

Division of Marketing
Agricultural Development and Diversification (ADD) Program
1995 Grant Final Report

Grant Number 10046

Grant Title Dairy Future Hedging: A Working Model for Forward Contracting
Milk Production from Milk Producers (Phase 2)

Amount Awarded \$21,900.00

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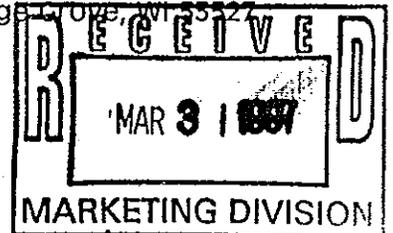
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Dairy Futures Hedging: A Working Model for Forward Contracting Milk Production from Milk Producers

Final Report prepared by Roger Blimling

Original intent of project and perceived benefit to Wisconsin agriculture

The original intent of this grant extension was to expand an ongoing forward contracting purchasing system to include the addition of Multiple Component Pricing (MCP). During the first phase of the grant project, Blimling and Associates, a grain and dairy marketing company, had consulted Alto Dairy Cooperative on how to utilize the futures markets for inventory hedging and input pricing. At this time, determination had been made that the market mechanism worked for the cheese plant and that it could work for the benefit of the Wisconsin milk producers through the forward pricing of fluid milk from the producers by the dairy plant. The main objectives of the grant extension were to develop a forward contracting program that is consistent with MCP, to gain another year's price history experience, and to continue the education of both the producer and the industry in the use of this marketing tool.

In this project, a forward contracting model adapted for MCP was to be developed and adapted for practical application, allowing for expansion in the number of producers in the program. Dairy bids for fluid milk were to be established by applying the theory. Both producers and the dairy plant were to be educated and trained in the market mechanism and in the use of forward contracting and MCP. This process was to be reviewed and refined on an ongoing basis for one year.

Economic Impact of the Project

In order to assess the economic impact of the project, one needs to determine whether the five major results that were expected at the conclusion of the project were, in fact, achieved:

1. It will be proven that milk pricing with MCP can be accomplished by dairy plants through the use of the futures markets.

*Alto Dairy used historical monthly component values as a baseline for the bids given their patrons. Adjustments were made when the actual component values of the milk were known. The cheese market did track with the BFP values throughout the whole period of the grant. (See chart.)

2. The working model will give confidence to lenders to provide financing to dairy plants for price risk management.

*Lenders have shown great interest in the concept of price risk management of dairy commodities. There have been no fewer than ten speeches/training sessions given directly to lender groups or to lender-sponsored client groups as a result of the grant project. There were lenders in the audience at many of the other speeches given to other groups and forums. With structured change coming in the Wisconsin dairy industry, lenders are being asked to finance expansion around the state. The ability of dairy producers to smooth cash flows by pre-establishing sales prices is a benefit to the lenders. The forward contracting program fits into this model well because the coop uses its collective financial strength to support the hedges used in the forward contracting program, thus freeing up working capital on the farm.

3. Milk producers will have a greater opportunity to manage the price risk and secure the profitability of their milk production through the use of forward contracting.

*The 1995-6 year proved to be the most volatile year for the dairy prices in recent history as measured by the BFP (See Table). The completion of the upward move in price did not take place until the fall of 1996. The existence of the program allowed users to look into the future and see profitable prices that were available in advance.

4. An organizational structure and system will be in place that can be reproduced by other cheese plants throughout the State so that all milk producers will eventually have the opportunity of forward contracting.

*In fact, dairy cooperatives in other states have started programs similar to the Alto program. As of today, only Swiss Valley Farms is offering a similar program in the State of Wisconsin. There still remains a problem with private plants offering a forward contracting program. The federal market order rules state that private plants must pay at least the minimum blend prices to their producers. If a producer chooses to lock in a price that turns out to be lower than the blend, the plant is obligated to pay the blend. It is a situation that needs to be changed in the federal rules.

5. This organizational structure and system will create new jobs in the areas of marketing, pricing, and finance.

*The Alto pilot program turned out to be very efficient to run. No new staff was hired to run the program. The need that surfaced is one for education, training, and market information. Dairy producers have never before had any reason to think about marketing their products because they never had the ability to do anything about it. The need for education, training, and market information will be ongoing and cannot be accomplished in a short time. As the dairy industry changes to a more market-driven system, the change dictated by federal policy, the need for this education, training, and market information will continue to grow.

Successes/Failures of the Project in Relation to the Stated Objectives

This project continued the development of a model that can be adapted and implemented by other dairy plants in the State of Wisconsin. Any cooperative in Wisconsin can do what Alto has done if it chooses. The model was adjusted for the change in pricing from 100-weight to MCP. The prices were driven by the Multiple Component Pricing system and delivered to the patrons in per hundred weight increments so that it could be easily understood. Alto provided patrons with daily bids for milk for least six months, and sometimes as much as a year, in advance. Guidelines and procedures for implementation were established and carried out by Alto personnel. No meaningful changes were necessitated due to the addition of MCP. Numerous educational meetings to educate and train producers were conducted around the state. In all, 103 contracts ranging in size from 10,000 lbs. to 150,000 lbs. were executed. The contract prices ranged between 11.46 to 14.13. There were 73 farms enrolled, 22 of which contracted.

In short, the goal of the grant, to improve the competitive position of Wisconsin by providing a new milk pricing system which includes MCP, was achieved by allowing producers to secure production profits in advance and by enabling the Wisconsin dairy industry to better compete with dairies from other states.

This system does work. State-wide implementation will probably take a period of time for no other reason than it is change, and change takes time. The data from the first year of the grant was collected and sent to the University of Wisconsin for analysis. The results are published in a paper written by Dr. Bob Cropp, entitled "Forward Milk Contracting Pilot Program, Alto Dairy Cooperative, Summary July 1994- August 1995." The most recent data has not yet been added to Dr. Cropp's findings.

Conclusion:

The grant project was a success. The program to establish milk prices in advance and to hedge the price risk in the futures markets works. At the completion of the grant program, Alto continued the program and uses it as a natural part of its business.

The number of contracts written in the second year was below initial expectations, but is not seen as a negative given the continuously upward price movement over the course of the year. Commodities other than butter, cheese and milk made record high prices in 1996. These include wheat and corn. If anything, the year gives further proof of the need to secure profitable margins.

Because this was a pilot program, the patrons at Alto were informed of its existence, but the program was not promoted. It was felt that it was important to let the project run its natural course and assess the results before promotion should take place.

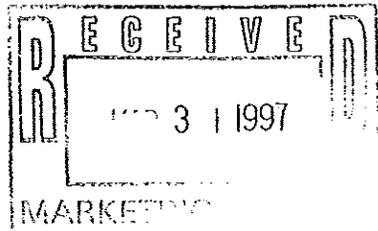
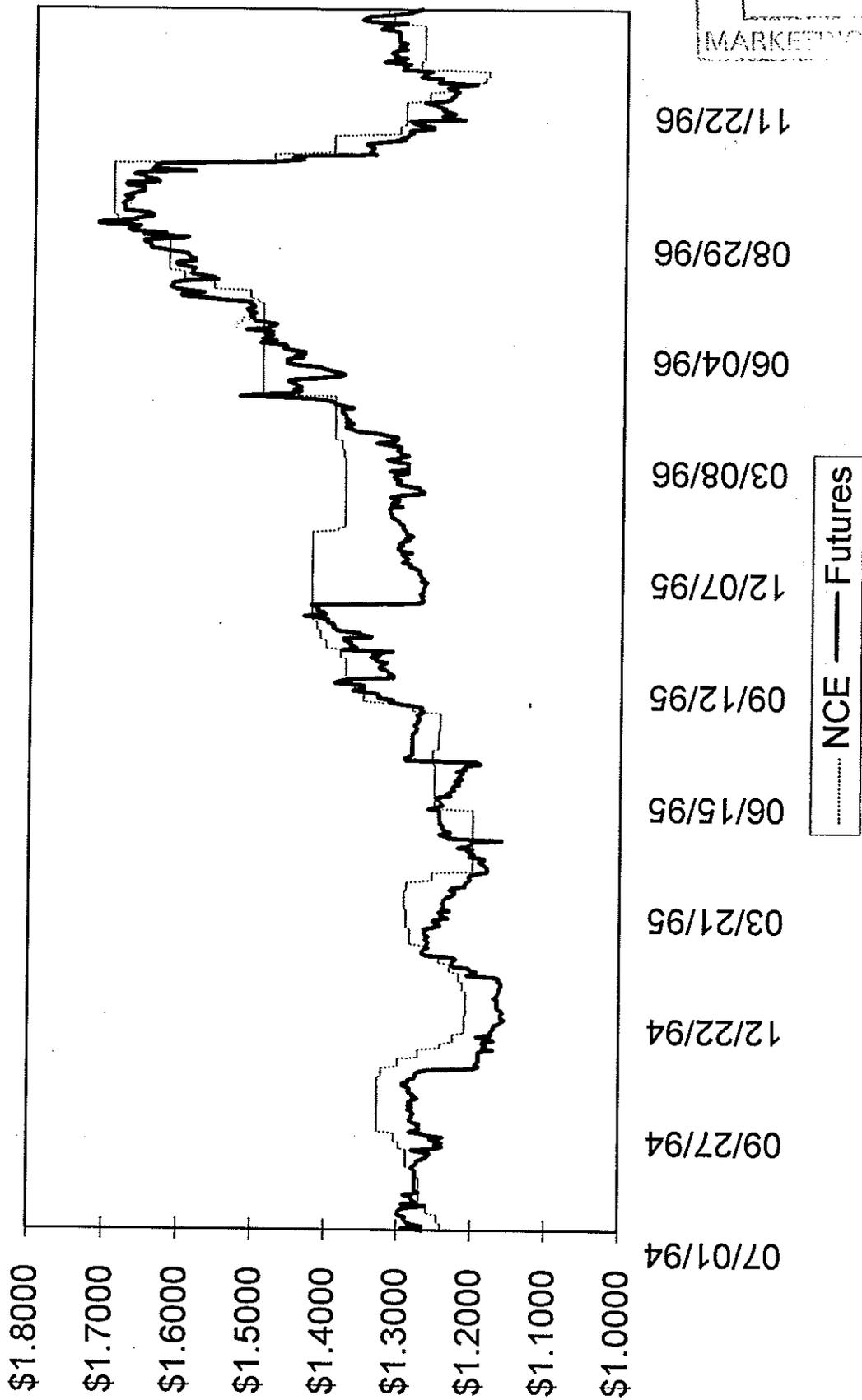
Many dairy product end users are looking at the ability of Alto to lock in forward prices for their patrons and requesting that forward prices for finished products like cheese be offered. Some forward contracts for cheese have been written and there is interest in other areas.

With the success of the pilot program, the need is to educate, train, and provide market information for dairy producers and members of the dairy industry.

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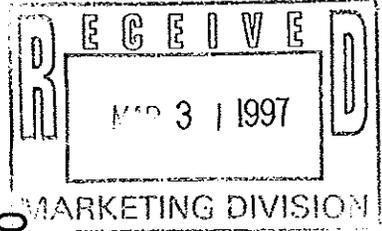
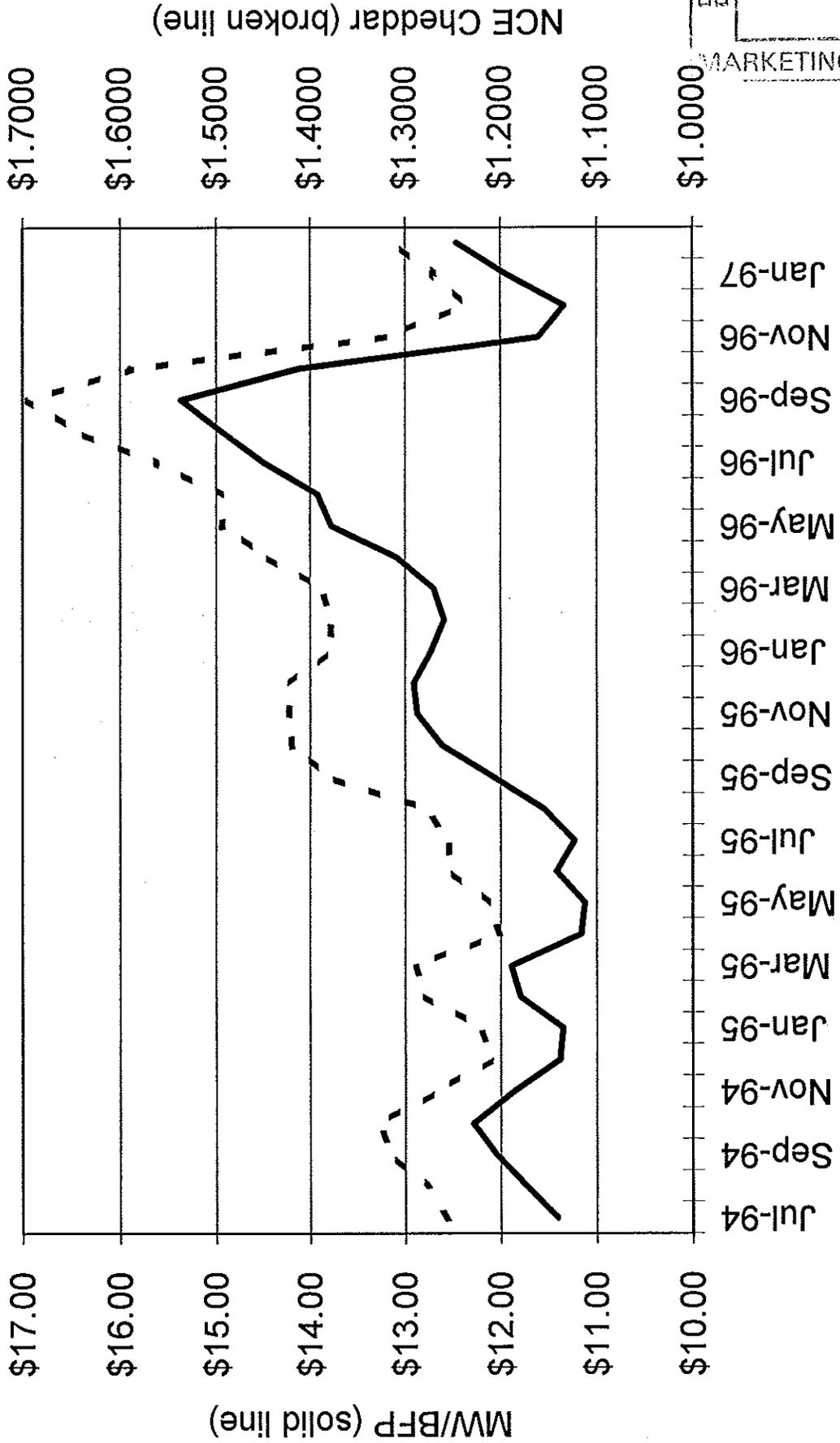
NCE Block Cheddar vs. Nearby Cheddar Futures

7/94-2/97 -- Daily Futures vs. Weekly NCE -- Source: CSCE, USDA



MW/BFP vs. NCE 40 Pound Block Cheddar

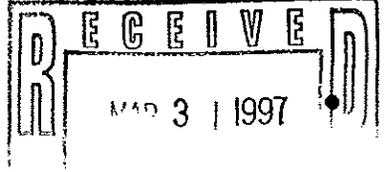
July 1994-February 1997 -- Source: USDA



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Range in MW/BFP

YEAR	HIGH	LOW	RANGE
1989	\$14.93 (DEC)	\$10.98 (MAR)	\$3.95
1990	\$13.94 (JAN)	\$10.19 (DEC)	\$3.75
1991	\$12.50 (OCT)	\$10.02 (MAR)	\$2.48
1992	\$12.59 (JUL)	\$10.98 (MAR)	\$1.61
1993	\$12.75 (NOV)	\$10.74 (FEB)	\$2.01
1994	\$12.99 (APR)	\$11.25 (JUN)	\$1.74
1995	\$12.91 (DEC)	\$11.12 (MAY)	\$1.79
1996	\$15.37 (SEP)	\$11.34 (DEC)	\$4.03



BLIMLING and Associates

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There were 73 member firm enrolled in the Program.

There were 22 farms that executed one or more contract during the program period.

There were 4,025,000 lbs. Contracted during the program period.

The contract size ranged from 10,000 to 150,000 lbs.

The price range of the contracts was \$11.46 to \$14.13.

Delivery Month	# of Farms	# of contracts	Total pounds	Range of	Alto pay Price
Sept 95	19	37	1,430,000	\$11.75-\$12.62	\$12.50
Oct 95	21	39	1,440,000	\$11.92-\$12.81	\$13.03
Nov 95	2	3	105,000	\$11.90-\$12.00	\$13.36
Dec 95	2	2	110,000	\$10.83-\$12.02	\$13.40
Jan 96	2	3	110,000	\$11.89-\$11.99	\$13.38
Feb 96	2	3	90,000	\$11.58-\$12.14	\$13.32
Mar 96	4	9	140,000	\$11.56-\$12.42	\$13.31
Apr 96	2	2	40,000	\$11.46-\$12.01	\$13.54
May 96	1	1	110,000	\$12.08	\$13.91
June 96	1	1	100,000	\$13.62	\$14.43
July 96	1	1	100,000	\$13.71	\$15.00
Aug 96	2	2	250,000	\$13.69-\$14.13	\$15.37

The forward contract prices and the Alto pay price reflect base prices and neither include premiums.