ADPI Commentary
Volume I
Issue 3

Dairy Risk Management - 20 Years Later - September 2013

While working with the Task force planning the upcoming joint American Dairy Products Institute and Chicago Mercantile Exchange Dairy Risk Management Seminar I began to reflect on how far we have come since the early days of the modern dairy futures contracts.

During the early 90's the Coffee, Sugar and Cocoa Exchange called a group of us from the industry to New York City to discuss developing dairy futures and options contracts. The big national and international confectioners and bakeries that traded sugar and cocoa on that exchange encouraged them to offer products that would allow them to protect against price volatility in their dairy ingredients. By mid 1993 Nonfat Dry Milk and Cheddar Cheese contracts were rolled out on the exchange. Milk futures and options were rolled out in 1995 and butter followed in 1996.

All of these contracts foundered for lack of liquidity. There was plenty of buy side interest, but dairymen and their cooperatives did not support the new contracts. Even though producers of other agriculture commodities and their organizations had been hedging their crops for over a century, the dairy contracts just couldn't get traction. This was partly due to the involvement of the government dairy support program in establishing milk and commodity prices, and that tended to often dampen price volatility. It was also a politically influenced program and subject to unpredictable changes periodically which could have an adverse impact on future positions being held. Some farm leaders openly worked against the program, characterizing it as mere speculation and gambling with producers' assets. Others feared that a strong futures program would jeopardize the Federal Order Program. The New York CSCE contracts only traded 25 to 40 contracts on a good day, so adequate liquidity was never achieved and the effort eventually failed.

During the fall of 1996 the CME started their program rolling out a delivered butter contract and milk contract. Early on this program struggled as well with inadequate participation resulting in a lack of liquidity. The butter contract struggled for 9 years until September of 2005 when a cash settled contract was introduced. This eliminated the nerve wracking need to go through the clumsy delivery process when it was impossible to get out of short positions before the settlement date and longs were forcing delivery. This contract started trading 100 a day almost immediately which was a huge volume in the dairy complex just 8 short years ago. In my opinion the CME's practice of finding a market maker to post active bids and offers was key to the success of this contract.

Since 1996 the CME has added several more commodities including Nonfat Dry Milk, Class III and IV Milk, Dry Whey, and as recently as June, 2010 a NASS settled Cheddar contract.

The CME dairy program has matured into a tremendously successful means for all phases of the industry to protect them from volatility. In 2005 butter open interest was measured in the 100s of contracts, today combined futures and options open interest are over 10,000. Class III milk range from 50,000 to over 70,000 with another roughly 25,000 futures contracts. Recent Cheddar options open interest was 10,000 with another 9500 futures contracts. Nonfat and whey are slowly ramping up in volume as well. Liquidity is no longer the challenge it was in the past.

Today trading has become quite easy with the advent of electronic trading and 24 hour access to markets. Market information including analysis and forecasting has become much better with several brokers putting out daily, weekly and special reports. The CME website also has a wealth of information.
ADPI and CME have put together a very strong 2 1/2 day Dairy Risk Management Seminar designed to meet the needs of both novices and those more experienced in using financial instruments to address risk. Milk producers, processors/manufacturers and end users will find the program beneficial in helping them run their businesses.

For many years the dairy industry lacked the tools to protect against risk. It has taken the better part of 20 years to develop a program that can be used confidently by a broad spectrum of the industry. Join us in Chicago October 16 to 18 to hone your skills in using these tools.
The author has over 44 years experience and currently is a dairy industry consultant as well as a member of the ADPI Center of Excellence.

Contributor:
Richard Langworthy

"ADPI Dairy Ingredients Commentaries" are contributions by the authors and do not necessarily represent the opinions of ADPI.