

Managing Dairy Farm Price Risk – Gold or Fools Gold

Dairy Price Risk is something that has always been a problem in the dairy industry. The reasons are magnified because of the perishability of the fresh product that cannot be stored or its shipment delayed for even a short time on the farm to wait for better prices. The investment in facilities, equipment and cows are all “long term investments” that once made are difficult to change based on “short term supply and demand changes and pricing”. A dairy cow is bred and then nine months later a calf is born. Two years of investment is made feeding and raising the calf until she begins producing milk. The productive life of that investment must be at least 3 years to be a profitable investment. Once all this investment is made, the most profitability is produced by feeding the cow to get the most milk she is capable of producing. But total supply must remain close to demand because of the perishability. When supply is even a very small amount over current demand, stocks of manufactured products begin to build in storage, which then allows the price of milk or milk products under the current pricing system to drop dramatically since buyers know that milk will continue to be produced. Price Risk is again magnified because the pricing system prices all milk based on the value or demand for the last few percent which can be called the Marginal Milk Demand. The volatility produced by this marginal milk pricing system has caused much discussion about how to manage this price risk.

The government price support system failed to be effective at managing risk so in the late 1990's a forward contracting program was piloted. The forward contracting program as setup was not effective at reducing price risk because it was based on the same volatile pricing system reflected on the CME. Then the MILC program was started and obviously has not been effective at reducing price risk. The MILC program just transferred the price risk to the tax payer. By transferring the risk to the tax payer it interfered with the market signal to reduce production in the short term causing the price to drop even more and actually extending the period of excess production and price risk.

Recently the “Risk Management” discussion has been around using insurance such as margin insurance or livestock gross margin insurance. The current MPP program uses national numbers for calculating a feed cost that are subtracted from the national All Milk Price to calculate a margin over feed cost to be insured at a chosen level by paying a yearly premium. The MPP program is missing the mark for a number of reasons. First since it only uses feed on the cost side it cannot reflect changes in the many other cost associated with operating a dairy farm. If I use the current MPP formula and calculate the margin over feed cost since the year 2000 for 5 year averages the margin has declined **while I am sure most other cost have risen**. For 2000 – 2004 the margin **averaged \$8.76**, for 2005 – 2009 the average **was \$8.61**, for 2010 to 2014 the average was **\$8.56** and just **\$8.24** for 2015 – 2106. This concept is also flawed because again it is just transferring the risk to someone else the **federal budget** after the premiums are subtracted from the possible payments. The math is easy to calculate since we know current U.S. milk production is over 210,000,000,000 pounds. For each dollar that the program pays out /100 pound of milk would cost \$1.68 billion even at 80% participation after the premiums are covered. Based on what I have heard from accountants this program would need to be paying out at least \$3.00/100# of milk just to get back to break even. Which means the minimum cost

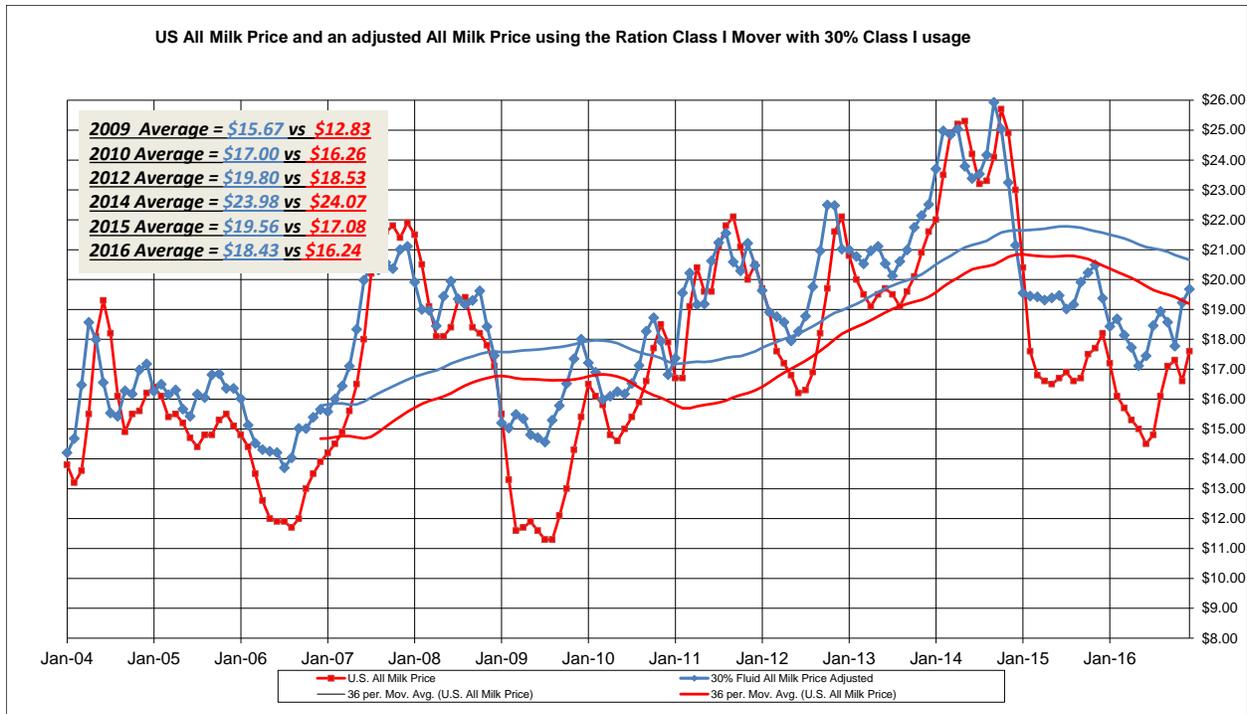
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of this program will be \$5 Billion to the budget. Currently this program is not working for the dairyman and if improved to the point that it is working for dairyman it will be a budget cost issue.

The solution to reducing price risk is not insurance, subsidies or support payments for today's regional, national and international markets. The solution also is not a calculated cost of production formula which is not influenced by the market signals needed to keep supply and demand in balance. The current proposals that use a cost of production pricing system such as S. 1640 the Federal Milk Marketing Improvement Act of 2011 are completely out of touch with the market signals from the export market and could easily destroy that market causing massive over supply problems here. The solution that stabilizes the domestic market price risk while allowing the producers participating in the export markets to react to their market signals involves using the **Ration-all Milk pricing concept** that is completely market oriented. By using the longer term market signals to value the milk components in fluid milk used for domestic consumption we stabilize the day to day and month to month volatility while still listening to the market signals. This reduces price risk for over 30% of current U.S. milk production by insulating it from the volatility of the international market signals that it should not have to compete with on a day to day basis. Each federal order would pool this stabilized price for the % fluid milk consumed in that federal order. The reduction in price risk to the blended price in each federal order will depend on the Class I utilization. The high class I orders will have a very stable blended price. The federal orders with less class I usage will still benefit from this concept by the % they use as class I milk. While their blended price will be much less insulated from the international pricing and volatility, it will provide some stability which will allow them to continue to compete during the times when the export market is low. I believe that through marketing agreements with the processors and retailers the same concept I am using to stabilize fluid milk could stabilize some percentage of the manufacturing milk over and above the fluid milk usage in the low class I usage areas. I believe that it could be possible for all areas of the country to reduce their price risk on 60% or more. This would then provide a true market based forward contracting system that would truly manage risk instead of just transferring it. I believe that the money is in the market to supply a profitable price to the dairyman and is the way that most dairymen prefer to be paid. If given a choice most would reject an insurance based system in favor of a market based system.

The following chart illustrates how just using the Class I pricing systems I am proposing would have improved the U.S. All Milk Price for dairyman that are in a federal order with 30% fluid usage. The red line is the current national all milk price we have experienced along with a 36 month average. The blue line is what the U.S. All Milk Price would have been using the pricing concept I am proposing. As you see that for 2015 - 2016 it would have increased the **U.S. All Milk Price by \$2.19 / 100**. The exact price will vary depending on each farms components and quality bonuses, but the change or increase would be consistent.

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More information on the Ration-all Milk pricing system can be viewed at <http://ration-allmilk.com/>. The documents with charts will illustrate how volatility can be reduced and price risk can be truly managed by fixing the pricing system instead of just transferring the risk to someone else.