Description of
Forward Milk Contracting Programs
Available to Wisconsin Dairy Producers

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# Table of Contents

INTRODUCTION......................................................................................................................................... 3
HISTORY THAT HAS LEAD TO FORWARD MILK CONTRACTING PROGRAMS.......................... 3
START OF FORWARD CONTRACTING .......................................................................................... 4
ALTO DAIRY COOPERATIVE............................................................................................................... 5
  MONTHLY FORWARD CONTRACT PROGRAM........................................................................... 5
  ANNUAL FORWARD CONTRACT PROGRAM........................................................................... 6
  MINIMUM PRICE FORWARD CONTRACT PROGRAM............................................................... 7
DAIRY FARMERS OF AMERICA, INC. ................................................................................................. 8
  MONTHLY FORWARD CONTRACT PROGRAM........................................................................ 8
INDEPENDENT COOPERATIVE MILK PRODUCERS, ASSOCIATION........................................... 9
  MONTHLY FORWARD CONTRACT PROGRAM........................................................................ 9
KRAFT FOODS..................................................................................................................................... 10
  FORWARD CONTRACT PROGRAM.......................................................................................... 10
LAND O’LAKES .................................................................................................................................... 11
  MONTHLY FORWARD CONTRACT PROGRAM....................................................................... 11
SWISS VALLEY FARMS....................................................................................................................... 12
  MONTHLY FORWARD CONTRACT PROGRAM....................................................................... 12
  ANNUAL FORWARD CONTRACT PROGRAM.......................................................................... 13
WEYAUWEGA MILK PRODUCTS......................................................................................................... 14
  FORWARD CONTRACT PROGRAM.......................................................................................... 14
SUMMARY............................................................................................................................................ 15
Description of Forward Milk Contracting Programs
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INTRODUCTION

Federal dairy policy has recently undergone a drastic change, which is changing the nature of the dairy industry. One of the largest changes that has come about is volatile farm milk prices. This volatility has increased the challenge of profitably cash flowing a dairy operation. These changes have put into motion risk management tools for dairy producers to take some control of their milk price, which would not have been considered 15 years ago. One of the major tools available is cash forward contracts provided by the milk buyers. These contracts allow producers different options to either establish a milk price for a period on a certain amount of their milk, and/or establish a minimum price for a certain amount of milk for a time period. This paper is designed for the Wisconsin dairy producer to compare different forward milk price contacting programs available.

History that has lead to forward milk contracting programs

From 1950 until 1981, dairy products and, in turn, farm level milk prices were supported at relatively high levels under the federal dairy price support program. As a result, there was little price or market risk in the dairy industry. Since 1981 the federal dairy price support program has been drastically reduced. The support price, which was $13.10 per hundredweight in 1981, was reduced to $10.10 per hundredweight by 1990. The support price in 1998 was $10.05. Absent high support levels, market forces largely determine dairy product and farm level milk prices. The result is increased volatility and uncertainty in dairy product and farm level milk prices (Appendix A). Prior to 1981, government involvement virtually guaranteed farmers a profit, if their cost to produce milk was below the support price. But the change to market-oriented dairy policy has brought about significant changes including lower and more volatile milk prices (increased market risk). Increased market price risk exposure may prevent dairy producers, from obtaining necessary financing for modernization and expansion, because either financial institutions will not take on that type of risk or the interest rate required by financial institutions will become cost prohibitive. This increased market price risk will also continue making the job of operating a dairy harder, creating more erratic swings in cashflow. Consequently, dairy producers interest in contracting a milk price is expected to grow as the industry seeks to address this increased price risk.

Price volatility and uncertainty prompted the industry to seek potential risk management solutions. The dairy industry turned to a time-tested vehicle: futures and options contracts. Futures markets for grains were organized by the Chicago Board of Trade in 1846. The first attempt to establish a futures market in the dairy was by the New York Coffee, Sugar, and Cocoa Exchange (CSCE). (The CSCE merged with New York Cotton Exchange on June 10, 1998, to
form the New York Board of Trade). The CSCE established cheese and nonfat dry milk futures and options contracts in June of 1993. The close correlation between cheese and milk prices led some to believe that producers could use cheese futures and options to protect farm milk prices. These cheese futures contracts could also be used to offer cash forward milk contracts, contracts to lock milk prices in advance, to producers. However, the fact that dairy producers did not understand the inherent link between milk price and cheese price and because the dairy industry, in general, had little understanding of price risk management, resulted in slow acceptance of cheese futures contracts.

Efforts to develop the cheese futures market were also hampered by its delivery mechanism. In most futures markets, only a small number (less than 2%) of contracts actually end in delivery. Most are offset with an opposing trade (i.e. if originally bought then offset with sale and vice versa). Delivery becomes a big concern in markets with little trading activity. The fear: once a position is entered, it can’t be exited. With cheese, fears were particularly acute for dairy producers selling cheese futures to protect against falling milk prices. If producers were unable to offset their position, they would be required to deliver cheese, which could be a challenge for a milk producer. The delivery issue and large contract size (equal to about 420,000 pounds of milk) was too large a hurdle to clear.

**Start of Forward Contracting**

The first cash forward milk contracting program began when Blimling and Associates, a dairy consulting firm in Cottage Grove Wisconsin, received a grant from the Wisconsin Department of Agriculture, Trade and Consumer Protection. The grant was to conduct a pilot study on the use of the cheese futures contracts to offer cash forward contracts to their Wisconsin dairy producers. This pilot study ran from August 1, 1994, through September 30, 1996. Blimling and Associated helped Alto Dairy Cooperative establish a cash forward contract. Although Alto had limited farmers participate in their original program, it proved to be a success because they learned they could use the cheese futures to offer dairy farmers a milk price in advance. Because Alto is a manufactures cheese they didn't have to worry about the delivery mechanism of the contracts, they could deliver cheese if they were unable to offset their position. Their success led other dairy companies to offer cash forward contracts. There are a limited number of private processors offering cash forward contracts. This is due to Federal Milk Marketing Order provisions, which require milk buyers to pay at least the established federal order minimum price to producers. Therefore, if the contract price is less than the minimum federal order price at the time of delivery, the milk buyer is forced to pay the higher federal order price. Dairy cooperatives are exempt from that provision.
Monthly Forward Contract Program

Description

This program allows all members to access bid prices through either a prerecorded phone message or the Internet. The bid prices are monthly base milk prices. The fat and protein premiums, volume premiums, and quality premiums would be calculated for an individual producer the same as on uncontracted milk. **This program allows producers to establish a base milk price for some portion, up to all, of their estimated monthly production.** If a member, who has signed a participation contract to enter into forward contracts, hears a price that is attractive and wants to contract milk, they simply call a designated number and give the appropriate information: month, amount of milk wanting to contract, and the price that was available. Milk that is contracted must be delivered.

Specification

Minimum Pounds: 10,000 lbs. initial and 5,000 lb. increments
Max Percent of Production: 100% of anticipated production for a month
Time Available: as far as BFP contracts are available in futures markets
Price Availability: Prerecorded phone message and Internet
Annual Forward Contract Program

Description

This program allows all members to access bid prices through either a prerecorded phone message or the Internet. The bid price is an annual base milk price. The fat and protein premiums, volume premiums, and quality premiums would be calculated for an individual producer the same as on uncontracted milk. **This allows producers to establish a base milk price for some portion, up to all, of their estimated annual production.** If a member, who has signed a participation contract to enter into forward contracts, hears an annual price that is attractive and wants to contract milk, they simply call a designated number and give the appropriate information, the amount of milk wanting to contract, and the price that was available. Milk that is contracted must be delivered.

Specification

Minimum Pounds: 10,000 lbs. initial and 5,000 lb. increments  
Max Percent of Production: 100% of anticipated annual production  
Time Available: 1 year at a time  
Price Availability: Prerecorded phone message and internet
Minimum Price Forward Contract Program

Description

This program allows all members to establish a minimum price for an amount of milk at a certain cost. The cost of the minimum price depends on several factors, one of the most important is how high the minimum price is. The cost for the different minimum prices can be accessed through either an automated phone system or the Internet. The minimum prices are a monthly base milk price. The fat and protein premiums, volume premiums, and quality premiums would be calculated for an individual the same as on uncontracted milk. **This allows producers to establish a minimum base milk price for some portion, up to all, their estimated monthly production at a certain cost.** If a member, who has signed a participation contract to enter into forward contracts, hears a cost for a certain minimum price that is attractive and wants to contract milk, they simply call a designated number and give the appropriate information: the amount of milk wanting to contract, the cost and minimum price associated with that cost. Milk that is contracted must be delivered.

Specification

Minimum Pounds: 10,000 lbs. initial and 5,000 lb. increments
Max Percent of Production: 100% of anticipated production for a month
Time Available: As far as BFP contracts are available in futures markets
Price Availability: Prerecorded phone message and Internet
Dairy Farmers of America, Inc.
P. O. Box 909700
Kansas City, MO  64190-9700
Phone 888-332-6455   Fax 816-801-6421

Monthly Forward Contract Program

Description

This program allows all members to access bid prices through talking to the appropriate person or a prerecorded phone message. The base price that is quoted to participants is the BFP, and is used in determining gross proceeds prior to deductions. So, a participant’s milk price would be calculated the same as always, however there would be an additional line that would show the gain or loss from the forward contract. This amount would be either added or subtracted from the gross value of the milk shipped that month. **This program allows producers to establish a base milk price for some portion, up to 50 percent, of their estimated monthly production.**

To participate in this program, members must complete a master agreement to indicate they understand the process of forward contracting. Then when a member decides that the price is at a level in which they wanted to contract they would call the appropriate number and state the amount of pounds they want to contract for a particular month and the price level. Then a confirmation will be sent to the participant stating the details of the agreement.

Specification

Minimum Pounds:  20,000 pounds  
Max Percent of Production: 50% of anticipated monthly production  
Time Available: as far as BFP contracts are available in futures markets  
Price Availability: Prerecorded phone message or personal contract
Monthly Forward Contract Program

Description

This program allows all members to access bid prices through either a prerecorded phone message overnight or call during the day. The bid prices are monthly base milk prices. The fat and protein premiums, volume premiums, and quality premiums would be calculated the same as on uncontracted milk. This allows **producers to establish a price for some portion, up to all, of their estimated monthly production**. If a member, who has signed a participation contract to enter into forward contracts, hears a price that is attractive and wants to contract milk, they simply call a designated number and give the appropriate information: month, amount of milk wanting to contract, and the price that was available.

Specification

Minimum Pounds: 25,000 lbs. increments
Max Percent of Production: 50% of anticipated production for a month
Time Available: As far as BFP contracts are available in futures markets
Price Availability: Prerecorded phone message overnight or call during the day
Forward Contract Program

Description

This program allows all patrons to establish a base price for some portion of their milk production in different time windows. The contracts range from one quarter (3 months) to a year in length. The patrons are notified of the bid prices by mail. The prices bid are component values for a base milk price. The producer would still receive the producer price differential (PPD), volume premiums, and quality premiums the same as on uncontracted milk. If a patron sees a price that is attractive and wants to contract milk, they simply complete a contract and mail it to the plant by a designated date.

Specification

Minimum Pounds: None
Max Percent of Production: 20% of anticipated production for the contract period
Time Available: quarterly up to a year at a time
Price Availability: mail
Monthly Forward Contract Program

Description

To participate in this program, members must attend a training session or obtain and watch a video about forward contracting. Then a member may complete a participation agreement to indicate they understand the process of forward contracting. Then these members are giving a password to access an automated phone system to hear the prices being offered for milk for future delivery. If a member decides that the price was at a level in which she/he wants to contract, she/he would complete a fixed price contract and fax it to Land O’ Lakes. This contract would state the amount of pounds being contracted, the contract month, the price, and be signed by the member.

The base price that is quoted to participants is the BFP portion of the milk payment. A participant’s milk price would be calculated the same as always in the contract month with a one-line addition or subtraction, depending on whether the contract price was higher or lower than the final BFP for that month. **This program allows producers to establish a base milk price for some portion, up to 50 percent, of their estimated monthly production.**

Specification

Minimum Pounds: 25,000 pounds  
Max Percent of Production: 50% of anticipated monthly production  
Time Available: as far as BFP contracts are available in futures markets  
Price Availability: Prerecorded phone message
Monthly Forward Contract Program

Description

This program allows all members to access bid prices through talking to the appropriate person(s). The bid prices are monthly base milk prices. The fat and protein premiums, volume premiums, and quality premiums would be calculated for an individual producer the same as on uncontracted milk. **This allows producers to establish a base price for some portion, up to 50 percent, of their estimated monthly production.** If a member, who has signed a participation contract to enter into forward contracts, hears a price that is attractive and wants to contract milk, they simply call a designated number and give the appropriate information: month, amount of milk wanting to contract, and the price that was available.

Specification

Minimum Pounds: 10,000 lbs. initial and 5,000 lb. increments
Max Percent of Production: 50% of anticipated production for a month
Time Available: As far as BFP contracts are available in futures markets
Price Availability: Personal contact
Swiss Valley Farms
21100 Holden Dr.
Davenport, IA 52806
Phone 319-391-3341  Fax 319-391-7479

Annual Forward Contract Program

Description

This program allows all members to access bid price through talking to the appropriate person(s). The price is an annual base milk price. The fat and protein premiums, volume premiums, and quality premiums would be calculated for an individual producer the same as on uncontracted milk. **This allows producers to establish a price for some portion, up to 50 percent, of their annual production.** If the member, who has signed a participation contract to enter into forward contracts, hears an annual price that is attractive and wants to contract milk, he/she can simply call a designated number and give the appropriate information, the amount of milk wanting to contract, and the price that was available.

Specification

Minimum Pounds: 10,000 lbs. initial and 5,000 lb. increments
Max Percent of Production: 50% of anticipated annual production
Time Available: One year at a time
Price Availability: Personal contact
Forward Contract Program

Description

This program allows all patrons to establish a base price for some portion of their milk production in different time windows. The contracts range from one quarter (3 months) to a year in quarter increments. The patrons are notified of the bid prices on their monthly milk check pay stub. The prices bid are component values for a base milk price. The producer would still receive the producer price differential (PPD), volume premiums, and quality premiums the same as on uncontracted milk. If a patron sees a price that is attractive and wants to contract milk, they simply complete a contract and mail it to the plant by a designated date.

Specification

Minimum Pounds: None
Max Percent of Production: 20% of anticipated production for the contract period
Time Available: quarterly up to a year at a time
Price Availability: mail or phone
Summary

The above programs have many similarities. Most all are bidding a base milk prices and some are multiple component prices. All programs allow producers to receive the quality and volume premiums beyond the price being quoted. Those programs with base bid prices provide for producers to get paid for their individual component values at their market price at the time of delivery. The multiple component price bids, however, set the value of components for the time period specified in the contract.

The growth of forward contracting is continuing and it is expected that more programs like these will develop. These programs are all a start and are expected to evolve as the industry develops new and different ways to contract milk with producers. Before signing a contract to price your milk producers should ask question to be sure they understand what part of their milk price is included in the bid price and what part is not included.