

# Agriculture Insights

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**THE LANCASTER CHAMBER**  
OF COMMERCE & INDUSTRY

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## Weighing Your Options

Agriculture is one of the few industries in the world where producers do not know their final selling price until after their goods are sold. This is why farmers are sometimes called 'price takers' rather than 'price makers'. As margins for returns continue to shrink, many farmers are beginning to explore futures markets and hedging as ways to help stabilize their returns. Price volatility and uncertainty are often things that not only producers, but also users of commodities attempt to minimize.

One of the newest players in the commodity free markets is the dairy industry. As the government price support systems begin to be phased out, dairy farmers will need to become aware of their alterna-

tives. For dairy farmers, the practice of using the futures and options markets to protect against low milk prices is known as hedging.

Richard Mollitor, an agriculture risk management specialist at the Chicago Mercantile Exchange, defines hedging as the practice of taking a position in the futures and/or options market opposite to that in the cash market. The opportunity includes locking in profitable selling prices (by selling futures contracts) and establishing a minimum selling price while still allowing you to benefit from a rising market (by buying Put options).

The Put option becomes your insurance against a dramatic downturn in the price of

milk. Just like insurance, you hope you'll never need it but if you do you'll be glad you took the time to figure it out.

According to Mollitor, dairy futures are beginning to gain more widespread acceptance. The biggest challenge is a lack of understanding based on misconceptions of the futures market.

Here is an example from one of Mollitor's actual accounts of how hedging can work for a dairy farmer. On April 1, a dairy farmer buys a June 12 00 BFP Put option for \$ 50 cwt (the cost was \$500 per 100,000 lbs of milk). At the time, the June BFP futures price was 11 67 cwt. The next five weeks saw dairy prices drop

significantly, and by May 7, the June BFP futures were at 10 82. This 85-cent drop (11 67-10 82) was responsible for the farmer's option price increasing to a value of \$1 16 per cwt. On May 7, the Put option was sold at 1 16 to realize a profit of 66-cents per cwt (1 16-50). With a commission cost of \$45 per contract (4 5-cents per cwt) the net profit was 61 5-cents per cwt.

The farmers who understood the market were able to realize 61 5-cents per cwt more revenue than the farmer who chose not to hedge their milk production. As milk supports are eliminated, it will be more important than ever that small to medium sized farms are able to maximize their returns. The need to have a fixed price several months out will eventually supersede the farmers' reluctance and fear of becoming involved

One way some dairy farmers will be able to explore the commodities markets is a pilot program announced by United States Secretary of Agriculture Dan Glickman called the Dairy Options Pilot Program (DOPP). Farmers in selected counties will be offered a financial incentive to use options to manage their price risks. Producers who participate in the program will be trained on how to use the commodities markets also.

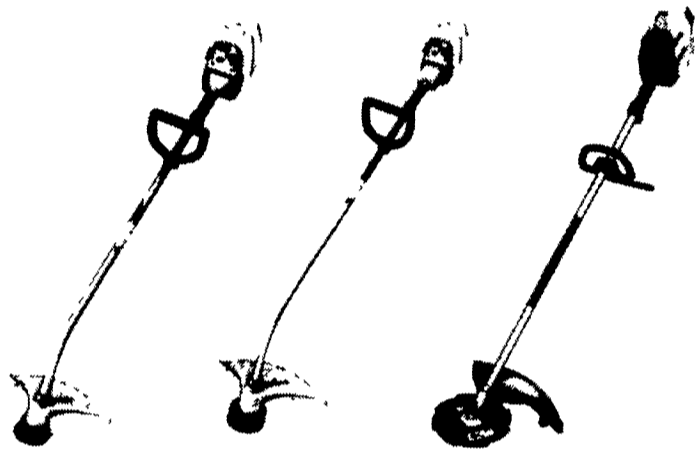
As farmers become exposed

more and more to the ups and downs of a free market economy, futures and options can offer some insurance against a dramatic downturn in the market. They may just keep you and your family on the farm.

Feel free to send your comments and ideas to Jim Shirk at The Lancaster Chamber of Commerce & Industry, PO Box 1558, Lancaster, PA 17608-1558, by email at jshirk@lcci.com or call him at (717) 397-3531.



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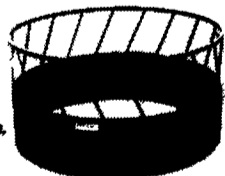
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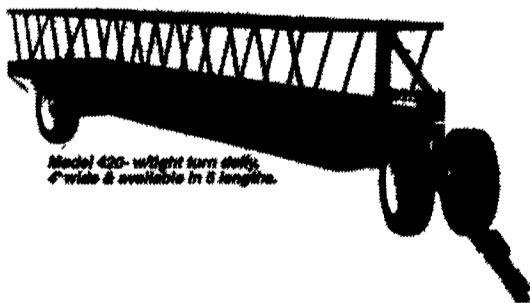
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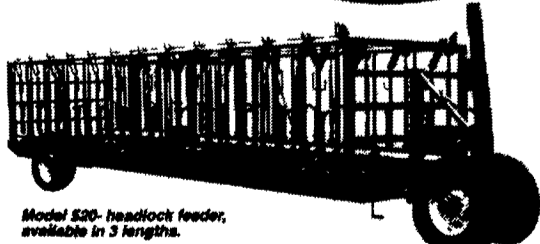
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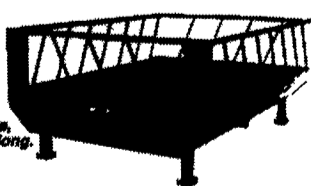
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