Cooperative Extension Offers Futures Market Satellite Conference

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contact their local extension office and inquire about the program.)

The gist of the program was that the use of the contracting tools by producers is being proposed as a way to ensure (not insure) that producers can achieve a constant, predetermined profit margin.

What is sacrificed is the ability to gain a huge windfall from an unexpected upturn in the price paid for milk delivered to a plant.

What is gained is protection from a huge loss from an unexpected downturn in the actual price paid for milk.

But, the bottom line is that the producer must already have a relatively low cost of production, relatively high level of production, and an astute awareness of his anticipated operational costs.

The way it works is that in New York and Chicago there are trade exchanges that have recently developed futures markets for dairy commodities — milk futures and basic formula price (BFP) futures, as well as options.

Trading is done on contracts based in increments of 100,000 pounds of milk.

The program was presented with a panel of experts, videotaped interviews with producers of different backgrounds who already use the markets, and question and answer periods, whereby participants at the 135 different downlink locations could telephone questions or send them via fascimile machine.

The program was scheduled from 1 to 3 p.m., Central Daylight Time. There is a little more than an hour difference in time between Lancaster and Madison.

Panelists included Bob Cropp, a University of Wisconsin professor and an Extension specialist in dairy marketing and policy; Janet Troye, vice president of the Coffee, Sugar & Cocoa Exchange Inc., New York, which offers the dairy trading and currently has the largest volume of business; Paul Christ, vice president of dairy planning and analysis at Land 'O Lakes Inc.; and Phil Plourd, a senior marketing specialist at Bliming and Associates, in Cottage Grove, Wis.

The farmers interviewed included John Blaska, Pete Knigge, and Mike Downes. Also shown in a video interview was Larry Lemmenes, president of Alto Dairy, a cooperative that, similar to Land 'O Lakes, offers fixed price forward contracting for its members.

There are currently three different "tools" available for use and one that is being suggested as a least-risk tool for producers.

The three are "forward contracting," "futures," and "options."

With forward contracting, the seller and buyer agree to a price before time, and delivery of product is included.

With futures, the seller and buyer are basically speculating on the prices and there is no delivery of product. However, they do make a cash settlement. It's more like a bet, with one or the other making or losing some money, depending on how closely they came to betting on the right price. This type of speculation is called "price discovery." A seller can offer to sell at any price he or she sets, but if there are no buyers... well, then, there are no buyers.

With options, a producer, for example, can buy an option to sell (put) or buy (take) at a certain price, then if the price comes in lower, he can sell at the higher price. This is considered to be more of an insurance plan, and carries a premium that has to paid (deducted). Again, this is a paper transaction dealing only with speculation and the exchange of cash.

It is not neccesssary to be a dairy producer to be involved, though it appears that the potential to make money by a non-producer is too slim to attract investment speculators.

Under the "futures" catagory there are "milk futures" and, more recently "BFP futures." The BFP futures appears to be the easiest for producers to use.

The way it works is that traders — buyers and sellers — are basically playing a guessing game on paper with what the U.S. Department of Agriculture will determine to be the basic formula price of milk in the future.

Cheese prices, historic trends, consumption and production trends, as well as other potential influences on the BFP can be used to help guess where the USDA will set the BFP.

What happens is that two parties — one a seller and one a buyer — arrive at a contract. The seller offers to "sell" a BFP futures contract at a certain level. The buyer agrees to it and puts up some money.

After the USDA announces the actual BFP, the two parties settle up.

So, if a farmer sells 100,000 pounds of milks on the BFP futures market at $12 per hundredweight (though he doesn't really sell the milk), he is basically guessing that the BFP will come in somewhere close to that.

If the BFP is lower, then the producer who sold that contract will have gained the difference between the lower price he got for his milk and the $12 per cwt. that he "sold" on the 100,000 pounds.

If he sells a BFP contract for $12 and it comes in at $13, then he has lost out on the potential for an extra $1 per cwt. But he still gets the $13 from the actual sale of milk.

Why play around with this side bet?

Because the BFP futures and the cash price for the milk generally go in opposite directions — when there is a higher BFP the producer will get more money in his blended price (which is based on the BFP) from the actual sale of the milk, which is to offset the loss from losing out on the futures contract; while if the BFP comes in lower, the farmer will make a profit on the side bet, which offsets the lower price he will get for actually selling his milk.

Why do all of this? Because the producer does not have control of, or knowledge of, what price he will receive for his milk until after it has been sold and the USDA generates the BFP and the milk plant calculates the milk check.

This side-betting futures scheme can allow a producer to eliminate the extremities in cash flow to the farm due to the wide variations in milk prices.

Forward Contracting

The foward contracting is basically a delivery agreement at a preset price. The cooperatives offering to members use the BFP futures to calculate and estimate the price for milk several months ahead. Then, to lock in some of their operating expenses at a known level, they have started offering to purchase some milk ahead of time through forward contracts.

If the price of milk increases, the cooperative gets milk at less cost, and the producer misses out on the potential to get that extra profit. If the price of milk decreases, then the cooperative has paid more than it may have, and the farmer gets more than he would have.

Forward contracts also have applications for the milk processor. The fluid milk futures are tools designed more for the milk processor.

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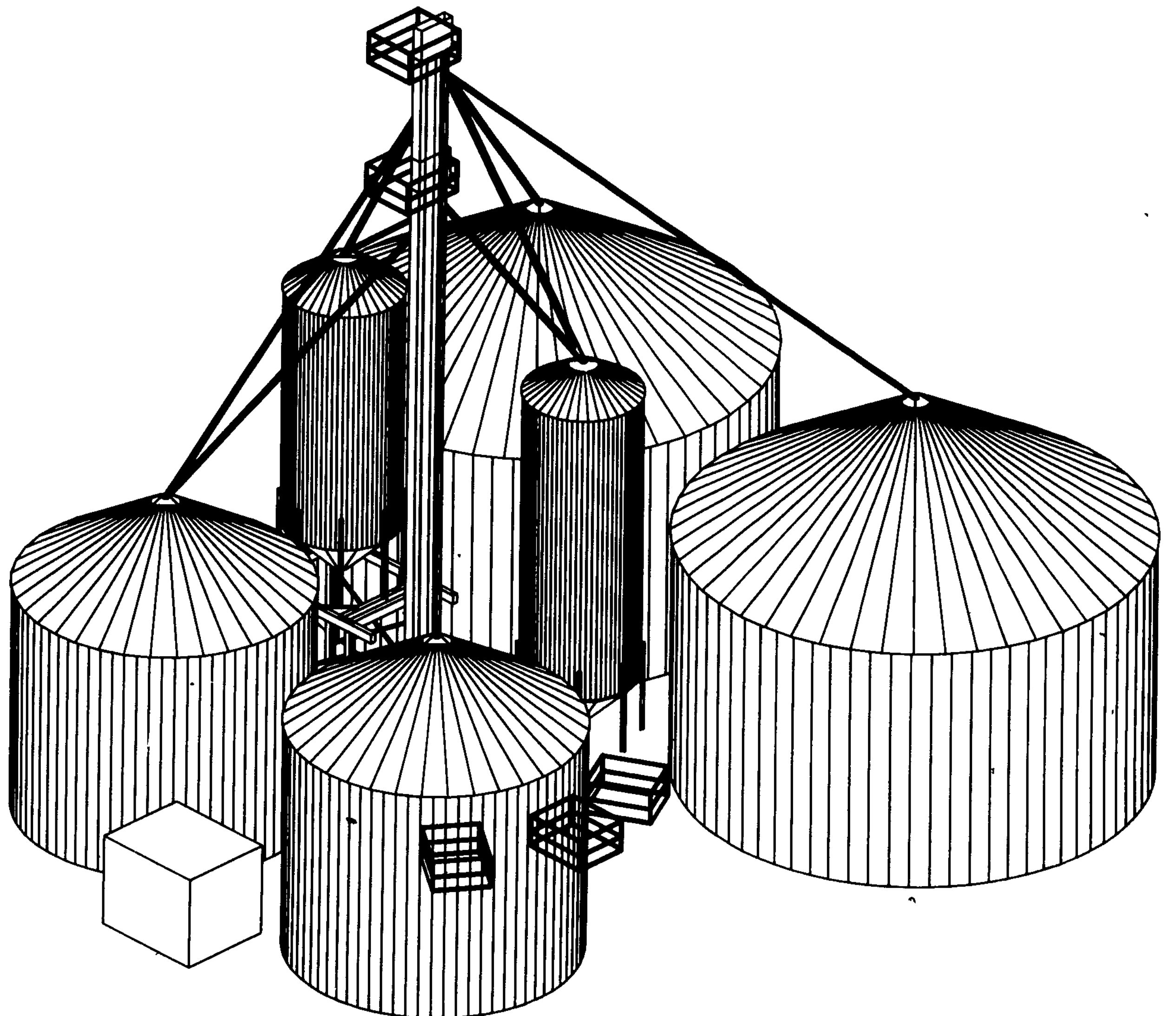

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