Risk Management Part II

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Before we get started, let me tell you a little about what we heard at the Mid-Year Dairy Outlook Conference last week (it ties into this discussion very well!). First, why are milk prices depressed now? Since manufacturers saw a potential milk shortage last spring (spring of '96) and they anticipated an increase in demand like we've seen for several years for cheese, prices for raw milk went up so they could build inventories. What happened? Milk price rose both at the farm level and at the supermarket level. This resulted in two things. First, more milk was produced, and second, consumers backed off buying cheese. So instead of having the right amount of inventory, they had too much and milk price started dropping. Consumers still haven't 'come back' to the dairy case thus inventory is still high. Right now, we are carrying enough cheese that all the cheese plants in the country could shut down for 10 days! Until we see a drop in inventory, manufacturing will be slow and milk prices will not improve much. This type of price fluctuation is going to continue. Mark Stephenson (from Ag. Ec. at Cornell) says producers basically have three choices: 1. Live with the price fluctuations, 2. Lock in a milk price (we'll get into this more), or 3. Hedge. So, here's the voice of an expert talking about the same thing we started talking about last month!

Types of contracts available (this is not an exhaustive list, just some of the more popular marketing plans):

1. Harvest Sale—cash market sale at harvest without prior pricing. While a harvest sale is aimed more at crop farms, this is what 99% of dairy farmers do: ship their milk and get what ever price they get for it the next month. This is easy, provides cash flow but it is extremely risky (prices going up and down).
2. Cash Forward Contract (CFC)—cash market price is established for a negotiated delivery date, quantity, quality, and place. For those of you that forward buy corn meal, this is what you are doing. It is easy, negotiable when written, and there is no market risk if the market were to go higher (if you are buying). However, there are penalties if you don't take or make full delivery quantity. Also, there is some risk of the market going against you or the basis going against you that could make the CFC higher than the spot market.
3. Storage—holding grain in on-farm or commercial storage for later sale (more for crop producers, but for a crop user such as a dairy farm, having storage for 10-12 months of grain is an option). Advantages are market flexibility, can be used as loan collateral, and tax benefits. This is risky though and you cut down cash flow. You also have to be able to handle the grain, deal with storage losses and quality losses. You are basically at high risk with this option.

4. Basis Contract (BC)—cash market transaction where delivery is made or taken, title of grain is transferred and basis is locked in. A price for the grain will be established prior to a negotiated date. Lots of advantages if and only if you know how the basis moves in your area! These include: market flexibility, cash flow, no basis risk, storage availability, and tax benefits. Disadvantages include: price risk (price may go higher if you are buying), title transfer (a disadvantage if you are a seller of grain if the elevator goes out of business), and limited market hours. This is not for the faint of heart! You have to do your homework to understand the basis before working with this.

5. Hedging with Cash and Futures Markets—while maintaining a cash market position (in other words, you buy and sell grain as you always have), you initiate a substitute transaction in the futures market (see last months article for an example). Advantage is you limit your price risk. If you know you are going to sell 100,000 pounds of milk between July and August, you sell one BFP (Basic Formula Price) contract for August and lock in a price. Disadvantages include: basis risk, brokerage fees, margins (which I'll explain in a little while) and contract sizes. Here's some contract sizes:

Commodity	Contract Size	Units
Corn-CBOT	5,000	Bushels
Corn-MidAm	1,000	Bu
Soy Beans-CBOT	5,000	Bu
Soy beans-MidAm	1,000	Bu
Soy Meal-CBOT	100	Tons
Soy Meal-MidAm	50	Tons
BFP-CMEC	100,000	Pounds

CBOT = Chicago Board of Trade
MidAm = Mid-America Commodity Floor
CMEC = Chicago Mercantile Exchange

6. Hedge to Arrive (HTA)—cash market transaction that locks in the price level. Producer decides on which day to lock in the basis within the negotiated time period. You decrease your price risk, but you maintain the basis risk. Pretty good option.

7. Options Hedge—We haven't talked about options yet (next month) so I won't say anything else except that I think this is the way for people to go.

8. Minimum Price Contract—cash market transaction that establishes the minimum selling price but allows producer to benefit if the market price increases within the negotiated time period; basis is locked in. This is done with options. Wait till next month!

9. Maximum Price Contract—cash market transaction that establishes the maximum buying price but allows producer to benefit if the market price decreases within the negotiated time period; basis is locked in. This is done with options. Wait till next month!

Margins: to put it simply, margins are ugly! When you buy a futures contract, you have to put some money up front. Good news is you don't put up the full value, rather a margin. For example, if you were to buy a soy bean contract at $7.50/bu, you don't write a check out for $37,500, rather you write a check for $1,500. The $1,500 is the margin for that one contract. It goes into an account with your name on it. At the end of every trading day, the account is adjusted for the change in value of the contract. For example, that $7.50 bean contract you bought. If the price were to drop to $7.40 today, you would have $500 subtracted from that account ($.10 x 5,000 bu). This is done every trading day until you offset the hedge. If your account falls below a set level, you get a phone call (called a 'Margin Call') requesting (requiring) you to deposit more money into your margin account (back up to your brokers minimum margin level—typically around $10,000). In most cases, the money must be wired. If you don't wire the money, you forfeit the account, the contract and face criminal charges. They don't mess around! Add on top of that brokerage fees, and you have a fair amount of money tied up in contracts. This is where we'll stop this month since this discussion leads to my favorite area: options! No margin calls, and smaller brokerage fees plus more flexibility! Again, bottom line is you need a marketing plan to make any of this stuff work. Are you working on one?