



United States House of Representatives
House Committee on Agriculture
Subcommittee on Livestock, Dairy, and Poultry
Witness Statement of
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President
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Cottage Grove, WI
July 21, 2009

Mr. Chairman and members of the Committee, thank you for inviting me to appear before you and participate in this important, ongoing discussion of current conditions in the dairy marketplace.

I am president of a pair of Wisconsin-based firms that work extensively with producers, processors, end-users and other interested parties on a variety of dairy market issues. Specific to this discussion, our firm has been a leading provider of market-based risk management services for dairy producers for more than 15 years. Indeed, in 1994, working in partnership with Alto Dairy Cooperative and the Wisconsin Department of Agriculture, Blimling and Associates introduced what is believed to be the nation's first futures-based forward contracting program for members of a dairy cooperative. Today, we administer a total of ten similar cooperative/plant programs from coast-to-coast. Those programs theoretically serve more than 10,000 farms – many located in the districts or home states of the distinguished Committee members.

I say “theoretically serve” because the reality is that only a comparatively small percentage of producers actually use these tools to hedge – whether on their own, through the programs we manage, or via programs managed by others. This is unfortunate on many levels, not only for the individual producers themselves but for the dairy industry at large.

And, it is curious.

Reasonably well-developed futures and options markets exist at the Chicago Mercantile Exchange Group (CME). While not to be confused with the corn or crude oil markets, the dairy markets have come a long way since their inception in 1993. Last year a total of about

470,000 Class III milk futures and options contracts traded at the CME; ten years earlier, in 1999, only 58,000 contracts traded.ⁱ Volume in 2008 equaled approximately one-half of US milk production. Class III milk futures and options combined open interestⁱⁱ stood at about 79,500 contracts on June 30, equal to about 8% of annual US milk production. In addition, there is also a small but growing marketplace in over-the-counter instruments for managing dairy risk that are not traded through the CME.

Beyond the development of markets over the past decade, great strides have been made in facilitating dairy producer access to the tools. Forward contracting programs like those managed by our firm are fairly common. Though I cannot say for certain, I estimate that at least 15 of the 25 largest US dairy cooperatives offer programs. In addition, thanks to a laudable provision of the last Farm Bill, several proprietary plants offer programs. While not every program is identical, they tend to share basic characteristics. Most notably, they allow smaller producers to access risk management tools because forward contracts are offered in increments smaller than the futures contracts traded at the CME (the plant or cooperative bundles milk forward contracts for sale in the futures market or to customers via a price for finished products). In addition, producers using a forward contracting program are not required to post margin monies as would be required if they were using futures directly in their own account. In short, many – and perhaps a majority – of producers have a mechanism available to contract milk with their cooperative or proprietary plant in much the same way grain producers can forward price corn, soybeans or wheat with a local elevator.

Finally, while the milk and dairy products markets are certainly volatile, they do not stand out among their peers in the agricultural arena. That is, standard calculations do **not** show dairy markets to somehow be so volatile as to in some way preclude risk management via traditional methods employed by producers of other agricultural commodities. For example, we calculate that 30-day historic price volatility in the block cheddar cheese market averaged 27.6% from 2006 through 2008. It was 26.5% in the Class III milk futures market over the same period. That compares with corn at 40.1%, wheat at 44.8%, soybeans at 35.0%, lean hogs at 36.8% and live cattle at 19.2%.ⁱⁱⁱ The dairy markets are not exceptionally volatile – at least as conventionally measured.

So: dairy futures and options markets exist. Convenient dairy producer access to those markets has been facilitated by forward contracting programs. And, volatility in the dairy complex is not wholly divergent from volatility in other domestic agricultural markets. Yet comparatively few dairy producers are using risk management tools.

What's going on?

For several years, I believed the slow adaptation rate was largely a function of experience – or the lack thereof. After all, dairy market volatility only really emerged in the late 1980s. Up to that point market-based risk management was not a concern for producers or anyone

else in the dairy industry. Sure, grain farmers hedged in larger numbers, but they had a 100-year head start. I must confess that, in less confident moments, I wondered if we were just somehow lousy teachers. We crisscrossed several states talking about risk management and forward contracting programs, conducting workshops for or visiting with literally thousands of dairy producers...and only a small percentage came on board.

More recently, however, I have reached a different and more plausible conclusion: in my opinion, producer risk management efforts are seriously hampered by the various and complicated systems employed to price milk in the United States.

Consider how corn producers typically manage risk. They look at futures prices. They call the local elevator for a quote. Elevators offer fixed-forward prices at the futures value plus or minus a local basis^{iv}. Producers agree to the price. When the time comes, they ship the corn and get paid the forward contract price.

Now consider how different the process is for a dairy producer in, say, Chairman Scott's home state of Georgia. The producer sees a Class III futures price of \$14.50/cwt posted for January 2010. He or she may be offered that Class III value as a "base price" via a cooperative. Here's the rub: dairy producers in Georgia are part of the Southeast Federal Milk Marketing Order. Typically, in that order, 60% of a producer's income is tied to the Class I price – which can be the higher of a base price determined by the Class III or IV formula set a month in advance plus a Class I differential zoned across the order; 10% of income is tied to the Class II price, which is based on an advanced skim value linked to the price of nonfat dry milk over a two-week period plus a Class II differential as well as butterfat related to a butter price for the entire month plus a fixed Class II differential; 20% of income comes from Class III, which is determined by the cheese and whey markets; and, finally, 10% of income is drawn from Class IV, which is again linked to nonfat dry milk and butter. On top of all that the producer finds plant and marketing agency premiums as well as volume, quality and hauling adjustments. Against that backdrop, it is difficult to know exactly what the \$14.50/cwt Class III futures price means to the dairy producer in Georgia.

Believe it or not, there is actually a pretty strong correlation between producer pay prices in Georgia and the Class III price that can be hedged in the futures market or via a forward contracting program. It would work. If we had an hour or two I could break out the spreadsheets, but unless you are one of the few dairy marketing professionals in this country who actually know all about the regulated milk prices and constantly changing premiums discussed in the previous paragraph, who would believe that at a glance? Who could?

Grain farmers would almost certainly hedge less, too, if confronted with a maze of pricing tied to whether the bushels they send to the elevator go into corn syrup versus corn flakes, creamed corn in a can versus frozen niblets in a bag, bulk poultry feed versus a fifth of corn

whiskey.

It has been our anecdotal observation over the years that dairy producers in areas with significant cheese production are more likely to hedge than producers in areas with more diverse milk product utilization. Producer hedging, in other words, is more widespread in Wisconsin, Minnesota and Idaho than in Pennsylvania (high Class I and II) or California (an entirely different pricing system and a lot of nonfat dry milk and butter in the pricing pool). Producers are more inclined to hedge when they can readily connect the Class III hedging mechanism with their milk check. This is not to say that a dairy producer in Northeastern Wisconsin has as easy-to-understand a hedging mechanism as his or her neighbor marketing soybeans. But it is closer.

Importantly, those producers who can make the connection and do hedge have significantly reduced their income variability in recent years. This was demonstrated by data included in the testimony offered by Mr. Kruse of Blue Bell Creameries last week. It is supported by our own internal studies of producer risk management performance. We have clients today who are receiving \$17 or \$18 per hundredweight for milk hedged last summer; some will be in the \$15 to \$16 range for the second half of this year based on marketing decisions made in February and March. This compares to base prices of \$10 per hundredweight that their neighbors are receiving.

The existing vehicles work; the road, however, is twisting and rutted.

Overall, it is my sense that we are in the murky middle so far as producer risk management is concerned.

We are trying to convince producers to use modern, market-based risk management tools; but they are compelled to do so in an antiquated, complex pricing system. We speak about trying to reduce volatility on a macro, market-wide level but underestimate the likelihood that micro, individual level volatility reductions would be far easier to achieve if the US milk pricing system were simplified in a manner that would allow traditional futures and options markets to thrive and foster the greater use of forward contracting.

The inherent challenges, I might add, are not limited to the producer community. Processors and end-users face myriad dairy risk management challenges as well – challenges that are also largely a function of the pricing system. For example, it is much more straightforward for a pizza maker to hedge the cost of wheat used to make dough flour than it is for a pizza maker to hedge the cost of cheese.

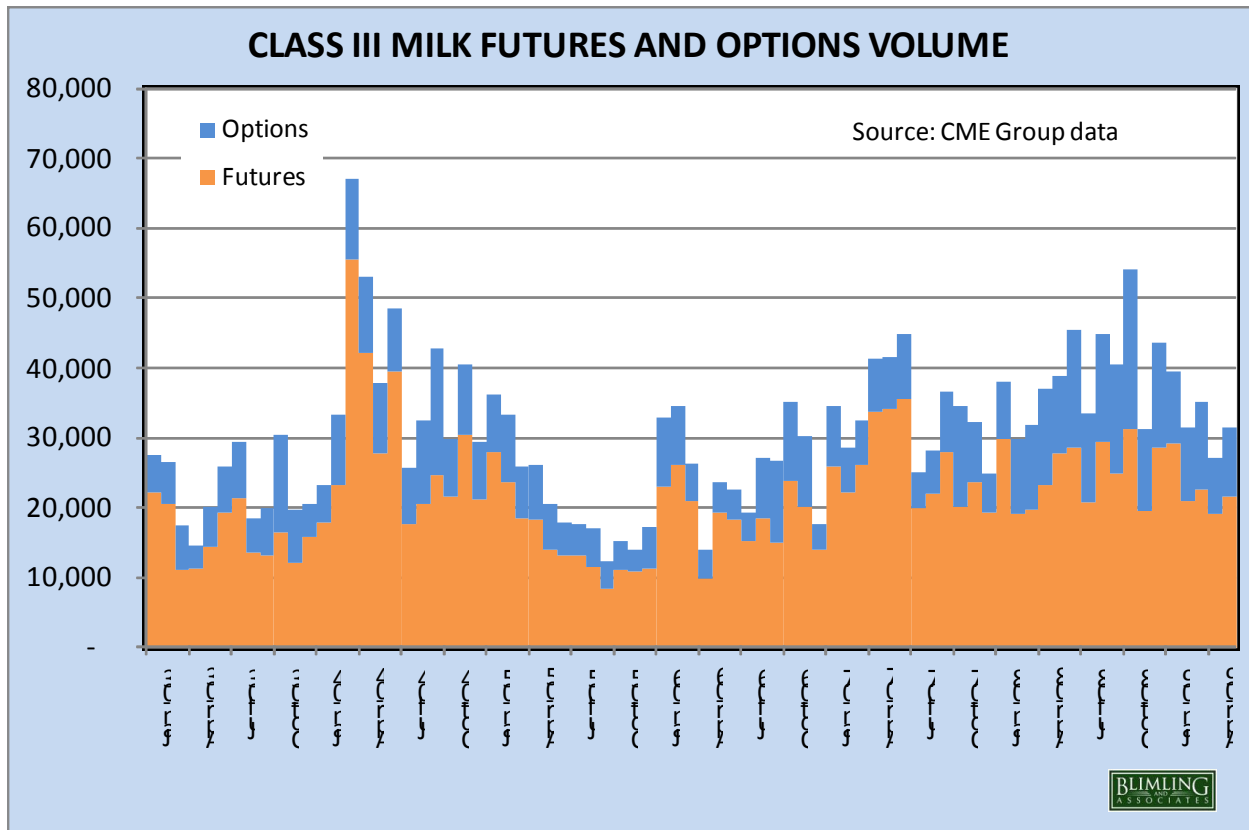
This is not a call for wholesale deregulation. Yes, that would definitely force the issue. Yet similar results could be achieved by making a conscious effort to align policy prescriptions with risk management realities. It boils down to some simple questions. Such as: if we

adjust policy in a particular direction, are we increasing or decreasing a producer's ability to manage risk via conventional methods? Or, perhaps more productively: how can we construct a pricing system that makes managing risk straightforward?

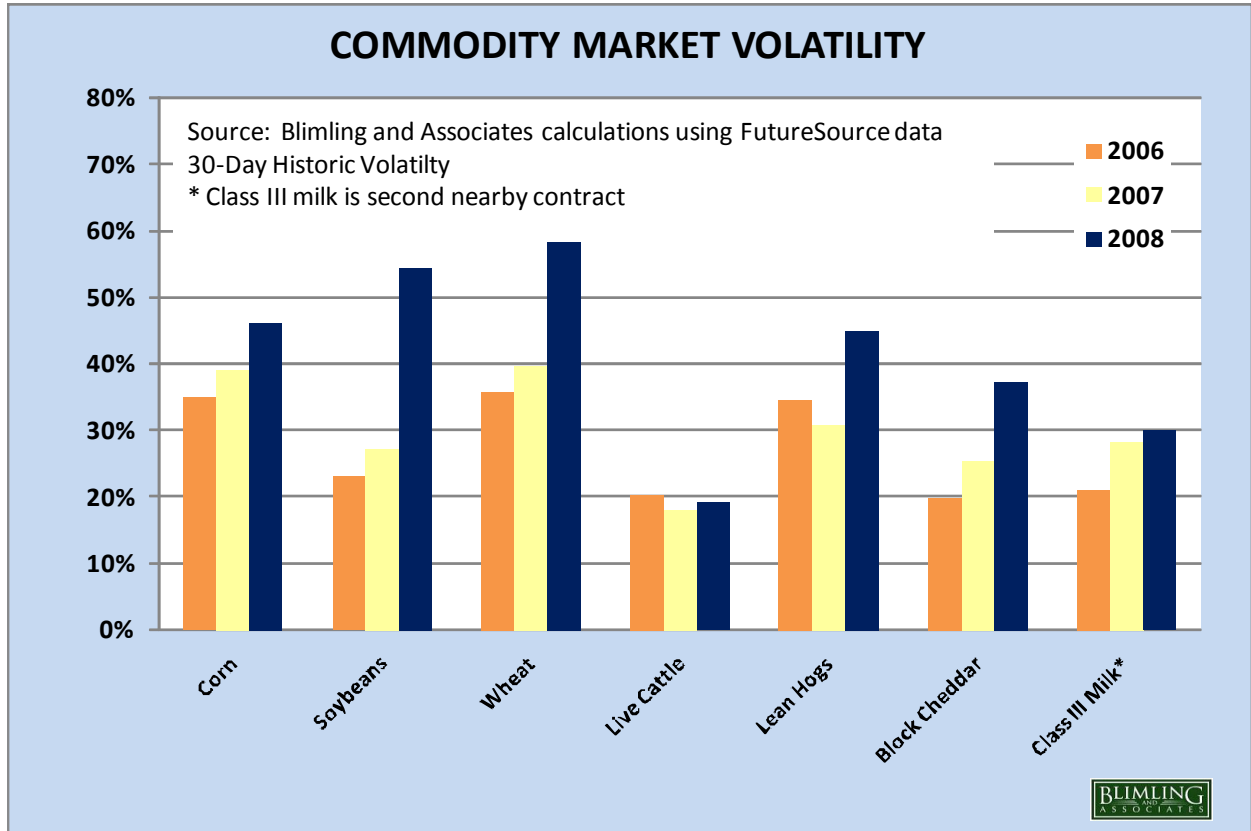
Our dairy producers deserve better than the pricing complexity that confronts most of them every day. US dairy farmers are the most dynamic producers in the world. They achieve the amazing day after day. Many understand how hedging works. It is my belief that they would be better served by a system that allows them to make it happen.

Thank you.

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ⁱⁱ *Open Interest* is a measure of market liquidity. It represents the number of contracts that have been entered into but not yet exited. For example, if two parties enter into a new futures market contract – one as a new buyer, one as a new seller – their activity generates one lot of open interest.



^{iv} *Basis* refers to the difference between a local price and a central market price. For example, corn in Eastern Iowa may be trading at $-\$0.03/\text{bu}$ relative to the CME Group corn futures price.