts, unlike the Cheddar and nonfat dry milk contracts, would succeed and that the new milk contracts would buoy volume for the other dairy contracts as well.

What milk futures contracts and options contracts offer producers, processors, and distributors is a new tool to hedge their milk price that reduces downside price risk in an era of increased price volatility as government support is reduced, says Larry Lemmenes, general manager of Alto Dairy Cooperative, Wausau, Wis. Alto has been a pioneer in using futures on Cheddar cheese to offer its members forward fixed-price contracts on milk, and Lemmenes says the new milk futures contract offers a more direct link with producer milk prices than existing futures contracts.

Producers can use the new contracts to hedge their milk price in one of three ways: buy futures contracts themselves that lock in milk prices for the contract month; buy an option that guarantees the producer the right—for a premium much like an insurance policy—but not the obligation to own a futures contract; or producers who sell milk to co-ops, such as Alto or Dairytea Cooperative, Inc., Syracuse, N.Y., that offer forward price contracts, can lock in a forward contract through their co-op. Jamie Zimmerman, director of Dairytea's farm management services, notes that the new milk futures may prove more efficient than Cheddar futures because of "a closer relationship with the Basic Formula Price."

### Key producer advantages

Using these new price discovery tools offers key advantages to producers, says Lemmenes. Because producers can hedge their milk price, cash flow budgeting becomes more accurate, and securing loans becomes easier, he says, because hedging offers bankers "an extra degree of comfort."

Lemmenes offers an example of how milk futures work: In March, a producer seeks to lock in a price for 100,000 lbs. of June milk production (2 contracts). June futures are priced at \$11.75 per hundredweight. The producer calls a broker in March and sells two June contracts at \$11.75, then buys two contracts in late June. If the cash market in late June drops to \$11, the producer makes 75 cents less brokerage fees, through the trades, but if cash

milk prices are \$12 in late June, the producer loses 25 cents over what could have been achieved by accepting cash market prices.

Producers should look at futures not as a lock in a high profit, but as a way to reduce downside risk, notes University of Wisconsin economist Ed Jesse. For example, the price for an \$11 options contract will probably cost "pennies per contract." In a volatile market that provides producers inexpensive insurance against the bottom falling out of milk; while an "in-the-money" option that locks in a \$15 milk price could cost \$4 per hundredweight.

No one disputes the concept that risk reduction tools are needed as the industry becomes more—or even totally—deregulated. But will milk futures succeed where Cheddar and nonfat dry milk futures have not?

### Why milk is different

Some, including James Bowe, CSCE's vice president for market development and trading, say milk contracts will succeed, for several reasons. First, the exchange is instituting a market-maker program in which traders have been authorized up to \$200,000 to make markets in futures and options. Each market maker is obligated to provide a bid or offer in the trading ring during the trading session thus guaranteeing that hedgers can get out of their position at any time. The market-maker program will also encourage companies with internal hedging on the percentage of a market position that are willing to hold to trade milk futures, Bowe says.

Second, the dollars at risk in milk are greater than it is in cheese and nonfat dry milk and as such, is likely to generate more liquidity for milk futures and options. For 1989-94, cash market volume of fluid milk was between \$18 billion and \$20 billion, with 8-20 percent price volatility, or \$1.5 billion to \$4.4 billion at risk, compared with only \$655 million at risk in Cheddar cheese, \$71 million for nonfat dry milk, \$2.4 billion for soybeans, and \$847 million for cocoa. Third, the industry is headed for more, less, price volatility, Bowe says.

Jesse, a proponent of futures, acknowledges that he has "absolutely no idea" whether the industry will use milk futures, and that it will take major losses—or the threat of them—before enough players for the futures contracts will succeed. One dairy processor at the seminar says he will study milk futures, but at the moment milk prices are not volatile enough to justify using futures contracts.

### Milk contract specs

Contract specifications for milk futures contracts are: 50,000 lbs. (one tanker load) of Grade A milk at 3.5 percent butterfat; delivery to the Madison District; with delivery months of February, April, June, August, October, and December. Trading hours are 9:15 a.m.

2 p.m., Eastern Time, and trading begins Dec. 12 on futures, and Dec. 13 on options. Price quotes will be available through all electronic market pricing services, or through daily faxed reports from the Coffee, Sugar, & Cocoa Exchange. Contact: 212-742-6106, or fax 212-748-4321, for more information.



# DAIRY PROFIT

December 18, 1995

## WEEKLY

Vol. VI, 2

### Milk futures trading off and running

On day one of milk futures trading last Tuesday, 124 contracts were traded for February, April, June and August at the Coffee, Sugar & Cocoa Exchange in New York. Trading volume declined on Wednesday, when 51 milk contracts were traded and Thursday, when 22 contracts were traded. By contrast, volume on the first three trading days of the Cheddar cheese contract in 1993 was 83, 30 and 9. Thursday's milk contract closed at \$12.35 per hundredweight for February; \$11.93 for June; and \$11.93 for October.

The first trading day for milk futures was Tuesday, December 12, 1995. The market opened at \$12.35 per hundredweight for the February contract, which was the highest price since the market opened. The price for the June contract was \$11.93 and for the October contract was \$11.93. The market closed at \$12.35 for February, \$11.93 for June, and \$11.93 for October. The market was very active on Tuesday, with 124 contracts traded. On Wednesday, trading volume declined to 51 contracts, and on Thursday, it was 22 contracts. The market is expected to continue to be active in the coming weeks.

# CHEESE MARKET NEWS

The weekly newspaper of the nation's cheese and dairy-deli business

Vol. 15, No. 43

A DAIRY FOOD & LODGING GROUP PUBLICATION

December 8, 1981

## CSCCE seminar explains milk futures and options

By Heather Lee Schroeder

MADISON, Wis. — To prepare for the launching of milk futures and options by Coffee, Sugar & Cocoa Exchange Inc. (CSCE), complimentary seminars, "Managing Milk Price Risk with Futures and Options," were offered in Chicago, New York and here this week.

In a mood of cautious optimism, more than 100 farmers and processors attended the Madison seminar to hear how the new markets could benefit their businesses. The audience repeatedly questioned the seminar presenters, asking whether the milk futures would be more successful than *Cheddar* cheese futures and what the benefits of using them might be.

• Futures and options "important tool?"

James C. Barr, CEO, National Dairy Producers Federation, opened the Madison session. He said in a period of increasing price volatility, the dairy industry is fortunate to have futures and options to manage the risk. He also said the futures and options will be an important tool for farmers to manage the price risk they are facing.

Larry Lemmenes, president, First Dairy Bank Corp., presented the seminar. Lemmenes said the total dollar volume in the milk market was \$2.48 billion in 1980.

Dairy farmers, co-ops, processors, bank processors, storage and inventory managers/processors/wholesalers will be heavy users of the milk futures and options according to Lemmenes.

• Understanding the market  
A seminar series covers the ques-

tion of what the price will be for a particular commodity. Lemmenes said a processor can use milk contracts to offset his future costs, but he stressed that milk contracts are not a cash market — they are a financial tool. To benefit from hedging, a producer or processor must know their price or what their annual operating budgets and improve their cash flow management.

Lemmenes said businesses must have a margin operating budget to lock in their hedge. The underlying benefits will be stability, better cash flow management and peace of mind for producers.

Lemmenes reviewed several examples with the workshop attendees illustrating a dairy farmer's scenario and a cheese manufacturer's scenario. He also said an ideal futures contract does not involve delivery, although that option is open to the buyer.

• Will it be used?

While the *Cheddar* cheese futures had a rocky beginning, Jan Bove, senior vice president, market development and planning, CSCE, said CSCE has put together a market maker program to ensure immediate liquidity for the milk futures. Those traders, who are committed to the bid/ask spread, will be given \$200,000 for trading on the milk market.

Lemmenes said in a later interview that the seed money will help the market be more successful.

That — in combination with the fact that there's going to be a full trading day and there will be brokers on the floor of the exchange — is every way to make a market — solves the liquidity problem," said Lemmenes.

Consumers may find the milk futures and options more difficult to use,

he continued, because milk has no intrinsic value for the processor, unless it's related to the price of a product. On the other hand, the market may be more attractive for the producer, he explained, because the cost of production and margin of return is easier to determine.

Charles Shaw, senior economist and director, policy development, International Dairy Foods Association, said all of the futures markets will become greater players in the price determination process if the government moves toward less regulation because, under dairy regulation, the government is the determiner of prices, not the market. CSM

DECEMBER 7, 1965  
**Bacon's**

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**CSCCE seminar  
 to focus on trade  
 of milk futures,  
 options contracts**

NEW YORK, N.Y. — The Coffee, Sugar & Cocoa Exchange Inc. (CSCCE) will present a free seminar on trading milk futures and options contracts in Syracuse, N.Y., on Dec. 7. The seminar entitled "Managing Milk Price Risk with Futures and Options," will discuss how the dairy industry can use the new CSCCE milk futures and options contracts to reduce milk price volatility and the risks which accompany this volatility.

The CSCCE milk futures contract, which will begin trading on Dec. 12, calls for the delivery of 50,000 pounds (one tanker truck load) of milk delivered FOB at certified plants, receiving stations or transfer stations located in the Madison, Wis., district. The contract will trade in dollars per hundredweight of milk between 9:15 a.m. to 2 p.m. New York time.

"Managing Milk Price Risk with Futures and Options" is co-sponsored by the American Dairy Products Institute, the International Dairy Foods Association, the National Milk Producers Federation, the Dairy Institute of California and New York State Dairy Foods, Inc. The seminars provide an opportunity to learn the fundamentals of milk futures and options trading.

After an introduction by Bruce W. Kasper, executive vice president of New York State Dairy Foods, Inc., the session will begin with an explanation of why the dairy industry needs milk futures and options, discussion of milk price volatility and an overview of the milk futures and option contracts led by Professor Mark Stevenson of Cornell University Department of Agricultural Economics.

Dane Runger, owner-operator of a 280-cow dairy herd in Antice, N.Y., will present "Managing Milk Price Risk with Futures," and James J. Bove, CSCCE general office vice president, market development and planning, will present "Managing Milk Price Risk with Options." They will discuss how different dairy industry participants can utilize the milk futures and options contracts to lower their price risk.

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EASTERN EDITION

NOVEMBER 25, 1995  
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## Dairy futures contract to be implemented Jan. 23

Wisconsin dairy economists say a milk futures market set to begin next year will help upper Midwest dairy farmers avoid the financial sting of fluctuating milk prices.

Milk future contracts designed by the Coffee, Sugar & Cocoa Exchange in New York will enable dairy farmers, cooperatives and processors to lock in a future price for their milk while giving speculators the chance to bet on the direction of milk prices.

The futures market is set to begin Jan. 23.

A study by three economists shows that the exchange's contract will offer significant risk protection for upper Midwest dairy farmers and processors, said Randall Fortmeyer, one of two University of Wisconsin-Madison economists who worked on the study.

"Now the dairy industry will have the ability to concentrate more clearly on the pricing side of the business, in addition to the production side," Fortmeyer said.

Producers in regions under federal marketing orders, which includes Wisconsin, can cut their price risk in half by hedging with futures contracts, the study found.

For example, if a farmer is wor-

ried that milk prices will fall, he can lock in a profitable target price by purchasing futures contracts in which a speculator promises to buy at today's higher prices.

If prices plunge by the time the contract matures, the farmer will still make a profit because he will be paid at the contract price by the speculator. If prices rise instead, he will lose money on the futures contract but still make a profit because of the higher cash price for his other milk.

The idea is you take a position in the futures market that is the opposite of your position in the cash market," Fortmeyer said. "As long as the two prices move together, any loss in one market is offset by a gain in the other."

Fortmeyer and colleague Robert Cropp worked on the study with Hector Zayas, a Louisiana State University economist.

The new milk futures contract calls for the delivery of 50,000 pounds of milk to specified sites in Madison. The contract will trade in dollars per hundred pounds of milk.

The Coffee, Sugar and Cocoa Exchange began trading cheddar cheese and powdered milk futures and options in 1993.

# CSCE Moves Milk Market Launch Date To Dec. 12, OKs Market Makers

New York—The Coffee, Sugar & Cocoa Exchange, Inc. (CSCE) announced Tuesday that it will launch milk futures contracts on Tuesday, December 12, 1995, and milk options contracts on December 13, 1995, instead of its previously planned launch date of January 23, 1996.

"In discussing our original launch plans with members of the dairy industry, several market participants asked why the Exchange was waiting until the new year to open the milk markets," said James J. Bowa, CSCE senior vice president/market development and planning. "They expressed interest and support for an earlier market launch, so we modified our launch plans to better meet their needs."

The CSCE milk futures contract calls for the delivery of 50,000 pounds (one tanker truck load) of Grade A raw milk delivered FOB at certified plants, receiving stations or transfer stations located in the Madison, WI district. The contract will trade in dollars per hundredweight of milk between 9:15 a.m. and 2:00 p.m. Eastern time.

The Chicago Mercantile Exchange recently announced a launch date of January 11, 1996, for its milk futures and options (see CR, 11/3/95, p. 1).

## Market Makers

The CSCE's board of managers on Tuesday approved Brian Kelly, Esposito Commodities, Inc., and NYAM Options Trading N.V., Inc., as Registered Market Makers in the milk markets, to serve as catalysts for market activity. Under the Market Maker Program, the Exchange will

loan \$50,000 to Brian Kelly, who will make a market in futures, and \$75,000 each to Esposito Commodities, Inc., and NYAM Options Trading N.V., Inc., who will make markets in futures and options.

Each Market Maker is obligated to provide a bid and an offer in the trading ring at all times during the trading day. The Market Makers provide risk capital integral to generating liquidity, thereby allowing the markets to satisfy the hedging and price discovery needs they were designed to address.

In addition to the Registered Market Maker Program, the CSCE is introducing a Milk Permit Program as part of its comprehensive launch plan. The CSCE will make available up to 25 transferable milk permits to develop member support in the market and foster initial liquidity.

Permits are available at a cost of \$2,000 for a two-year period, a fee which is refundable at \$1,000 per year if the permit holder executes 1.5 percent or more of the total volume in the first two years of trading. The milk permits entitle the holder to trade all dairy products; to date, six applications have been received.

## Educational Seminars

The CSCE, in association with the American Dairy Producers Institute, International Dairy Foods Association, National Milk Producers Federation, Dairy Institute of California and New York State Dairy Foods, Inc., is hosting a series of six educa-

tional seminars, entitled "Managing Milk Price Risk with Futures and Options." Free to all interested parties, the seminars will discuss the fundamentals of milk futures trading, how the markets work, the contract specifications, what industry participants can benefit from using futures and options, and how market participants can use the contracts to suit their business needs.

The seminars, led by CSCE officials, dairy association executives, dairy industry representatives and futures traders, will be followed by a cocktail reception. Seminar dates and cities are as follows (all times are local):

•December 4, Edgewater Hotel, Madison, WI, 3:45 p.m.

•December 5, Hyatt Regency O'Hare, Rosemont (Chicago), IL, 3:45 p.m.

•December 6, Marriott Financial Center, New York, NY, 4:00 p.m.

•December 7, Sheraton Inn Syracuse, Syracuse, NY, 3:45 p.m.

•January 8, Ontario Airport Marriott, Ontario, CA, 3:45 p.m.

•January 9, Holiday Inn, Plaza Park, Visalia, CA, 3:45 p.m.

Reservations are required to attend. To register, contact the CSCE marketing department at (800) HEDGE III or (212) 742-6100.

#### Audit Trail Standards

Meanwhile, the CSCE announced that the Commodity Futures Trading Commission (CFTC) has determined that the CSCE is in compliance with the heightened audit trail standards mandated by the Commodity Exchange Act. In a letter dated Novem-

ber 3, the CFTC commended the CSCE on material improvements to its audit trail system and reported that, based on the CSCE's commitment to implement the CFTC's recommendations pertaining to trade timing and sequencing, the CSCE is in compliance with the audit trail standards.

The enhanced audit trail standards of the Commodity Exchange Act, which became effective October 26, 1995, require that exchanges capture unalterable, continuous, independent, and automatic or similarly reliable audit trail times and the precise sequence of all traders. In June, the CFTC issued a report on exchange audit trail systems which indicated that the CSCE Audit Trail System had exceeded the 90 percent accuracy level mandated by the Commodity Exchange Act, and was the only exchange to pass both tests set forth by the CFTC. At that time, the Commission recommended that the CSCE implement additional enhancements to its audit trail system, most of which were already under development.

The CSCE has implemented manual recordation of execution times for every fifth trade on each trading card and has committed to aggressive enforcement of order ticket recordkeeping requirements to improve order ticket timestamping compliance. The Exchange also committed to upgrade the electronic Ring Reporter System to include entry of the selling broker's identity to enhance matching of time and sales prints to specific trades by the second quarter of 1996.

# New option suggested for farmers

## suggested for farmers

### Dairy producers urged to look at fluid milk futures market

By Tom Murphy  
Press-Gazette

Dairy farmers will do themselves a favor by exploring the fluid milk futures market to see if it fits their operation.

"It helps take you out of the pricing peaks and valleys as a price you yourself have determined," said the Wisconsin Farm Bureau dairy spokesman, however, the probability is not in any way certain, he noted.

Anderson, who runs 50 cows, said the 25,000-pound milk was 100 pounds in their industry. The dairy has to make up the pooled contracts to allow their own program to continue, he said.

The farmer with a 200-cow herd probably can get it done," he said. On other matters, the Farm Bureau spokesman said:

• Congress' failure on Wednesday to scrap the federal milk market order system can be blamed on six-line lobbyists and the National Milk Producers Federation. Finalization of the program was set

aside in budget negotiations.

Farm Bureau and other dairy interests, Wisconsin Farmers Union, favored dismantling of the federal milk market order and dairy price support systems once it was apparent a single order was not possible.

Market orders allow premiums paid to dairy farmers based on the volume of their production from the state. The program originally was developed in the 1930s as development to ensure an adequate supply of domestic milk across the U.S.

It is opposed by farmers in the southeast and northwest. "I don't think National Milk Producers Federation is interested in dairy cooperatives that operate in the milk business in the United States," Wisconsin, which generates 50 percent of the U.S. milk supply, was the largest in the program. He said the price likely will increase as the federal milk support program is dismantled.

Anderson said he would like to see a market order system that would allow farmers to sell their milk at a price that would be set by the market. He said he would like to see a market order system that would allow farmers to sell their milk at a price that would be set by the market.

Green Bay News Service reported that the program was opposed by some of the federal milk market order program and the dairy price support program will be kept on an equal footing with the market order system.

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AGWEEK

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NOVEMBER 16, 1995

Bacon's

DAIRY

## Betting milk money

— New York exchange offers futures contract

MILWAUKEE — Upper Midwest dairy farmers can reduce their risk of exposure to changing milk prices by 50 percent using a new futures market set to begin Jan. 23, dairy economists say.

Milk future contracts designed by the Coffee, Sugar & Cocoa Exchange in New York will enable dairy farmers, cooperatives and processors to lock in a future price for their milk while giving speculators the chance to bet on the direction of milk prices.

A study by three economists shows that the Exchange's contract will offer significant risk protection for farmers and processors.

"Now the dairy industry will have the ability to concentrate more clearly on the pricing side of the business, in addition to the production side," says Randall Foranbery, one of two University of Wisconsin-Madison economists who worked on the study.

### Reduce price risk

The contract will trade in dollars per hundred pounds of milk under federal marketing orders, including Wisconsin,

can cut their price risk in half by hedging with futures contracts.

For example, if a farmer is worried that milk prices will fall, he can lock in a profitable target price by purchasing futures contracts in which a speculator promises to buy at today's higher prices.

If prices plunge by the time the contract matures, the farmer will still make a profit because he will be paid at the contract price by the speculator. If prices rise instead, he will lose money on the futures contract but still make a profit because of the higher cash price for his other milk.

Foranbery and colleague Robert Cropp worked on the study with Hector Zanata, a Louisiana State University economist.

The new milk futures contract calls for the delivery of 50,000 pounds of milk 50 percent milk in Madison, Wis. The contract will trade in dollars per hundred pounds of milk.

— Associated Press



## COUNTRY FOLKS WEST

Palm Springs, Calif., NY

Oct - 11, 2000

Weekly

NOVEMBER 8, 1995



## Rural Chat Chat

By: Ed Slusarczyk,  
Farm Broadcaster  
Ag Radio Network

### DAIRY FARMERS SHOULD LOCK IN MILK PRICES IN FUTURES MARKETS

Since the introduction of the Cheddar cheese futures contracts in 1993, many dairy producers have been using the futures market to lock in a milk price for upcoming production, thus reducing their price movement risk. Some producers lock in a price through a cooperative-run hedging program, but many producers hedge on their own by opening a hedging account with a broker.

Coill, WI, dairy farmer Brad Brunner urges dairy producers to start locking in a milk price to protect farm income by hedging in the Coffee, Sugar & Cocoa Exchange, Inc.'s Cheddar cheese futures market.

"Too many people are standing on the sidelines. I don't know why. I guess they just aren't comfortable with the concepts yet," Brunner said. "But if everyone did a little bit of trading, then we would have liquidity in the markets and low bid-offer spreads."

Brunner, a National Milk Producers Federation (NMPF) Advisory Committee Member who milks 200 cows, began hedging in the Cheddar cheese futures market in May 1994. He will hedge up to 200,000 lbs. of his farm's 350,000 lb. monthly milk production if he feels milk prices will fall.

"For example, if I want to make a minimum of \$13.00/cwt., I will put sell orders into the Cheddar futures market for nothing less than 130.00 cents/lb. If the market reaches that point, my orders are filled and I have locked in that price for my chosen month's production."

With the current low volume in the Cheddar market, Brunner is patient when entering the market. He places orders with his broker to sell Cheddar contracts at certain prices, a process known as placing limit orders. (That's an order given to a broker specifying a certain maximum or minimum price, beyond which the order is not to be executed.) If market prices reach these levels, then his orders are executed at the chosen prices. Brunner also liquidates his futures positions in advance of the contract month's expiration, which occurs on the last trading day. Holding contracts to expiration would obligate him to deliver cheese, so by getting out of the market early, Brunner uses the futures market solely as a financial transaction.

"I glean what I can from industry sources to make my market outlook. I subscribe to Dairy Profit Weekly, receive information from my broker, and study

feed prices, weather reports and cheese inventory levels," Brunner said. "Then, since I know my operation's cost of production, I can lock in a price above that level. If I think milk prices are going to fall."

Brunner became interested in the dairy futures markets after attending a Farm Credit Services seminar in April 1994. He quickly opened an account and sold July 1994 Cheddar contracts. Since then, he has locked

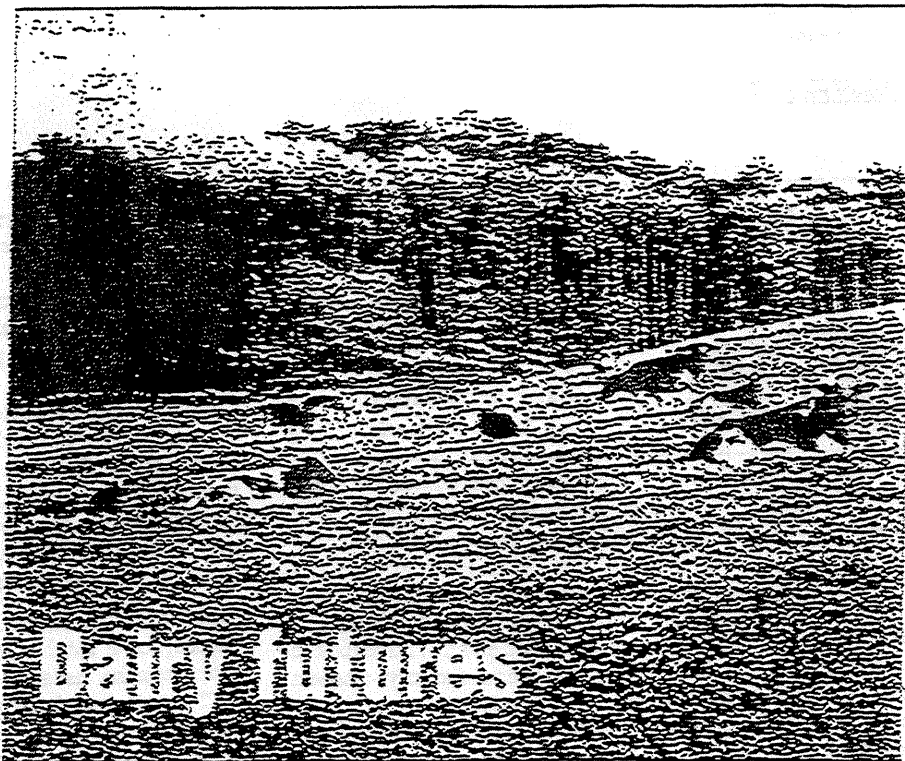
in his milk production's price six times, for a total of six production months hedged.

"I don't mind margin calls, because I am going to sell the physical milk anyway," Brunner said. "If prices move against me in the future market, I will make it up on my milk to get the locked in price."

Brunner expects cooperatives to play a larger role in the futures market in coming months, not only by offering fixed-price forward contracting programs,

but also by hedging the value of their cheese inventories.

"If the co-op has a major swing in cheese inventory value, we bizime it on the cheese price," he said. "But someday, producers will not accept that answer anymore, not with the co-op able to lock in inventory value through the futures market. It may take a while to become comfortable with the concepts, but it's about time the industry uses dairy futures. In fact, it's long overdue."



## Co-ops help farmers lock in price, lock out guesswork

BY LORI WEAVER

**T**o market, to market, producers' milk goes, but how the price will shake out, farmers seldom know—at least not at the time it leaves the farm gate. In fact, the uncertainty and volatility of farm milk price is sometimes pointed to as a bigger problem for producers in the '90s than the price level itself.

But now dairy producers finally have an alternative to sending their product to market without knowing the price. With the start-up of futures and options trading in cheddar cheese and nonfat dry milk—and proposals to launch a fluid milk futures as well—some dairy farmers are discovering a whole new set of tools for working toward a guaranteed milk price.

University of Wisconsin ag economists Bob Cropp and Ed Jesse point out that for nearly forty years, from 1950 to 1988, the industry worried little about price volatility. The federal dairy price support program worked as a fairly effective buffer against big jumps and dives in price. But by the late 1970s and early 1980s, Congress deemed the level of milk surpluses, CCC purchases and costs unacceptable. Parity was replaced with congressional action

to determine the support, using the level of CCC purchase and costs as criteria. Dairy producers in the 1980s saw the support price reduced eight times until it finally came to a \$10.10 per hundredweight suit has been prices above support level most of the time. federal dairy price support program no longer provide price stability or assumes of the market price risk.

Enter the mid-1990s a chance for producers to shut door on some of the ups downs they had been living. In August 1994, Alto Dairy cooperative began offering members the opportunity to forward contract their milk, again as part of a limited-a partially state-funded experiment to be offered to a portion of its member-producers.

is now offering forward contracting as a regular part of its program for all of its members.

Here's how it works: Alto uses the milk futures market of the Coffee, Sugar and Cocoa Exchange in New York City to hedge the profit it receives for the cheddar cheese manufactured from member milk. By locking in futures prices for cheese, the co-op can lock a price to farmers for the milk supplied. It gives their members the choice to either lock for a contracted price, or take their share with the rest of the industry on what has times been an extremely volatile market.

Alto producer-members can currently contract up to 50 percent of production. Ed Lemmenes, Alto's president and general manager, says the co-op has been useful to export to its members that the opportunity to forward contract does not guarantee a price superior to the cash price, only less uncertainty from price swings. But that's a benefit in itself that many producers apparently find appealing.

Dave Tays, Brandon, Wis., says simple volatility led him to try forward contracting on Alto's program. He milks 30 cows three times a day. "I just wanted to be able to lock in a price that I thought would make us a profit," he says. "I know all my expenses, so I know what I'm in order to guarantee that I'll be ahead." Dave says his wife, Kathy, calls two to three times a week to check on the contracting price. A producers can call an 800 number for the future prices and through funding from a state grant, the co-op has also offered its members educational workshops to help them

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derstand the process. "If she sees prices that look attractive to us, we can contract up to 75,000 lb. We try not to contract too far in advance. The longest has been about six months ahead. There have been some months when we didn't like the prices, so we didn't contract," Tavs explains.

Tavs says he went into the program with his eyes open, understanding full well that what his co-op was offering wasn't necessarily a better milk price, but rather a more certain one. "There's been months we've been as much as 50 cents ahead. But I suppose there's been other times we may have been behind by almost that much. In the end, I just want a more stable price and one that I know will be profitable for our operation."

Forward pricing for milk has probably been most popular at its onset with farmers who are used to forward contracting their grain. It also has obvious appeal to producers who have a real need for predictable cash flow, such as those carrying substantial debt. But the opportunity appeals to a broad spectrum of producer-members.

"I'm convinced that what we set out to examine has been accomplished," says Lemmenes. "We've been successful in getting producers to participate at a pace that's appropriate and we've now got producers actively contracting month to month, or at least periodically. We've found that hedging does work and that in some cases, those participating are getting a higher price, although at other times they maybe aren't making a gain. There's no reason why we wouldn't allow our producer members to contract for a higher percentage of their production. We just don't want anyone to get where they can't deliver what they've said they would."

Lemmenes says producer interest has spread, leading some fellow cooperatives to begin launching similar programs. "I think the use of dairy futures will become more common," Lemmenes says. "Since the launching of our program as a pilot project to a limited number of producers in August 1994, we've opened it up to all members." Alto continues to work with Roger Blimling, who actually received the ag development and diversification grant from the state ag department, now for a second year, to continue developing the program with educational workshops and assistance for producers. Blimling runs a grain marketing and futures contracting business in Cottage Grove, Wis., and was highly involved in getting the Alto pilot program off the ground.

"If cooperatives can provide this service, producers can choose to use it or not. Since producer-members are the owners, it makes

good sense for co-ops to offer a program like this that is of real benefit to the members." Blimling notes. "Producers never had the opportunity to do this before, which was all right because the government support price was so high there was really no need. But now it's low, so a program like this can really provide a piece of security that otherwise isn't there. I think it makes a lot of sense for other co-ops to do."

One of the co-ops following suit is Swiss Valley Farms, based in Davenport, Iowa. It began offering its forward contracting program on July 27 of this year. "In the first month, we already had a few producers who were ready to contract," relates Rod Behr, Swiss Valley Farms vice president-finance. He says the idea to begin a forward contracting program came about after learning of the success Alto Dairy had had with such a program, and the Swiss Valley program was in fact patterned after it. As the co-op, we're able to pool contracts for a number of smaller producers, so it really is a plus for them," Behr explains.

So what's next on the horizon? Expansion of the "product line" for one. This spring, both the Coffee, Sugar and Cocoa Exchange, Inc. and the Chicago Mercantile Exchange filed for federal approval to offer fluid milk futures and options contracts. Many in the industry feel that the contracts could be offered before the year is out.

The Exchange feels the milk futures contract will open up hedging opportunities for the greatest possible range of industry participants, stating in its dairy markets newsletter that a farm "with as few as 30 producing cows will be able to use this contract."

Some feel that the ability to deal with this new milk holds greater appeal for producers, although the UW's Cropp points out that all someone using the fluid forward contracting process really will do is lock in on an M-W price, which moves with the cheese price anyway, and then estimate a pay price from there. Still, Cropp concedes, there may be some added appeal for dairy farmers who would rather be involved in direct hedging rather than cross hedging, and he expects that more cooperatives will look at offering forward contracting once the expected fluid futures is in place.

"There's a real need for this kind of thing," he adds of forward contracting. "We know the price support program will be phased out even more with the next Farm Bill if not eliminated all together. Price risk will continue to be real, making this an excellent tool for farmers."

**Price risk  
makes dairy  
futures an  
excellent  
tool.**

MICHIGAN FARM NEWS

Lansing, MI

Size - 45,000  
25 Times/Year

OCTOBER 30, 1995

### Milk futures coming in January

The New York Coffee, Sugar and Cocoa Exchange (CSCE) has received approval from the Commodity Futures Trading Commission for dairy futures contracts effective Jan. 23. According to a Knight Ridder Financial News report, the contracts will be traded on the U.S. dairy market and will supplement existing contracts for nonfat dry milk and cheddar cheese which were introduced in 1993.

CSCE Chairman Brian Kelly predicts that the milk futures and options will provide the dairy industry with an effective tool for managing milk price volatility.

The contract will be traded in 50,000-pound units (one milk truck load) of milk delivered FOB at certified plants, receiving stations or transfer stations in the Madison, Wis. cluster. The contract will be traded in U.S. dollars and cents per hundred-weight, with contract months available for February, April, June, August, October and December. The standard will be Grade A raw milk with 3.5 percent butterfat content.

## Alto Chief Looks At Dairy Deregulation, Futures, Cheese Yields, Mergers

by Ray Mueller

Ripon, WI—If milk support prices, the Commodity Credit Corporation (CCC), and federal milk marketing orders disappear because Congress deregulates the dairy industry, there's no need to panic, Alto Dairy Cooperative president and general manager Larry Lemmenes assured members and guests at one of the co-op's 1985 district meetings.

"A lot of people are concerned" and "some dire predictions have been published," Lemmenes acknowledged. But economic models compiled by dairy economists at the University of Wisconsin-Madison suggest that "if anyone is in a reasonably good position for deregulation, it is the Wisconsin cheese industry," he emphasized. "There has been much talk but perhaps we should not be fearful of deregulation."

Lemmenes noted per capita cheese consumption has doubled since 1970 although the rate of increase has slowed in recent years. He said the price supports have not played a role in the cheese market for a number of years, that the CCC is now purchasing only about dry milk, and that Alto has not sold any product to the CCC in 10 years. Without a Class I milk price set by market orders, however, there would be a problem in keeping dairy farmer income up in high fluid use areas such as the Northeast and Southeast states, he pointed out.

"I don't claim to be an authority on an export" and "we might not foresee everything that will happen in the short-term" under deregulation but the long-term possibilities look promising, Lemmenes continued. "Under deregulation one alternative is to effectively sell all that you produce.

There will be no safety net." He noted Alto faces strong cheese price competition from "non-traditional" areas - Idaho, Utah, New Mexico, and California.

Alto and other dairy processors can succeed in the long-term by finding "new market relationships" with consistent rather than one-time or occasional customers, both within the United States and beyond, Lemmenes believes. He hopes that deregulation of the dairy industry would be coupled with federal support for exporting products.

A futures market both for cheese and fluid milk could be "a valuable tool, particularly if we enter into deregulation," Lemmenes suggested. He believes futures contracts will become a common practice for both dairy farmers and processing plants but emphasizes the futures markets need more traders and more liquidity.

Alto carried out a pilot project for futures pricing of cheese on the Coffee, Sugar & Cocoa Exchange in New York, contracting with members for a price on nearly 2 million pounds of milk during the first year. Futures contracts are also being offered by Swiss Valley Farms Co-op, based in Iowa, and Dairyco Co-op at Syracuse, NY, while Land O'Lakes Dairy Foods is considering the idea. The New York market will be offering fluid milk contracts in January and the Chicago Mercantile Exchange might also trade them, Lemmenes noted.

In the first year of forward milk price contracting at Alto, the 43 members who took one or more contracts averaged one cent per hundred above the co-op's cash price for the contract month, Lemmenes reported. But the objective should not be trying to beat or outguess the price for a given month but rather to "reduce price risk" and lock in a profit based on known production costs, he emphasized.

During the early months of Alto's forward contracting program, which is continuing, all of the contracted prices fell below the co-op's cash price for the month. For the spring and summer of 1985, however, the cash prices were lower than the con-

tracted prices, resulting in close to an overall balance for the year.

The drop in cash prices came because of record low milk components for making cheese - a direct result of the hot weather during the summer of 1985. "Our plants have never had lower components than in July, August, and early September," Lemmenes explained. "We expect a cheese yield of 10.1 to 10.2 pounds from a hundredweight of milk over a whole year but in August the yield was down to 9.7 pounds. On 110 million pounds of milk a month, that's a loss of 500,000 pounds of cheese."

Low cheese yields explain the lag in cash milk prices although the market prices for cheese from June to early October went up by 20 cents per pound, traditionally meaning a \$1.50 to \$2.00 rise in the milk price. Lemmenes said he noted a rebound in the components (butterfat and protein) in recent weeks and predicted a fairly strong milk price rise for October, following the 50-cent per hundred jump in September.

One problem Alto has not had to contend with in 1985 is milk volume except for being overloaded at its processing plants in Alto and Black Creek, which ran at capacity for the fiscal year which ended on June 30. Co-op members increased their milk shippings by 15 percent for a fiscal year total of nearly 1.25 billion pounds.

Alto sold milk to other Upper Midwest member dairies at bargain prices in the spring of 1985 but has installed a new reverse osmosis unit at the Alto plant to increase the daily capacity by 175,000 pounds of milk and will be adding an evaporator at Black Creek by March to handle 400,000 pounds more per day. The co-op considered acquiring new facilities but backed off because of the investment required and the challenge of maintaining quality standards and its cost of operation ratio. "Keeping costs down and adding volume to our plants will keep us competitive in the long run," Lemmenes promised.

In addition to dairy bulk milk shipments to Swiss Valley's bottling plant in Chicago, Alto gets many bulk orders to Alabama, Georgia, Florida, Kentucky, Virginia, and the Carolinas

after mid-August, Lemmenes reported. By mid-October, the co-op was still sending five trains per day to the South and "getting very nice premiums for that milk."

Noting the merger of Foremost Farms USA and the Morning Glory region of Associated Milk Producers, Lemmenes said "we are in the midst of a changing and consolidating industry. We cannot be negative or run back the clock. We must take advantage of changes and new opportunities." Lemmenes expects Foremost and Morning Glory "will concentrate on marketing and they will have more resources for product research and

OCTOBER 25, 1955

# Futures market may expand

By Gloria Hafemeister  
for the Daily Times

By the end of 1955 there is a good chance producers will be able to trade fluid-milk futures and options just as they have had an opportunity to do with cheese and non-fat dry milk during the last couple of years.

The Coffee, Sugar and Cocoa Exchange and the Chicago Mercantile Exchange have petitioned the Commodity Futures Trading Commission to trade fluid-milk futures and options and the commission has until next spring to approve fluid-milk contracts. Both the CSE and the CME had booths at World Dairy Expo to show what they have to offer to dairy producers and milk cooperatives.

The unique thing about this system is that it was designed from the dairy point of view, according to Michael Downes, a dairy farm operator at Eau Claire and a commodity broker in Chicago. He said a farm with as few as 50 producing cows will be able to use the system and also, milk futures and options will allow dairy cooperatives, food companies and industrial users, brokers and processors of other dairy products to reduce the risk of their raw materials cost.

For many years, government intervention in the dairy industry served to reduce price volatility. The decrease of price support levels has increased price volatility to the dairy farmer and this price movement has hurt both the milk producer and the milk consumer.

In the absence of government support, the dairy industry was exposed to price risk but futures and options allow producers and buyers to lock in their prices for a period of time.

Locking in a milk price involves a relatively simple transaction. A milk producer sees that the milk futures price for a particular delivery month is profitable and sells a future contract. By doing so, the producer has created a situation where future market gains will roughly offset any decline in the value of milk when it is shipped, and vice versa.

"It is important to note this is a financial transaction," Downes pointed out. "The producer continues to ship milk to the cooperative or cheese plant as always."

When production month arrives, the producer buys back the milk futures contract, liquidating the futures market position. If the price has dropped, the milk producer has a futures market profit (sold high and bought low). That profit is applied to the lower price received for milk shipments. On the other hand, if the price has risen, the producer has a futures market loss (sold low, bought high). However, the producer has also received a higher price for milk in the cash market. In the end, the final price received once the milk is delivered and the hedge liquidated is equal to the futures contract selling price months earlier.

# DAIRY PROFIT

## WEEKLY

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### Dairylea offers fixed pricing

Dairylea Cooperative, Inc., Syracuse, N.Y., became the nation's second large dairy co-op to offer its members the opportunity to forward contract a fixed milk price based on cheddar cheese futures contracts on the Coffee, Sugar & Cocoa Exchange. Alto Dairy Cooperative, Waupun, Wis., was the first.

Dairylea's program has been operative since early June and so far "a number of people are signed up and interested in it and a small number are actually committed to contracts," says Jamie Zimmerman, director of farm services for Dairylea and administrator of the program. Futures prices have been "fairly volatile," he says. "I think we have some attractive prices right now." Like Alto, Dairylea has a call-in line where producers can receive daily quotes as to what the co-op is offering its members in terms of a fixed milk price.

Dairylea offers prices for contract months six months into the future that are equivalent to a Federal Order No. 2 blend price for the contract month. The co-op uses formulas to translate the cheddar cheese futures prices into an equivalent Basic Formula Price (formerly M-W) then into an equivalent Federal Order No. 2 blend price, Zimmerman notes. "Once fluid milk contracts begin to trade (target date October), our job will be a little easier," he adds. That will eliminate one step in the price translation, but the co-op will still need to translate the contract price into a blend price.

So far, Dairylea says its program is running smoothly. "We haven't had any problem as far as liquidity is concerned in getting in or out of the market," Zimmerman says. The advantage for Dairylea producers who want to forward contract a milk price is that the co-op takes care of the details, leaving more time for the producer to manage the dairy. "They receive a guaranteed price. We take care of the rest—place the hedge, put up margin money," and calculate price translations, says Zimmerman.

Dairylea was asked by some of its members to provide forward price contracting. And the co-op agreed that the service was needed and offers members a management tool, especially when planning is critical, such as during an expansion. "They can go to a bank with a contract in hand and show that they have a guaranteed income," Zimmerman says. Plus, hedging requires that producers keep close tabs on their cost of production to determine whether an offered price gives them the margin they need. Dairylea limits the amount of milk a producer can contract to one-half of the producer's total month's production for which the futures contract is sold. But that's open to change, Zimmerman notes.

#### Alto's success

Alto Dairy Cooperative, Waupun, Wis., was the first dairy co-op to offer its members fixed forward pricing through a co-op run futures hedging program in cheddar cheese. "Eighty of our members are currently contracting periodically in the program," says Larry Lemmenes, general manager. Alto received a grant from Wisconsin's Department of Agriculture, Trade, and Consumer Protection to help initiate the program by providing analysis and education. That grant recently was extended, says Lemmenes, who although comfortable with the number of producers using the program, expects it to grow.

ples, refer to the list of Hedging Terms on page 34.

# Minimize Your Price Risk With Futures

By Shirley Roenfeldt

## Hedging can help you avoid price swings that affect your milk check.



You can use the cheese futures market — and, soon, fluid milk futures — to lock in a milk price. Here's how to do it.

Your first step should be to gather some information about your operation, says Mike Downes, commodity broker and dairy producer in Augusta, Wis. First, you need to know your cost of production for each 100 pounds of milk produced. And, second, you need to know how

much milk you produce each month. With these two pieces of information, you can determine what milk price you need to make a profit.

Here's two examples of how to use the futures market. These example hedges were placed in the cheese futures market by ABC Dairy in 1994 on the Coffee, Sugar and Cocoa Exchange in New York City.

If you need help with any of the terminology used in these exam-

### Situation 1:

Milk prices predicted to decline March 1994. Cheese prices are unusually high — above \$1.80 per pound for a 10,500 pound contract — and the milk supply is tight, as production is down 6 percent in the Upper Midwest. Market forecasters predict prices will hold for a few months and then decline.

### Strategy:

ABC Dairy wants to maintain the \$12.50 to \$13 milk price it has been receiving the last two months. To counter the predicted milk price decline, ABC Dairy hedges half of its expected July production — 105,000 pounds — against a price drop. ABC Dairy prefers to be conservative when hedging anticipated production.

Working through a commodity broker, ABC Dairy sells one July 1994 cheese contract at \$1.85 per pound on the Coffee, Sugar and Cocoa Exchange. At that same time, ABC Dairy also has to make a security deposit, called a margin deposit, with the broker. That charge currently ranges from \$250 to 5 percent of the contract price.

This one 10,500-pound cheese contract equals 105,000 pounds of milk.

To lock in a price for upcoming milk produced, ABC Dairy first must sell a futures contract and then buy it back to close out the hedge. If you buy a contract first, you put yourself in a risky position.

Futures contracts for cheese are offered in February, May, July, September and November. ABC Dairy sold a July contract because it wanted to protect against a price drop for milk which will be produced that month.

Based on the historical cheese and milk prices in ABC Dairy's area, a \$1.85 cheese contract should yield a milk price of \$13 per hundredweight, which is well above this 100-cow dairy's average cost-of-production of \$11.50.

\$1.85 - cheese contract price	x	10 - conversion factor	
			from cheese to milk
<hr/>			\$18.50
	-	50 cents for basis	
<hr/>			\$18.00 per cwt. price objective.

Basis is the usual difference



between the futures and the cash prices for your geographic region. And for ABC Dairy, the basis is usually 50 cents.

At the end of June, three months later, the price of July 1994 cheese contracts declines to \$1.18 per pound. ABC Dairy buys one contract to close out the hedge.

Even though ABC Dairy places a hedge in the futures market, it still participates in the local cash market because the milk continues to be delivered to the local co-op.

With cheese futures at \$1.18, and the basis remaining constant, the local milk price is \$11.80. Example 1 shows how hedging affects the milk price.

### Situation 2:

Milk price direction uncertain August 1994. The cheese market is recovering from summer lows. Nationally, cow numbers have slowly increased for the past three months. If this trend continues, market forecasters predict, a milk surplus and a price decline could occur.

### Strategy:

ABC Dairy's cash milk price for August is \$11.73. November cheese futures have been hovering between \$1.23 and \$1.27 (which equals a milk price of \$11.80 to \$12.20). With the market direction uncertain, ABC Dairy decides to

hedge half of its production if it can lock in a \$1.27 cheese price.

Working with a commodity broker, ABC Dairy sells one November 1994 cheese contract for \$1.27, which should yield a \$12.20 milk price.

\$1.27	- cheese contract price
x 10	- conversion factor from cheese to milk
<hr/>	
\$12.70	
-	50 cents for basis
<hr/>	
\$12.20	per cwt. price objective

At the end of October, two months later, ABC Dairy buys one November cheese contract at \$1.28 to close out the hedge. Cheese futures haven't really dropped as

## EXAMPLE 1

### Futures Market

Sold one cheese contract \$1.35  
Bought one cheese contract \$1.18

---

Difference +/- \$0.17

\$0.17 - profit in cheese futures  
x 10 - conversion factor from cheese to milk

---

\$1.70 per cwt. of milk

### Futures trading expenses

Margin deposit \$250 (refundable)  
Broker fees - \$30 per contract \$30 (non-refundable)  
\*Fees vary by broker

### Cash Market

\$1.18 - cheese contract price  
x 10 - conversion factor from cheese to milk

---

\$11.80

- 50 cents for basis

---

\$11.30 local cash price

### Profit Comparison for July milk:

Half of production is hedged

July cash milk price \$11.30  
Profit from futures transaction + 1.70

---

Price for hedged milk \$13.00  
Cost of milk production \$11.50

---

profit/loss \$ 1.50 per cwt.

105,000 pounds milk  
x \$1.50/cwt.

---

\$1,575

- \$30 Fees paid to broker

---

\$1,545

Half of production which is not hedged

July cash milk price \$11.30  
Cost of milk production \$11.50

---

profit/loss (\$0.20)

105,000 pounds milk  
x (\$0.20) /cwt.

---

(\$210)

That means ABC Dairy earned an additional \$1,545 on the half of its production which was protected by a hedge on the futures market.

## EXAMPLE 2

### Futures Market

Sold one cheese contract \$1.27  
Bought one cheese contract \$1.28

---

Difference +/- \$0.01

\$0.01 - loss in the cheese futures  
x 10 - conversion factor from cheese to milk

---

(\$0.10) loss in milk per cwt.

### Futures trading expenses

Margin Deposit \$250 (refundable)  
Broker fees - \$30 per contract \$30 (non-refundable)

### Cash Market

\$1.28 - cheese contract price  
x 10 - conversion factor from cheese to milk

---

\$12.80

- 50 cents for basis

---

\$12.30 local cash price

### Profit Comparison for November milk:

Half of production is hedged

November cash milk price \$12.30  
Losses from futures transaction (\$0.10)

---

Price for hedged milk \$12.20  
Cost of production \$11.50

---

profit/loss \$ 0.70

105,000 pounds milk  
x \$0.70 /cwt.

---

\$735

- \$30 Fees paid to broker

---

\$705

Half of production which is not hedged

November cash milk price \$12.30  
Cost of production \$11.50

---

profit/loss \$ 0.80

105,000  
x \$0.80 /cwt.

---

\$840

Even though ABC Dairy earned 10 cents/cwt. less on the milk it hedged, it was able to achieve the target price of \$12.20.

predicted. Instead, they fluctuated near \$1.27.

Higher cheese prices mean higher milk prices. And, the \$1.28 cheese contract translates into \$12.80 local cash milk price.

Since the basis did not change, ABC Dairy received \$12.20 per hundredweight, which is what it expected when it placed the hedge.

Remember, back in August when ABC Dairy placed the hedge the market direction was uncertain.

ABC Dairy's strategy was to lock in a price for half of its milk production if it could guarantee a price of \$12.20. Example 2 on page 82 shows how hedging affects the milk price.

One additional market scenario is that of rising milk prices. In that case, you can use hedging to lock in prices and protect yourself from the eventual downside. By doing this, you may not always get the peak price, explains Edward Jesse, University of Wisconsin agricultural economist. But you can minimize your price risk and help lock in a favorable milk price relative to your cost of production. ■

**Futures Contract** - A contract to either buy or sell commodities some time in the future — but at a price you agreed upon today.

**Margin** - A security deposit you have to put up to guarantee you'll stick with a futures contract even if the market moves against you. Usually about \$250 to 5 percent of the price of the contract.

**Margin Call** - If the market moves in the opposite direction you expected, your security deposit (margin) will be used to offset gains to traders whose market position is opposite of yours. When this occurs, you must deposit money to maintain the level of your initial security deposit.

**Hedge** - A technique used to reduce price risk by selling a futures contract for milk you'll have ready to sell in the cash market later. Goal is to sell high and buy low.

**Basis** - The difference between the

price you receive in your milk check and the milk equivalent trading price for a cheese contract on the futures market.

**Long Hedge** - A term used to describe the transaction of buying a futures contract. Used to guarantee the price today at which you can buy a commodity at a future date.

**Short Hedge** - A term used to describe the transaction of selling a futures contract. Used to guarantee the price today at which you can sell a commodity at a future date.

**Offset the Hedge** - A technique used to complete your hedge. If you sold a contract you must buy a contract to complete the hedge. If you do not offset a hedge, you must make or take delivery of the commodity for which you purchased a contract. Always close out your hedge.

**Cash Market** - The market in which you sell your milk locally.

# They've tried dairy futures ... and liked them

You can do it yourself or work through some co-ops.

by Lorraine Susan Merrill

FOR the first time, dairy farmers have an alternative to sending milk to market without knowing the price until the next month. The opening of futures and options trading in Cheddar cheese and nonfat dry milk has put new tools in the hands of dairy farmers and their cooperatives. Cheese and NDM futures are traded daily at the Coffee, Sugar & Cocoa Exchange in New York (call 1-800-HEDGETT for info).

Dairy farmers can benefit from futures trading three ways, says University of Wisconsin dairy economist Bob Cropp.

- Cooperatives — and, therefore, their member owners — can benefit from hedging product inventory and raw milk costs to reduce their risks of losses from price volatility.

- Cooperatives and other buyers of farm milk can use futures markets to forward-price milk. This means farmers can sign fixed-price contracts for their milk, helping them reduce risk and protect profit margins or cash flows.

- Farmers also can work directly with a broker to trade in cheese futures contracts as a cross-hedge on future milk production. Some dairymen may forward-contract part of their production and do some hedging on their own. (See glossary of futures and options terms, August 10, 1988, issue, page 508.)

### We could lose it...

"Dairy producers have to see what an opportunity there is that we've never had before," asserts Woodstock, Ill., dairy farmer Linnea Hooisire. "If we don't take advantage and jump on it, we won't have it. Other futures that didn't trade well after a few years have been dropped."

Hooisire and her husband, Joel, milk 225 cows and also grow corn and soybeans. She forwards-contracts corn with her local elevator and also trades grain futures on her own, so she knows how futures markets work. "I had the knowledge, so I wasn't afraid to try it," she says of her decision to hedge milk, too.

Knowledge is the key, according to experienced farmers, brokers and economists. Opinions are mixed on how successful dairy futures will be. (See August 10, 1988, issue, page 507.) Dairy farmers themselves must make the decisions of whether, when or how to use these tools. They need to educate themselves to make smart decisions.

Cropp says dairy farmers will benefit from learning and following futures markets even if they opt not to participate. The concept of hedging and locking in prices requires managers to focus on cost of production and markets. "We haven't been too strong on that in dairy," notes Cropp.

At the University of Missouri, dairy economist Ken Bailey says of futures and dairy: "It's going to be the future, and, if you want to be ahead of the curve, start learning now."

"It's really good to read a lot," advises Hooisire. She started by getting information from the exchange where she traded commodities, reading everything she could find on the subject and

attending workshops. She learned even more, she adds, with practice.

Dairy farmers shy from hedging out of fear prices will go up, Hooisire notes, "but you're always at risk of the price going down."

Since the changes in government support, dairying has taken on a new kind of risk, observes broker and marketing consultant Roger Blumling, Blumling and Associates, Cottage Grove, Wis. "The only risk before was in producing milk. Now you carry two risks: production risk and price risk."

### Keeps up to date...

Hooisire started using these futures last October. She follows the markets, keeps up to date with dairy newsletters and magazines. "I base my decisions on the projections of several dairy economists — Bob Cropp, Ken Bailey, Andy Novakovic," Hooisire adds.

Hooisire does not always take a position in futures. She waits to lock in a price she knows will be profitable. Her trading costs are broker's commission at \$40 a contract, and margin deposit of \$400 or less per contract which is returned when the contract is bought back. "We place orders well ahead of time — up to a week," she says.

When interviewed in May, Hooisire had not hedged on. "We got out of hedges when the price really dropped," she says. "It's recovered since then, but the present price on futures is not high enough to lock in." Fall cheese futures were trading at around 1.27. She was waiting for 1.30.

Last fall, the Hooisires were worried about low prices at spring flush. Between October and January, Linnea sold four May cheese futures contracts at 1.25, equivalent to a 12.50¢/lb.

Those four contracts (one Cheddar contract is 10,500 pounds which takes 105,000 pounds of milk) equaled about half the Hooisires' May and June production, or all of May. Hooisire started buying back those May contracts April 15, buying two at 1.18 and two at 1.19. She was happy to net a futures profit of about \$2,000 to add to their May milk checks.

Hooisire is excited about the proposals for fluid milk futures. "It will be much better when we can start trading fluid futures because the price will be the same. Cheese has some differences from milk, but it's the best we've got to work with." She would rather trade in milk than cheese, just as she prefers soybean futures to soybean oil.

### Works through co-op...

Pete Knigge, who farms in Orono, Wis., with his wife and son, is forward pricing some of his milk through a pilot program his co-op, Alto Dairy, started last August. "I like the chance to take out some of the valleys" in milk prices, he says.

With a 55-cow dairy and 350 acres of crops, Knigge has experience forward-contracting corn, soybeans and wheat with his elevator. "That's what got me interested in the futures market for milk," Knigge says.

Alto hedges the pool of milk that participants submit, taking care of trading, commissions and margin. Alto figures that into the contract price,



TRADING IN GRANTS provides excellent education for Linnea and Joel Hooisire. Now they hedge milk prices by trading in the dairy futures market. "If we don't take advantage and jump on it, we won't have it," says Linnea.

so participants pay the costs but avoid putting money up front and the hassle of trading.

"I like the Alto concept," comments Bob Cropp, "because we have a lot of small farms. They pull milk together from several farms, and the farmers don't have to worry about it."

The 70 dairy farmers in the Alto program choose when to forward price and can contract 25,000-pound increments up to 50 percent of production. "We're trying to be conservative, to be sure committed milk is produced," explains Jerry Lemmenes, Alto president and general manager.

### Avoids violent swings...

"We offer a price based on our ability to hedge cheese. The hedged cheese price translates into a base price per hundredweight guaranteed to participants," Lemmenes explains. "The ability to forward contract does not mean the price will be superior to the cash price, but it avoids the violent swings." Forward pricing may be attractive to people who want predictable cash flow, especially those who are carrying substantial debt.

"If someone's heavily leveraged, they can lock in a price which helps with budgeting," Knigge notes. "I try to maximize my pay price," he says. "We shouldn't be trying to just beat the market, but, when I see a respectable price, I lock it in."

Knigge figures he came out about even with the cash price on the February and March milk he contracted. But he got 36 cents per hundred-weight more for the contracted half of his April milk than the regular co-op pay price.

Knigge tracks the market with a chart on his desk. Alto offers members training workshops. Members can call an 800 number for daily futures prices.

Mike Downes owns a 230-cow dairy farm near Ben Claire, Wis., and works in Chicago as a commodities trader with Rosenthal Collins. "If you're a dairy farmer in business to make money, futures have to be part of your vocabulary," he says.

Learn about futures, and incorporate it into your financial planning, Downes suggests, to protect your feed needs and lock in milk prices. He hedges feed purchases and milk sales for his farm.

The CFO (chief financial officer) and COO (chief operating officer) of the business — often wife and husband — have to sit down and say, "What price do we want for milk three or four months from now?" he says.

To use these tools effectively Cropp advises that you need to understand the market, know how milk prices relate to the cheese markets and know their cost of production.

"We're thinking about starting a club in Missouri, so farmers can do hedges as a group and start to get comfortable with it," notes Bailey. "Ask your co-op or extension to form a club," he advises dairy farmers who want to get started on the learning curve.

# Beginner's guide to futures' and options' terms

by Lorraine Stuart Merrill

**FUTURES market:** Organized buying and selling of commodities at some future point in time. Futures trading allows buyers and sellers of commodities to protect themselves from price risk — the risk of losses as prices change.

**Coffee, Sugar & Cocoa Exchange:** The futures exchange in New York City where futures and options in Cheddar cheese and non-fat dry milk are traded daily from 1:45 to 2:45 p.m. Eastern time on the exchange floor. CSCE is seeking approval for fluid milk futures.

**Chicago Mercantile Exchange:** Among the largest-futures exchanges, the CME also is seeking approval of fluid milk futures and options.

**Brokers:** Carry out futures and options trades for clients who pay a commission.

**Traders:** People who actually shout out bids and offers on the exchange floor, ensuring all trades are open and competitive.

**Futures contract:** A standardized agreement to buy or sell a commodity at a future date and agreed-upon price. The contract specifies: the type, quantity and quality of the commodity, delivery point and date.

**Offsetting a contract:** Removing the contract obligation to deliver or receive commodity by buying back or selling back the contract. Known as a round-trip trade.

**Hedging:** Trading futures and options to reduce the risk of unfavorable price changes in the cash markets for a commodity.

**Speculating:** Trading futures and options for investment purposes, seeking to profit from the risk of changing prices.

**Short in the market:** By selling a futures contract, the seller is said to take a short position in the market or be short futures.

**Short hedge:** Selling a futures contract to protect against price declines in future cash sale of a commodity traded in an exchange.

**Long in the market:** By buying a futures contract, the buyer is said to take a long position in the market or be long futures.

**Long hedge:** Buying a futures contract to protect against price rise for a commodity purchase that you plan to make.

**Margin:** A performance bond or good faith payment required when buying or selling futures contracts to cover possible losses from unfavorable price changes. Margin deposit for one cheese future is about \$250. Margin accounts are marked to market or adjusted to reflect movements in the futures market each trading day. Margin calls are additional margin deposits required when unfavorable price changes

cause the account to fall below the minimum. Margin balance is returned when the trade is offset, minus the broker's commission.

**Locking in a price:** Hedgers lock in prices for future sale or purchase of a commodity by selling or buying, respectively, futures contracts. If cash markets fall in price by the time of cash sale, the loss is made up by the futures contract gain. If cash prices rise, the gain in cash price offsets the loss on the futures contract.

**Basis:** The difference between local cash price and the price of the same or similar futures contract at the time the commodity is sold is called basis. Hedgers must know their basis to calculate a hedge. Basis risk is the possibility of basis change.

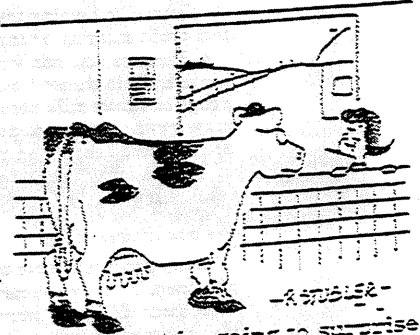
**Cross-hedging:** Hedging one commodity with futures contracts in a closely related commodity. Dairymen can hedge future milk production by selling Cheddar futures contracts because farm milk prices are so closely tied to cheese prices by the basic formula price (BFP), formerly the M-W price. Cross-hedging is more complicated, with more basis risk, than straight hedging.

**Forward contracting:** A contract to buy or sell a commodity at a specified price and time, another way to lock in price. A co-op or cheesemaker can use futures markets to offer forward pricing to milk producers.

**Options:** Options in future contracts work like real estate options. Buying a futures contract option gives the buyer the right — but not the obligation — to purchase or sell a futures contract at a specified price. Buying options is like buying insurance. For a price — the premium — it is possible to protect the price of a commodity on the up or down side. To exercise the option is to buy or sell the futures contract. Or the option may be sold to someone else, or allowed to expire.

**Calls and Puts:** Options to buy or sell futures contracts at a specified price.

For more information, call the Coffee, Sugar & Cocoa Exchange at 1-800-HEDGEIT or the Chicago Mercantile Exchange at 312-920-8210 or a broker.



"Daddy must be going to surprise you with a present. I heard him say he was giving you the book."

HOARD'S DAIRYMAN

August 12, 1995



**Milk Forecast**

When you are in the business of forecasting milk prices, it is a good idea to stop and check how well you are doing. The chart on the bottom of this page shows the "track record" of my forecasts in *Dairy Herd Management* for the last seven months. For example, last month we forecast the March M-W price for manufacturing-grade milk would be \$11.87 per hundred-weight. The actual M-W was \$11.89 — making the forecast off by only two cents.

I base my M-W forecasts on a statistical model that looks at cheese and other dairy commodities. The forecasts are made about one month before the actual M-Ws are announced.

**Try the Futures Market**

Dairy producers are facing volatile milk prices today. This results in cash flow problems, particularly when milk prices decline and other cash flow obligations — like feed and debt repayment — remain the same.

To deal with this uncertainty, consider trading cheese contracts on the futures market. The Coffee, Sugar and Cocoa Exchange offers five cheese futures contracts that trade daily. Each contract is for 10,000 pounds of cheese, which represents about 105,000 pounds of milk. Dairy producers can use these contracts to "lock in" futures prices.

Mike Downes, a dairyman as well as a broker, uses the futures market on his own operation. "You've got to develop a hedging strategy before you start buying and selling," he says. Also, you have to know how the cheese price affects your farm milk check. He recommends that you use the futures markets to offset predicted drops in your milk price.

For example, I forecasted cash prices for 40-pound blocks to fall from a

high of \$1.89 in March to low of \$1.19 in May. This is pulling the M-W and your milk price down. To offset this income loss, you could have taken a position in the futures market in February or March by selling a contract. Remember, you don't have to own a contract before you sell it. And then, when cheese prices fall, you would have offset your original position by buying a contract. The difference between selling high and buying low is money in your pocket.

While your actual milk check does not go up, you do have additional income from the futures market.

But, in the same example, if the cheese price rose above the original sell contract you purchased, you would have lost money on the futures market. However, your milk price would have risen from higher cheese prices, offsetting your trading losses.

Either way, you reduce your risk by taking an offsetting position against a precipitous price drop.

Joel and Linnea Kooistra, dairy producers from Woodstock, Ill., use the futures market. "We

market about 400,000 pounds of milk per month and look to hedge half of it when we expect market prices to decline," says Linnea. "When things work out, we add the profits from the hedge to our milk check."

She believes the futures market represents an important marketing tool that cooperatives should be offering to their members. "Cooperatives exist to help farmers market their milk. They are not serving their members well unless they help us forward contract. If I can contract my corn and beans at the local elevator, why can't I do the same with my milk?"

Some cooperatives already use the futures market. Aito Dairy of Waupun, Wis., has developed a forward milk pricing program for its members. And, Mid-America Dairyman, of Springfield, Mo., is hedging its cheese inventories.

If you are interested in the futures market, contact the Coffee, Sugar and Cocoa Exchange at 212-938-2829 and ask how you can begin trading. Or contact Mike Downes at 1-800-231-3089.

Month	Forecast	Actual	Difference
September 1994	12.29	12.15	-0.14
October 1994	11.86	11.86	0.00
November 1994	11.68	11.30	-0.38
December 1994	11.85	11.30	-0.55
January 1995	11.78	11.83	0.05
February 1995	11.89	11.87	-0.02

*Ken Bailey*  
 Ken Bailey  
 Dairy Economist  
 University of Missouri

ADAM - NEW

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Week,

MAY 25, 1955

# New York Wants Fluid Futures, Too

By Joel McNeil  
State Editor

For the second time in as many weeks, a futures exchange has announced that it will seek government approval to trade fluid milk contracts.

The board of managers of the Coffee, Sugar & Cocoa Exchange (CSCE) of New York last week approved a proposal to ask the Commodity Futures Trading Commission (CFTC) to trade milk futures and options. The CSCE wants to offer contracts representing 50,000 pounds of 3.5% butterfat Grade A milk. The program would include six delivery months each year.

The request is similar to the one made two weeks earlier by the Chicago Mercantile Exchange. By fall, producers, processors and marketers could have access to two markets for hedging future milk supplies.

CSCE's decision was not linked to the announcement from Chicago, said James Bowe, senior vice-president for market development and planning at the New York exchange. Bowe explained that the CSCE has been trying to work out a fluid futures program for several years. Exchange officials had problems attempting to establish a nationwide delivery system for fresh fluid milk traded on the market.

Like the Chicago Merc, the CSCE finally decided to target delivery to processing plants in the Upper Midwest. "We were pretty stupid," Bowe remarked. "We should have done fluid futures when we were starting out."

Instead, two years ago the CSCE launched futures contracts for cheddar cheese and nonfat dry milk. "(Those) markets clearly have not been successful," Bowe acknowledged.

The dairy industry and professional speculators have avoided the New York dairy markets in droves. As of mid-May, just 10 nonfat dry milk contracts were open on the CSCE. The New York powder pit had gone 25 consecutive days without any sales.

Cheddar is doing somewhat better. In mid-May, 135 contracts were open. Up to 24 sales were completed in a single day last month, when cheese markets were in turmoil. Alto Dairy Cooperative has been participating in cheese futures as part of its forward pricing project for members' milk.

Even cheese futures pale next to the kind of action seen in most farm commodity pits. For instance, around 350,000 corn contracts were open last week at the Chicago Board of Trade, and sales volume was near 50,000 per day.

Bowe notes that dairy companies and traders have been reluctant to use the cheese and powder futures because the market doesn't have enough players. He said people don't want to open a contract if it represents 10% of the active futures market.

"We never could develop the critical mass necessary to have this market," Bowe lamented. He said dairy companies continually say they are interested in hedging their products. But the big dairy players also say they won't enter the futures pit until the market is big and capable of providing accurate pricing signals. Meanwhile, the market won't become big until the big players decide to enter.

"It's a chicken-and-egg situation," Bowe said. Dairy futures trading at the CSCE remains limited to one hour after the completion of the normal trading day.

Like the Chicago Merc, Bowe thinks fluid futures will be a much bigger draw for the CSCE. He said that fluid milk is the industry's basic product, and the one that most interests dairy people ranging from farmers to major marketing firms. That interest, he noted, is sure to grow if government price supports for milk and dairy products are scaled back or eliminated by the 1955 farm bill.

The New York Exchange intends to open a new dairy pit that trades fluid, powder and cheese, and to conduct its market during the full trading day. Many of the CSCE contract specifications are similar to those proposed by the Chicago Merc.

Contracts for both markets will be in pounds of raw Grade A milk and 3.5% butterfat test. Prices will be in dollars and cents per hundredweight.

Both will offer six delivery contracts. CSCE contracts will be for February, June, August, October and December. The Merc will also trade February, April and substitute July, September and November the last three months.

CSCE price moves will be in 1-cent increments with a 50-cent daily limit if removed in certain situations. Chi changes will be in 2.5-cent increments with a maximum daily move of \$1.50 per weight.

The Merc intends to offer milk options. While it is asking the CFTC to offer options, the New York does not intend to trade them immediately.

The CFTC has up to one year to set up new markets. However, Bowe says the CSCE program could be approved by this fall.

The New York exchange official said futures can be maintained at a level over the long run. Assured Bowe made a commitment to the dairy. "The industry is comfortable with us though we're from New York."



# Dairyline by Lee Mielke

The nation's dairy herd continues to supply more milk and producers continue to "milk it for all its worth," which most would say isn't much these days. USDA's preliminary data puts April milk production, in the top 25 dairy producing states, at 11.5 billion pounds, up 2 percent from April 1994.

Cow numbers, at 8.1 million head, were up 19,000, but were 4,000 head fewer than March 1995. Production per cow averaged 1,433 pounds, a 27 pound increase from a year ago. March milk production was revised down to a 3 percent gain instead of

the originally reported 4 percent jump.

Dairy is keeping a steady eye on cheese prices at the National Exchange in Green Bay, knowing that for every penny movement in the cheese price, they can expect about a 10 cent movement in milk prices. The 40-pound block cheese price inched up a half cent May 19 hitting \$1.2650, after holding steady for 5 consecutive weeks. 640-block held at \$1.1825, and barrel cheese lost another quarter cent, slipping to \$1.1750, after losing a quarter cent the previous week. A year ago the block price stood at \$1.1950, while barrel stood at \$1.1775.

Butter prices were steady again May 19. Nonfat dry milk (NDFM) was weaker. Total DSI? sales for the week of May 15 amounted to only 143,333 pounds. 110,250 pounds was NDFM, to the Caribbean and Central America and the rest was anhydrous milkfat.

Butter prices should hit 80 cents a pound over the next 3 to 4 weeks, predicts industry analyst Jerry Dryer. "Both butter makers and end users keep putting a few extra loaves away," says Dryer, and "that's kept the market above support for the past several weeks." With the ice cream season approaching, additional pressure should occur on cream supplies and trigger higher butter prices.

Butter makers find themselves in an unusual situation, reports Dryer. Typically they buy back government surplus butter at this time of year, to the tune of 40-50 million pounds, to help temper price increases. The double "A" price is already at the government's setback level, which is 10 percent higher than the purchase price and it's expected to go higher because Uncle Sam has no butter to sell.

Butter makers are building inventories, says Dryer, trying to manage the situation themselves, but first quarter sales were up a whopping 40 percent compared to a year ago, mainly because substantial volumes moved overseas where there's a world wide milk fat shortage. Several manufacturers told Dryer they were hanging on to their inventories to protect the domestic market rather than capitalize on existing export opportunities. In what some might consider to be an unusual coalition, the Milk Industry Foundation and the Center for Science in the Public Interest have petitioned the

U.S. Food and Drug Administration to change the rules for lowfat and skim milk labeling. If approved, 2 percent lowfat milk would be renamed "reduced fat milk" and skim milk would be permitted to carry a "fat free" label. The move would bring milk into compliance with government definitions of a "low-fat" food.

In other industry news, the Chicago Mercantile Exchange (CME) has filed for approval with the Commodity Futures Trading Commission (CFTC) to begin trading 50,000 pound units of fluid milk. Michael Downes, account executive of the Chicago-based Rosenthal Collins Group and himself a dairy producer, says the announcement is significant because the CME is "the biggest, strongest, and most dynamic exchange in the world." Dollar for dollar, Downes says the CME is ten times the size of the New York Stock Exchange, and has already been creative in developing new contracts for perishable commodities such as live hogs, cattle, and feeder cattle. Downes says options trading offers the dairy industry "tools of price discovery and risk management" that will aid it to "compete in free and open world trade."

Not to be outdone, the Coffee, Cocoa and Sugar Exchange (CCSE), announced May 17 that it too is seeking CFTC approval for futures and options on fluid milk. While the CME may have the size advantage, the CCSE has a head start because it

has been trading cheese and NDFM for about two years. The industry has been cautious in its use, but Downes says he feels trading fluid will coax more participation, because the fluid market

"reaches a much broader market and everyone in the dairy industry starts their business with fluid and has an interest in fluid." The exchange that will succeed, according to Downes, is "the one that can get its members to rally around the dairy industry and support their market." He says he'll direct his business "to the exchange that services the client." Dairyline Radio features a dairy futures report on its daily broadcasts heard on over 90 radio stations across the country.

Meanwhile, hearings to aid in crafting a new farm bill are taking place on Capitol Hill. Senate and House Committees have proposed million-dollar spending cuts meaning just about everybody's ox will be gored. As we've said many times, right or wrong, budget realities will shape the new farm bill including dairy policy. Serious effort by the dairy industry must be directed at designing the best possible policy with what we have to work with and then unite behind it, rather than wasting a lot of effort fighting the cuts, or each other. Failure to do so will result in lawmakers in Washington writing the dairy title, people who are as qualified to do so as, perhaps, you or I, to direct NADA on how to run the space program.

Have a "dairy good" safe

## MORE FUTURES, AND OPTIONS, FOR THE FUTURE

No doubt some cynics in the dairy industry greeted last week's news that the Chicago Mercantile Exchange was seeking federal regulatory approval to trade fluid milk futures contracts with bewilderment, wondering whether fluid milk would fare any better than Cheddar cheese and nonfat dry milk contracts have at the Coffee, Sugar & Cocoa Exchange in New York. Those contracts, as anyone who follows the futures market well knows, haven't done particularly well in the nearly two years since they were launched.

So, will fluid milk futures fare any better? Perhaps not, but it's worth

cross-hedging other dairy products such as Mozzarella cheese. It seems that the concept of futures trading alone is confusing and scary enough. Concepts like cross hedging and options trading are not just foreign concepts to many; they're from another planet.

There should be less confusion with a fluid milk contract. Milk is used in dairy products ranging from fluid milk to G&H. Anyone who buys or sells milk should have an interest in the ability to lock in prices for that milk. After all, for most dairy processors, the cost of milk represents upwards of 80 percent of the cost of

fluid milk futures and options contracts might garner more interest than have Cheddar and NDM. Currently, it's possible, but fairly difficult, for producers to hedge milk prices on the OSCE. But producer interest in locking in milk prices is quite high, as evidenced by Alto Dairy's forward milk pricing program (which uses OSCE Cheddar futures and options). Providing producers the opportunity to trade contracts for milk, rather than manufactured products, could pave the way for a tremendous increase in producer interest in futures trading.

But the Merco's proposal should also hold considerable interest at the processor level. This could be particularly true for Cheddar cheese manufacturers, who would, with fluid milk futures and options contracts, have the ability to lock in both the cost of their raw material coming in one end of the plant, and the cost of the finished product going out the other end of the plant.

Such an arrangement may not always be desirable, but the flexibility should draw some interest. Back before the OSCE launched Cheddar and NDM trading, pricing was largely a hit-or-miss proposition. That wasn't so bad for many years, when price volatility was almost unheard of. But as government support prices declined and price volatility increased in the late 1980s and early 1990s, milk pricing became more and more of a hazard of doing business in the dairy industry. Cheddar cheese and NDM futures and options contracts offered some potential relief from price risks; fluid milk futures and options trading will offer more potential relief.

"Potential relief" is the operative phrase here. "Potential" is important because the industry has had the ability to use futures and options contracts for a couple of years now, but trading activity has been pretty low. Still, the futures markets offer some possible risk reduction, if used properly.

"Relief" is also important, but perhaps not something with a certain future. "Relief," in this case, means relief from price risks, risks brought about due to price volatility. Volatility

is a fairly recent phenomenon in the dairy industry, and comes courtesy of the government scaling back its involvement.

That leads, like so many roads these days, to the 1995 farm bill. How radically Washington decides to alter dairy programs could be the most important factor in the success or failure of dairy futures markets, be they Cheddar futures or fluid milk futures. Continuation of anything resembling current programs could mean less volatility in prices, particularly for NDM but also for cheese and milk. While we noted earlier that the M-W has varied from \$10.92 to \$13.94 in the 1990s, it's worth noting that those extremes were reached in March of 1991 and January of 1990, respectively. Last year's M-W varied from \$11.25 to \$12.99 - still volatile, but less so than in 1990 and 1991. And the industry has learned, after several years, that volatility is a way of life. Most companies have learned to live with it, albeit not always happily or profitably.

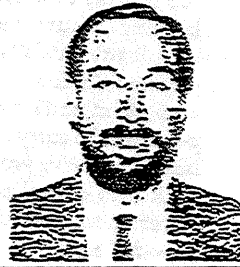
But deregulation of dairy pricing, depending on how far it goes, could lead to greater volatility than we've seen in the last two years, or even the last five years. Get rid of the support program and you get rid of floors under cheese and, probably more significantly, NDM prices. Major reform of the federal order program could also boost price volatility, particularly if the entire program is terminated. "This-or-not" market orientation, of getting government more completely out of dairy pricing, would seem a likely way to spur interest in futures trading, indeed, the presence of the futures markets could even make Congress more willing to deregulate dairy pricing.

Dairy industry participation in the futures market remains low today, but policy decisions that will be made later this year could mean futures markets are necessary options to ensure a profitable future for producers and processors alike.

The Cheese Reporter welcomes letters to the editor. Comments should be sent to Dick Groves, The Cheese Reporter, 4210 E. Washington Ave., Madison, WI 53704; or they can be faxed to (608) 266-8271; or e-mail your comments to [CheeseRep@aol.com](mailto:CheeseRep@aol.com).

### EDITORIAL COMMENT

Dick Groves



noting that there are some differences between the fluid milk and the cheese and NDM contracts, and those differences could help boost interest in these fluid milk contracts. In fact, some futures market supporters even feel the fluid milk contract could boost interest in the cheese and NDM contracts. Certainly, this new contract will get people talking about the futures market; again, interest seems to have slipped since the initial hype over the OSCE contracts a couple of years ago.

The most obvious difference between the CME and OSCE contracts is, of course, the products covered. The CME wants to trade fluid milk contracts; the OSCE trades Cheddar and NDM contracts. While the OSCE contracts offer opportunities for

doing business.

And that cost has been pretty volatile in recent years. The M-W price just in the 1990s has varied from a high of \$13.94 to a low of \$10.92. Indeed, that price volatility may help increase interest in fluid milk futures. Currently, NDM futures are at a standstill, largely because NDM prices are pretty calm. Cheddar contracts are more active, because cheese prices, like milk prices, have been pretty volatile lately. Granted, both Cheddar and milk have a ways to go to match the volatility of some other commodities - coffee being an example that comes to mind - but there is much more volatility with those two products than with NDM.

The potential at the producer level is perhaps the biggest reason why



## CSCCE approves milk futures

NEW YORK — The Coffee, Sugar & Cocoa Exchange Inc. (CSCCE) board of managers has approved a comprehensive launch plan for milk futures contracts. The plan is currently under review by the Commodity Futures Trading Commission (CFTC).

The plan includes two new programs: a Milk Permit Program (MPP) and a Registered Market Maker (RMM) program.

Under the MPP, CSCCE will make available up to 25 transferable permits entitling the holder to trade all dairy products at a cost of \$2,300 for a two-year period.

The fee is refundable, as a permit holder executing 1.5 percent or more of the total volume in the first two years of trading is eligible for a \$1,000 a year rebate. MPP participants must meet CSCCE general membership guidelines.

To reward traders for their commitment to the new product, permanent transferable trading permits will be issued (up to five for any single trader) for each two percent of contract volume a trader executes during the first two years.

All CSCCE members qualify for trading dairy contracts by virtue of their seat ownership. MPP extends free trading rights to CSCCE associate members for the first two years of trading.

The RMM program is structured to loan \$100,000 each to one or two traders who agree to dedicate a trade to maintain bids or offers at all times. This trader, or "Registered Market Maker," is an Exchange member designated to "make a market" in the milk contract.

The RMM is obligated to provide a bid and an offer in the trading ring at all times during the trading day on contract months where that person is the RMM. The bid and offer must be within a maximum range of price ticks and for a minimum number of contracts, both agreed to by the RMM and CSCCE.

The RMM has priority over all other traders in the ring at its bid or offer when making a market for the specified number of contracts. The RMM serves as a catalyst for market activity, as traders are aware of the maximum cost of trading — reflected in the spread between bid and offer — at all times.

June 29, 1995 COMMODITY MARKET NEWS

## CSCE Launch Plan Designed To Foster Liquidity In New Milk Futures Contract

New York—The Coffee, Sugar & Cocoa Exchange, Inc.'s (CSCE) board of managers last week approved a comprehensive launch plan for the Exchange's milk futures contract, which is currently under review by the Commodity Futures Trading Commission (CFTC).

The launch plan includes two new programs: a Milk Permit Program (MPP) and a Registered Market Maker (RMM) program.

"The Milk Permit Program is designed to develop member support and foster initial liquidity in the market," said Brian Kelly, CSCE chairman. "The Registered Market Maker will provide the risk capital necessary to generate liquidity, thereby allowing the markets to satisfy the hedging and price discovery needs they were designed to address."

Under the Milk Permit Program, the CSCE will make available up to 25 transferable permits enabling the holder to trade all dairy products, at a cost of \$2,500 for a two-year period. The fee is refundable, as a permit holder executing 1.5 percent or more of the total volume in the first two years of trading is eligible for a \$1,000 a year rebate. MPP participants must meet general guidelines for CSCE membership.

To reward traders for their commitment to the new product, permanent transferable trading permits will be issued (up to five for any single trader) for each 2 percent of contract

volume a trader executes during the first two years.

All CSCE full members qualify for trading the dairy contracts by virtue of their seat ownership. The MPP extends a free trading right to CSCE associate members for the first two years of trading, and CSCE full and associate members are eligible to receive permanent transferable trading permits.

Continuing the Exchange's commitment to joint projects with the New York Cotton Exchange (NYCE), the CSCE will extend to members of the NYCE and its affiliate exchanges the same dairy trading rights extended to CSCE members and associate members, and NYCE participants are eligible to receive permanent dairy trading permits if they meet the requirements.

The Market Maker Program is structured to loan \$100,000 each to one or two traders who agree to dedicate a trader to maintain bids or offers at all times. This trader, or "Registered Market Maker" (RMM), is an Exchange member designated to "make a market" in the milk contract.

The RMM is obligated to provide a bid and an offer in the trading ring at all times during the trading day on contract months where that person is the RMM. The bid and offer must be within a maximum range of price ticks and for a minimum number of

contracts, both agreed to by the RMM and the Exchange.

The RMM has priority over all other traders in the ring at its bid or offer when making a market for the specified minimum number of contracts. The RMM serves as a catalyst for market activity, as traders are aware of the maximum cost of trading — reflected in the spread between bid and offer — at all times.

The CSCE said it will embark on a comprehensive marketing/education program, including teleconferences, introductory seminars, hedging workshops, literature and meetings with members of the industry. The CSCE milk futures contract being reviewed by the CFTC calls for delivery of one tank load (50,000 pounds) of Grade A raw milk with 3.5 percent butterfat at FMS certified plants in southern Wisconsin and northern Illinois.

"The CSCE is committed to the development of a milk futures market," commented Bennett J. Conn, CSCE president. "These two programs will ensure the support necessary in introducing a new product."

In addition to the CSCE milk futures petition, the CFTC is also reviewing a petition from the Chicago Mercantile Exchange to trade fluid milk futures.

# A Guaranteed Price For Your Milk

By Mike Fishery

## Proposed trading of milk futures contracts would give you price leverage.

Mike Downes, who owns a 250-cow operation near Eau Claire, Wis., is close to obtaining the pricing system for his milk he's been fighting for the last two years. When in place, he says, the system will give all producers — large and small — a new way to survive in a world of wildly fluctuating milk prices.

It's a new futures contract market for fresh, fluid milk.

At the insistence of Downes and others like him, both the Chicago Mercantile Exchange and the Coffee, Sugar and Cocoa Exchange in New York have applied to the federal Commodity Futures Trading Commission for permission to sell futures contracts in units of 50,000 pounds of fresh Grade A cow's milk. If approved, the futures contract would bring to the dairy industry what it brought to the grain and livestock industry — a system by which producers can transfer some of their risk to others, specifically those traders who gamble on the direction prices will take.

It is a tool that all of you, regardless of size, can use for forward pricing and hedging your product.

### Looking in prices

"It's going to give producers a chance to lock in a price for their milk," says Downes, who splits his time between his Angaria, Wis. dairy operation and an office in the Chicago Board of Trade building in downtown Chicago where he trades futures contracts for his brokerage firm, Rosenthal-Collins. "They can price their milk, then relax for the summer and con-

centrate on producing milk."

It's still early in the federal approval process, of course. Economists, the CFTC and producers will need to answer many questions before futures contracts



become a marketing tool in an industry where milk prices are still regulated by federal marketing orders. The CFTC will be listening to industry opinions on the two applications and make suggestions to improve the system. But both exchanges say they expect to see approval for a fresh, fluid milk futures market by this fall.

When it arrives, it will be a useful tool for dairy producers and processors, says Paul Christ, vice president of dairy operations for Land O'Lakes near St. Paul, Minn. With the ability to lock in prices for milk, producers — and their bankers — will be better able to plan cash-flows and predict profitability. That's going to be more important as the federal government continues to remove itself

from the industry, and as dairy prices continue to swing wildly. Processors will also be able to secure supplies of milk at more predictable prices, which will help stabilize their balance sheets, Christ says.

The system would work similar to the grain futures market. Producers could, for example, directly hedge their milk prices, agreeing to sell their milk to the futures market in September for say, \$18 per hundred-weight. If the price goes down to \$12, they buy back their contract, pocket the \$1 profit and secure a guaranteed \$18 per hundred-weight for their milk. If the price goes up to \$14, they buy back their contract at a \$1 loss. But by selling their milk for \$14 cash, they're still guaranteed a \$18 price. (Note: Milk is never actually delivered under the futures contract. These are paper transactions only.)

As in the cash grain market, most producers would use the futures market indirectly, says University of Wisconsin dairy economist Bob Crapp. Instead of participating directly in the futures market, producers would sell milk to processors who are doing the hedging. Processors would then be able to offer producers future prices for milk — just as grain elevators offer farmers forward prices for grain.

Even in the grain industry which has been using futures contracts for years, only about 10 percent of grain farmers actually participate directly in the futures market, Crapp said. All of the rest participate indirectly by selling their grain at forward contract prices to elevator operators, who actually do the futures trading. That's likely how it will work in the dairy industry, too.

### No guarantees

There are no guarantees of success for the new market — especially with two futures markets for milk opening at almost precisely the same time. But a futures market for milk is a large market. Virtually everyone in the dairy industry has to deal with supplies of fresh milk and struggle with its volatile prices, says Jim Bowe, a spokesman for the Coffee, Sugar and Cocoa Exchange. Mike Fishery is a reporter for the Wisconsin State Journal in Madison, Wis.



# Dairy Broker Directory

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The following list of companies are firms that are members or clear their trades through member firms of the Coffee, Sugar & Cocoa Exchange and have identified individuals in their organizations who handle customer business in the Dairy markets. This list has been prepared as a service of the Exchange to assist those who are seeking access to firms to handle their Coffee, Sugar and Cocoa Exchange dairy futures and options business. The inclusion of any individual or firm cannot be considered as an Exchange recommendation or endorsement.

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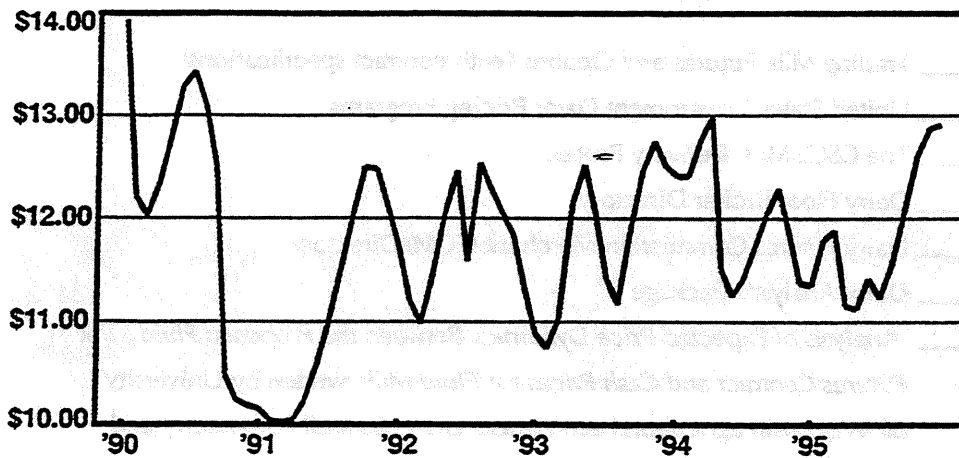
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- Analysis of Expected Price Dynamics Between the Proposed Fluid Milk Futures Contract and Cash Prices for Fluid Milk*, written by University of Wisconsin agricultural economists Dr. T. Randall Fortenberry and Dr. Robert A. Cropp and Louisiana State agricultural economist Dr. Hector O. Zapata
- The Milk Futures Contract: What Does the Futures Price Represent?*, written by Paul Christ, Vice President, Planning and Analysis/Dairy Group, Land O'Lakes, Inc. and Dr. Jeffrey E. Levin, Vice President/Chief Economist, CSCE
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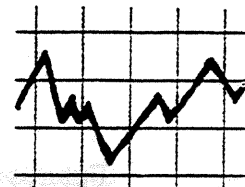
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# Marketing and Policy Briefing Paper



Department of Agricultural Economics, College of Agricultural and Life Sciences, University of Wisconsin-Madison  
Cooperative Extension Service, University of Wisconsin-Extension

Paper No. 54  
December 1995  
REVISED

## Futures Contracts For Milk: How Will They Work?

Ed Jesse and Bob Cropp<sup>1</sup>

### INTRODUCTION

In June 1993, the Coffee, Sugar and Cocoa Exchange (CSCE) introduced futures and options contracts for cheddar cheese and nonfat dry milk<sup>2</sup>. These new contracts provided the opportunity for dairy industry participants – dairy farmers, manufacturers, distributors, and others – to manage price risk in an era of increasingly volatile dairy markets.

Now, expanded risk management opportunities exist via futures and options contracts for Grade A milk. On October 10, 1995, the Commodity Futures Trading Commission approved Grade A milk futures and options contracts for both the CSCE and the Chicago Mercantile Exchange (CME). The CSCE began trading these contracts on December 12, 1995. The CME announced a starting date of January 11, 1996.

In this paper we discuss these new milk futures contracts, focusing on their potential uses for hedging. We explain the differences between the CSCE and the CME contracts and implications for hedgers. Several hedging examples are provided. In this paper, we deal exclusively with the futures contracts. In a later paper, to be issued after some trading experience with the new contracts, we will look at related options contracts offered by both exchanges and their potential use in a risk management strategy.

<sup>1</sup> Professors and Extension Dairy Marketing and Policy Specialists, Department of Agricultural Economics, University of Wisconsin-Madison/Extension.

<sup>2</sup> For more on the cheddar cheese contract, see *Futures and Options Trading in Cheese: Basic Principles for Hedgers*, Bulletin No. A3593, University of Wisconsin-Extension, Cooperative Extension, October 1993. This bulletin also provides a detailed discussion of hedging and basis calculation.



## WHAT IS THE PURPOSE OF FUTURES CONTRACTS?

Futures contracts are marketing tools for managing price risk. Using futures to manage price risks is not new. Futures contracts for grains have been traded for about 130 years. Today, more than one hundred different commodities are traded on U.S. futures markets.

There had been only limited experience with dairy futures prior to introduction of the cheese, nonfat dry milk, and milk contracts. From the early 1950s until 1976, the CME traded butter futures. However, the contract was lightly traded, mainly because, there was little need for dairy futures markets to manage price risk for producers and there was little interest on the part of speculators in trading a commodities with an effective price floor.

The federal dairy price support program provided a relatively high floor (safety net) under manufacturing milk prices directly and under Grade A milk prices indirectly. The federal dairy price support program requires USDA's Commodity Credit Corporation to purchase unlimited quantities of surplus butter, cheddar cheese and nonfat dry milk at specified prices that enable manufacturers of these products to pay the support price. This federal price support program provided price protection for milk and dairy products. For many years, there was little price risk and therefore, there was no interest in dairy futures as a risk management tool.

But all that has changed. The federal price support level for milk has been cut from \$13.10 per hundredweight in 1981 to \$10.10 per hundredweight in 1990, where it remains today.<sup>3</sup> At this low level of price support, market forces -- not the federal support program -- determine cheddar cheese and nonfat dry milk prices most of the time. And for the past two years, even butter prices have usually been above support. Indeed, manufacturing milk prices (as measured by the M-W price and the more recent Basic Formula Price) have not been at support since 1988.

Market-driven milk prices have created uncertain and volatile dairy product prices and milk prices. For example, for the past five years the ranges in the Minnesota-Wisconsin Price (M-W) per hundredweight from high to low were: 1990, \$3.75; 1991, \$2.48; 1992, \$1.61; 1993, \$2.01; and 1994, \$1.74. Dairy producers, milk processors and marketers, and buyers of fluid milk and dairy products now are exposed to major price risks. As a result, there is increased interest in dairy futures and options contracts as a tool to manage this price risk.

The risk of price change is reduced through the *hedging* on the futures market. Hedging is taking opposite transactions in the cash and futures markets. By taking opposite transactions losses (gains) on the cash market can be offset by gains (losses) on the futures market. With

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<sup>3</sup> The support price was raised to \$10.35 per hundredweight on January 1, 1996, under provisions of the 1990 Food, Agriculture, Conservation and Trade Act. New dairy legislation is being debated that will likely change the support price.

these offsetting losses and gains, hedging enables the users of futures markets for price protection to realize close to their price objectives. We illustrate how this works in the paper.

### WHY GRADE A MILK FUTURES AND OPTIONS CONTRACTS?

Cheddar cheese and nonfat dry milk futures and options have been used since their inception in June, 1993 as risk management tools by dairy farmers, milk processors and marketers and buyers of cheese and milk powder. But the interest has been limited and trade volume has been disappointing. Both cheese and nonfat dry milk contract markets lack the broad liquidity enjoyed by most commodity futures.

Cheddar cheese and nonfat dry milk futures and options may be used by both buyers and sellers to protect themselves against changes in the prices of these manufactured dairy products. But these same contracts can be used to reduce the risk of a change in farm level milk prices. This is because the *base price* and *mover* of Grade A milk prices under all federal milk marketing orders is the Basic Formula Price (BFP).<sup>4</sup>

The BFP is the grade B price paid to producers by butter, milk powder and cheese plants located in Minnesota and Wisconsin adjusted by a product price formula for the same three products. Since about 85 percent of the grade B milk in Wisconsin and 65 percent in Minnesota is used to make cheese, cheese is the major determinant of the BFP. About 90 percent of the change in the BFP may be explained by changes in cheddar cheese prices. With such a strong relationship, dairy producers and buyers of farm level milk can use cheese futures and options contracts to reduce the risks from changing milk prices. Dairy cooperatives have successfully used cheese futures contracts to offer cash forward price contracts to their producer members<sup>5</sup>.

About 80 percent of all grade A milk is priced under federal milk marketing orders. But prices for grade A milk not priced under a federal order and prices for Grade B milk have similarly strong relationships to cheese prices. In California, for example, a state order is used to price grade A milk. But prices for cheese, nonfat dry milk and butter are used in a formula to calculate the minimum pay prices to the state's dairy producers.

Protecting milk prices via cheddar cheese futures contracts is a "*cross hedge*" (cheese prices against milk prices) and not a "*direct hedge*" (milk prices against milk prices). Although the price relationship between cheddar cheese futures and milk is high, the price relationship

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<sup>4</sup> The Basic Formula Price has been used since May 1995 as the federal order Class III price and Class II and Class I price mover. From 1961 until May 1995, the M-W price served that role. Both price series are based on pay prices by (unregulated) Grade B plants in Minnesota and Wisconsin.

<sup>5</sup> Alto Dairy Cooperative has been offering their producers cash forward contracts hedged through the CSCE cheddar cheese futures since August, 1994. Since then, Swiss Valley Farms and Dairylea Cooperative have made cash forward contracts available to producers and there may be others.

between milk futures contracts and milk prices should be even higher. This is because other factors besides cheese prices influence milk prices.

Further, dairy producers and fluid milk bottlers may have more interest in a direct hedge. Dairy producers don't normally manufacture cheese. Therefore, dairy producers may better relate to milk prices than cheese prices. And, since futures contracts are deliverable, dairy producers are in a position to deliver milk but not cheese. The same is true with fluid milk bottlers. Bottlers are interested in purchasing grade A milk for bottling. Bottlers do not sell or purchase cheese.

Dairy cooperatives and other dairy companies who wish to offer cash forward price contracts to dairy producers may find the grade A milk futures preferable to cheese futures. Even if the milk purchased by the cooperative is used to make cheese, the grade A milk futures provides for a direct hedge, producer milk prices protected with grade A milk futures. Cheese prices would not need to be converted to milk prices, which is necessary when using cheese futures to offer cash forward contracts to producers.

#### WHO WILL USE THE MILK FUTURES CONTRACTS?

Dairy producers, firms that buy producer milk for bottling, and dairy product manufacturers will likely be interested in using the new milk contracts.

*Dairy producers* may use these contracts to lock in milk prices for future production. For example, in February a dairy producer might be concerned that milk prices will weaken towards spring. The producer sees that June milk futures contracts are trading at a reasonable level and in February *sells* one or more June milk futures to protect future milk production against declining milk prices. Prior to the delivery date of the June contract the producer would offset this position by *purchasing* June milk futures contracts.

The producer would deliver milk to a dairy cooperative or other milk buyer in June. If the price of milk had declined from February, the June milk futures price would have also fallen and a profit would be made on the futures market from buying June milk futures at a lower price than what they were sold for in February. The profit from the milk futures is used to offset the lower price received for June milk delivered to the cooperative. By adding the futures market profit to the lower June milk price received from the cooperative the producer receives a net June milk price close to what was a price objective back in February.

But what if milk prices had increased instead of declining? June milk futures would be purchased at a higher price than what they were sold for back in February and a loss would be experienced on the futures market. Nevertheless, after subtracting the futures loss, the producer still nets a June milk price close to what was believed back in February to be a fair price for milk delivered in June. The objective of using dairy futures is not to receive the highest possible price, but rather to protect a price objective. This price objective is a reasonable price from the

perspective of the producer; a price that will return an acceptable profit. Dairy producers should not lock in an unacceptable price.

*Dairy cooperatives or other milk buyers* could provide a service by offering cash forward contracts to dairy producers for milk delivered in the future to the plant. The cooperative would use the grade A milk futures contract to offer a cash forward contract at a specified price. For example, in February the cooperative quotes a price for milk to be delivered in June. If a dairy producer accepts this price offer, the cooperative protects itself by *selling* June milk futures. When June rolls around and the producer delivers his/her milk, the cooperative offsets its futures position by *purchasing* June milk futures. If June milk prices have declined from when the hedge was placed, then the cooperative can still pay the producer the contract price with the profit generated from the future market transactions. If June milk prices were higher, the cooperative can still only pay the producer the contract price because the loss experienced on the futures market would need to be deducted from the higher milk price.

*Cheese makers or other manufacturers of dairy products and bottlers of fluid milk* may use grade A milk futures to reduce their plant operation risks stemming from rising milk costs. For example, a cheese manufacturer could negotiate with a cheese buyer a price for cheese manufactured and delivered at some future date. The risk to the cheese maker is that the price of milk to make the cheese may be higher than anticipated. This would result in reduced plant margins or even a loss from making the cheese and delivering it to the buyer at the prior negotiated price.

But this milk cost risk could be reduced by using the Grade A milk futures for hedging. For example, assume that a cheese maker negotiates in May with a cheese buyer to deliver 50,000 pounds of cheddar cheese in October at a specified price. In determining its selling price the cheese maker would consider the estimated cost of milk and manufacturing costs. In May, the cheese maker could use the trading price for October milk futures as its estimated milk cost to make this cheese in October.

In May, the cheese maker would *purchase* October milk futures. Then, in October when it is time to procure milk and make the cheese, the cheese maker would offset the long position by *selling* October milk futures. If the cost of milk had increased, the cheese maker would experience a profit on the futures market by selling October milk futures in October at a higher price than what October milk futures were purchased for back in May. The futures profit can be subtracted from the higher cost milk procured and thereby protecting the margins of the cheese plant from delivering cheddar cheese to the buyer in October at prices established in May. If the cost of milk had declined, then the cheese maker would have suffered a loss on the futures market. Nevertheless, by adding the loss to the lower cost of milk procured in October the cheese makers still experiences the plant margin that it expected when it placed its hedge.

The concept would be similar for a bottler attempting to negotiate the future sale of packaged milk at a specified price to a large retail food chain. A future selling price could be negotiated. The bottler could reduce the risk from higher than anticipated milk costs by

*purchasing* milk futures at the time the price for packaged milk to be delivered at a future date was negotiated. Then, when the milk was later procured, packaged and delivered to the retail chain the bottler would *sell* milk futures. As with the cheese maker, the bottler, through the use of milk futures, would have reduced its plant margin risk associated with changing milk costs.

A *buyer of packaged milk* could itself use milk futures to negotiate with a bottler a supply of packaged milk to be delivered at some date in the future at a specified price. The danger to the buyer is that farm level milk prices decline, lowering the price for, packaged milk. The buyer would be at competitive disadvantage in attempting to selling packaged milk to its customers at the previously negotiated higher price. The buyer would either have to risk loss of customers or sell its packaged milk at a loss.

But this problem could be reduced by hedging in milk futures. When negotiating the purchase price for packaged milk to be delivered at a future date, the buyer would protect itself from a subsequent fall in price by *selling* a milk futures. For example, let's say a buyer in October wishes to lock in a price for packaged milk purchased and delivered in December. The buyer would use the December milk futures to negotiate its fixed price and protects itself by *selling* December milk futures.

Then, when December rolls around and the packaged milk is delivered, the buyer *purchases* December milk futures. If the price of packaged milk had actually declined, the buyer would experience a profit from the futures by purchasing December milk futures at a lower price than what December milk futures sold for back in October. The buyer can meet the competition in selling packaged milk in December. The profits from the futures market can be added to the lower selling price for packaged milk. If packaged milk prices had instead gone up, the buyer would experience losses on the futures market. Nevertheless, after subtracting these losses from the higher selling price for packaged milk in December, the buyer still nets out a margin close to what was anticipated back in October.

## THE BASIS

Success in reducing price risks through hedging hinges on the *predictability of the relationship between the cash price and the futures price*. In this case, we are taking about the relationship between the cash market price for Grade A milk and the grade A milk futures price. The relationship between the cash price and the futures price is referred to as the *basis*.

Successful hedges are possible only if the basis relationship is known and predictable. That's because the net outcome of a hedge is equal to the change in the basis. The likelihood of the basis being different at the time the hedge is placed and when it is removed or offset is referred to as *basis risk*. If the basis is exactly the same at placement and offset, then the net outcome will be equal to what was anticipated when the hedge was set. If the basis changes, the net outcome will be either better or worse, depending on which direction it changed, from what was anticipated earlier when the hedge was set.

The level of basis is immaterial; i.e., it makes no difference whether the cash price for milk is, for example, \$1.00 per hundredweight higher or \$1.00 per hundredweight lower than the milk futures price. What does matter is that this relationship is predictable and stable. If it is, then losses (gains) on the cash market will be closely offset by gains (losses) on the futures market.

The good news is that the basis is normally more predictable than cash prices. Therefore the risk exposure from a change in the basis is less than the risk of changing cash prices.

### CONTRACT SPECIFICATIONS OF MILK FUTURES

The contract specifications for grade A milk futures contracts for the NY CSCE and the CME are given in the table below. There are some significant differences between the two contracts.

Contract Specifications: Milk Futures Contracts, CSCE & CME

Contract Specification	CSCE	CME
Commodity	FOB delivery of Grade A milk with 3.5 percent butterfat content from an approved plant	FOB delivery of Grade A milk with 3.5 percent butterfat content to an approved plant
Trading unit	One tanker load	One tanker load
Delivery Unit	One tanker load; allowable variation 48,000 to 50,000 pounds	One tanker load; allowable variation 3%
Trading hours	9:15 AM to 2:00 PM NY time	8:00 Am to 1:00 PM
Delivery Months	Feb., Apr., Jun., Aug., Oct., Dec.	Feb., Apr., Jun., Jul., Sept., Nov.
Price Quotation	Dollars and cents per hundredweight	Same
Minimum Fluctuation	\$.01 per cwt., equivalent to \$5.00 per contract	\$.025 per cwt., equivalent to \$12.50 per contract

Contract Specification	CSCE	CME
Daily Price limits	From previous day's settlement price, \$.50 per cwt. with variable limits effective under certain conditions. No price limits on 2 nearby months, with no limits on 3rd. nearby month from first day of a delivery month until the last trading day of the delivery month	From previous day's settlement price no trading at a price more than \$1.50 per cwt.
Standards	Grade A raw milk with 3.5% butterfat content	Same
Delivery points	From Interstate Milk Shippers (IMS) certified plants, receiving stations or transfer stations located in the Madison district of Chicago federal order	To CME approved facilities within borders of Wisconsin and Minnesota or that portion of surrounding states included in the Chicago or Upper Midwest federal orders.
Delivery	Pick up by the buyer from the seller's plant	Seller to buyers facility
Last trading day	Six Exchange business days prior to the last Exchange business day of the delivery month	Seven Exchange business days prior to the last Exchange business day of the delivery month
Notice of delivery	First exchange business day following last trading day	Same

Contract Specification	CSCE	CME
First and last delivery day	First Exchange day following notice day up to the last Exchange business day of the delivery month	Buyer and seller shall select a day so that delivery can be made by the last calendar day of the delivery month. If no agreement is conveyed to the Clearing House, the Exchange will chose a delivery date from calendar days beginning four days after notice of no agreement and ending on the last calendar day of the delivery month

The biggest distinction between the CSCE and the CME grade A milk contracts is the delivery point. The CSCE contract requires delivery *from* an approved plant or facility in the Madison, Wisconsin district of the Chicago Regional federal milk marketing order. The buyer is responsible for picking up the shipment and assuming all transportation costs from that point. The CME requires delivery *to* a CME approved facility within the borders of Wisconsin and Minnesota or located in that portion of surrounding states included in the Chicago Regional or Upper Midwest Federal Milk Marketing orders. The seller assumes all transportation costs to the buyer's facility except that the buyer will be assessed a standard freight rate per mile for each additional mile the milk is hauled over and above the distance between the seller's facility and either Eau Claire or Fond du Lac, Wisconsin. The excess hauling cost will be paid to the seller.

There are other differences in delivery conditions. For the CSCE contract, the seller is required to give notice of intentions to deliver by the first Exchange business day following the last trading day and delivery can be made from the first Exchange day following notice day to the last Exchange business day of the delivery month. For example, if October milk futures had been available in 1995, the Notice of delivery would have been required by Tuesday, October 24 (the first business day following the last trading day which would have been Monday, October 23). Delivery could be made as soon as Wednesday, October 25, but would have to be delivered by Tuesday, October 31.

The notice procedure is similar for the CME, but there are differences in delivery procedures. After notice of intentions to deliver by the seller, the seller and the buyer are to



select a mutually agreeable day and time for arrival so that the shipment can be received by the last calendar day of the delivery month. Again using October, 1995, that would have been October 31st. The last day could fall on a weekend or holiday. If no agreement is reached by 12:00 noon on the day after the buyer submits routing instructions, the seller shall notify the Clearing House and an arrival date will be chosen by the CME from those calendar days beginning four days after assignment by the Clearing House and ending on the last calendar day of the month.

Another difference between contract provisions are delivery months. Although both Exchanges have six delivery months, the months are different. Both Exchanges have February, April, and June as delivery months. Additional delivery months for the CSCE are August, October, and December. But for the CME the additional delivery months are July, September, and November. While the CSCE uses every other month beginning with February as delivery months, the CME starts the same but then has two back-to-back months, June and July and then returns every other month, but has no delivery months for two months, December and January.

There are also differences in the minimum price fluctuations. Price changes are \$.01 per hundredweight, \$5.00 per contract for the CSCE. The CME allows minimum price changes of \$.025 per hundredweight or \$12.50 per contract. Daily price limits also differ. These are limits on how much a contract price may change from the previous day's settlement price. The CME specifies a limit of no more than \$1.50 per hundredweight. The CSCE sets this limit at no more than \$.50 per hundredweight. However, there are no price limits on the two nearby months for the CSCE contract and no limit on the third nearby month from the first day of a delivery month until the last trading day of the delivery month.

There is a slight difference between the two contracts in allowable variations in quantity delivered. The CSCE will allow a cash settlement in lieu of delivery, but only if the seller fails to satisfy the grade specifications in an initial attempt to deliver. In that case, the seller is obligated to deliver a substitute load within 72 hours and be responsible for all costs associated with the substitution. Alternatively, the buyer may request a cash settlement in lieu of the substitute delivery, but with some penalty imposed upon the seller.

Under the CME milk futures contract, if the seller fails to present "deliverable milk" at the time and place specified, the seller will be penalized \$.50 per hundredweight each day until the requirements are met. If the seller fails to deliver a load of milk, the seller will be penalized \$1.50 per hundredweight on each day until the requirements are met. Further, if a buyer fails to unload "deliverable milk", the buyer will be penalized \$.50 per hundredweight and if it is not unloaded within 12 hours, the penalty is increased to \$1.50 per hundredweight.

Both the CSCE and the CME specify that grade A milk deliveries be from or to, respectively, a facility regulated under a federal milk marketing order. Federal milk marketing orders use classified pricing, setting minimum pay prices for milk according to use class. Class III-A is skim milk used for nonfat dry milk. The minimum price is established via a nonfat dry milk product price formula. Class III is grade A milk used to make cheese. The minimum