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Global dairy commodity prices dropped to multi-year lows in 2015 as supply growth outpaced demand. Strong domestic fundamentals have supported US cheese and butter prices above global prices, but milk powder and whey products have been caught in the downdraft of falling prices in Oceania and Europe. As supply and demand comes back into balance in 2016, dairy prices are expected to start moving higher, although the timing and magnitude are unknown. While each year is different, dairy price volatility is here to stay. As a result, managing dairy price risk is increasingly important for all segments of the supply chain.

In simple terms, managing price risk is about protecting an expected profitable margin. It is not about trading for profit or speculating on market movements. However, a common problem at companies is for the buyer or risk manager to focus on locking in profitable margins while management is concerned about making or losing money on the hedge. For a risk management program to be successful, goals need to be established and agreed to by key stakeholders. In short, a company needs to adopt a risk management philosophy that is aligned with their business needs and risk tolerance. Therefore, it is important to have a risk management policy in place along with a framework on how the process will work.

If a company can pass through commodity cost changes to their customers, then minimal coverage should be taken. But if a company can't pass through commodity cost changes, then a coverage strategy should reflect this risk. To develop a commodity risk management strategy, first start with a perspective on prices in the future. At this time of year, the budget forecast for the upcoming year can be used. Compare the budget prices to what price can be hedged. If a hedge can be executed to lock in a cost at or below the budget, this may be a good opportunity to get some coverage in place. The price should also be compared to historical averages. If prices are near longer-term lows, then more coverage could be taken. Conversely, if prices are historically high, then less coverage could be taken, as there is a higher probability of prices declining.

After the strategy is developed and approved by management, it is ready to execute. A strategy could be for a fixed price using futures, forward contracts, OTC's, or inventory. It could also use options to establish floors, ceilings, or ranges of prices. More sophisticated strategies could combine both fixed price and options coverage. Until the last few years, liquidity was an issue for most dairy contracts at the CME Group. However, since 2013, volume and open interest for all dairy futures and options contracts have grown to a point where a full suite of dairy risk management products are available to buyers and sellers.

While companies in other parts of the world are just learning about dairy risk management, the US dairy industry has over 20 years of experience with risk management tools. Farmers and processors in Europe are experiencing free market price volatility for the first time and are developing tools to manage this risk. New Zealand has a small, but growing dairy futures market, and Fonterra has started offering forward contracts to farmers. For the US, the evolution of the dairy futures markets has introduced some new dynamics into the dairy marketplace as futures and cash markets are becoming more interrelated. At some point, the dairy industry will move to price discovery off futures markets like other agricultural commodities.

Commodity price volatility brings both opportunities and challenges. Companies should develop commodity risk management programs to help mitigate negative financial impacts and better manage margins. It is also important to provide adequate resources and staffing to successfully implement and maintain a commodity risk management program.

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