

The Farm and Risk Management FOCUS

A University of Wisconsin – Extension FARM Program Team Publication

October 2005

Inside This Issue

- 1 Greetings from the FARM Program Team
- 2 Call for Farm and Risk Management Articles
- 2 Focus on Milk Markets
- 3 Focus on Grain Markets
- 5 Focus on Cattle Economics
- 5 Upcoming FARM Program Team Educational Events
- 6 Focus on Ag Law
- 7 Focus on Farm Management
- 10 Focus on Risk Management

Greetings From The FARM Program Team!

On behalf of the UW-Extension Farm and Risk Management (FARM) Program Team, I would like to welcome you to the first issue of the Farm and Risk Management FOCUS! The FOCUS was developed by the UW-Extension Farm and Risk Management (FARM) Program Team. The purpose of the FOCUS is to supply Wisconsin farm managers, advisers and stakeholders with pertinent information on a variety of farm and risk management topics.

The FOCUS will be published three-times per year. Each edition will contain articles concerning commodity market news and analyses, agricultural law issues, farm and risk management research summaries or farm and risk management idea integration and/or idea synthesis articles. The FOCUS will also inform its readers of upcoming FARM educational programming events.

In this issue, three of our UW-Extension commodity market specialists – Ed Jesse, Rami Reddy, and Brenda Boetel – will share their views on the dairy, crop and livestock commodity markets. Phil Harris discusses the legal aspects of fencing. I present a summary of research I conducted concerning the effect of government income on Wisconsin dairy farm financial performance, and Kevin Bernhardt discusses some common misconceptions about price risk management.

The FARM Program Team hopes you enjoy this and all future editions of the FOCUS!

- Gregg Hadley
FARM Program Team Co –Leader
FOCUS Co-Editor

Call for Farm and Risk Management Articles



Are you a UW-Extension county agricultural agent or specialist? Have you recently completed an interesting farm or risk management research project, developed a unique farm and risk management educational program, or thought of a new way to look at farm and risk management? The FOCUS would like to hear about it!

The FARM Program Team would like to invite their UW-Extension colleagues to submit articles concerning farm and risk management research, education, or idea/program synthesis and integration. All articles will be peer reviewed by both UW-Extension county and state specialist faculty. If interested, please contact Gregg Hadley at gregg.hadley@uwrf.edu or 715-425-3188.

Focus on Milk Markets with Ed Jesse

All in all, 2005 is shaping up to be a good year for Wisconsin dairy farmers, certainly better than expected early in the year.

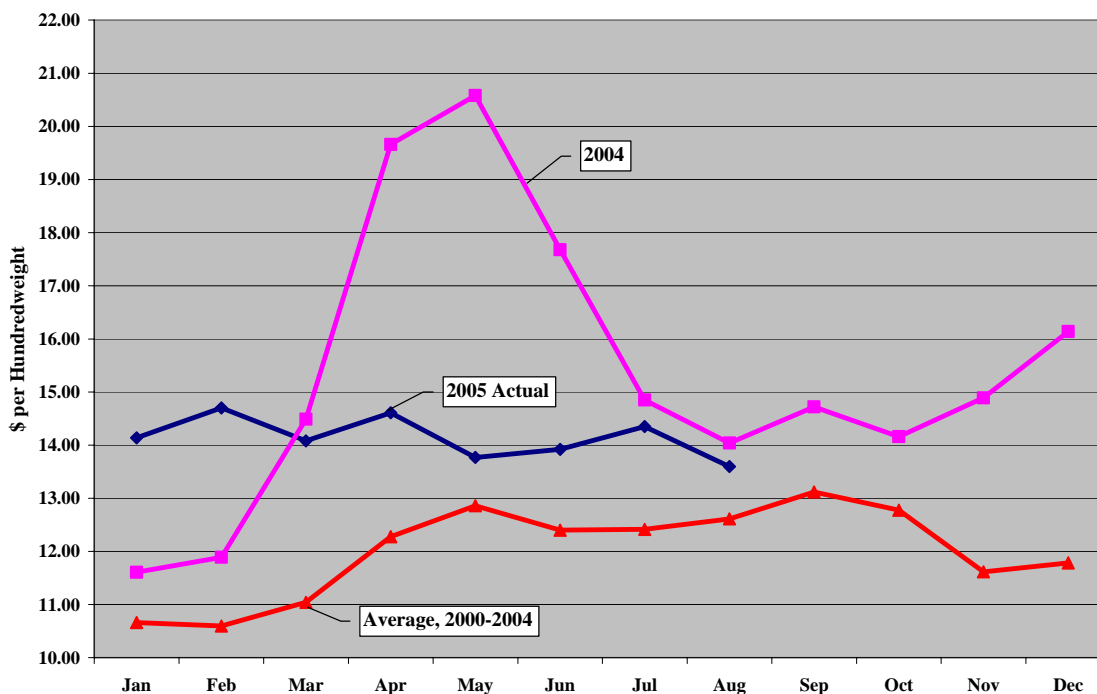
Milk prices have been strong through mid-year (**see chart, pg 3**). While falling short of record 2004 levels in most months, the Class III price through August has averaged \$2.29 per hundredweight over five-year same-month averages. Using current futures as a guide, the annual average Class III price will break \$14.00 in 2005, which would be only the third time this has happened. Expect the Wisconsin all milk price for the year to average around \$15.50.

Prices in 2005 have been unusually stable. The high-low Class III range through August was only \$1.10 compared to \$8.97 in 2004 and an average \$4.64 since 1995.

Milk prices remain strong despite recent large gains in milk production. Second quarter 2005 U.S. milk production was up 4.5 percent from 2004, with more cows (+32,000 in July compared to year-earlier) and more milk per cow (+80 pounds). Within the national picture, Wisconsin is more than holding its own. Second quarter Wisconsin milk production was up 4.8 percent from last year. July 2005 cow numbers in the state were down only 4,000 from last July and milk yield was up 95 pounds per cow. Wisconsin is on track to produce 22.5-23.0 billion pounds of milk 1n 2005 compared to last year's 22 billion pounds. This is good news for the state's dairy plants, who need larger volumes of milk to operate more efficiently.

Markets have clearly been able to absorb the added milk in 2005. Spurred by lower prices for dairy products compared to last year, commercial disappearance has been solid, gaining 2 percent over 2004 for the second quarter and 1.6 percent for the first six months. Some of the additional milk is also going into replenishing depleted inventories. Butter stocks at the end of July were down 10 percent from 2004 and cheese inventories were down 4.5 percent. Manufacturers' stocks of nonfat dry milk were down 27 percent, and the huge government stocks of nonfat dry milk from two years' ago are nearly gone because of very attractive export opportunities for powder.

Class III Milk Price



Ed Jesse is a Professor of Agricultural and Applied Economics at the University of Wisconsin-Madison and the University of Wisconsin-Extension.

Focus on Grain Markets with Rami Reddy

The production season for corn and soybeans from May till now can be characterized as volatile during summer months (May, June, and July) and most recently (August till now) with declining trend in the prices. Currently, the prices are low for both corn and soybeans. As harvest is progressing and expected to reach full scale in a few weeks the market has not seen seasonal lows, yet. Historically, in a high production year, around this time of the year, prices will move sideways and later down as harvest nears completion in Midwest states.

From the beginning of production season information regarding farmers intentions of planted acres, weather situations such as drought conditions, pests and disease problems such as Asian rust, USDA crop conditions reports and world supply/demand estimates etc., have made grain markets volatile. Hurricane Katrina severely affected the trade flows and led to low prices for grains at various local markets.

The short-term fundamental outlook for soybeans and corn is weak. High carryover stocks, anticipated higher production in 2005/06 crop year, lack of storage, slower grain movement through export pipeline, and high energy prices are reasons for this bearish sentiment.

Fears of inflation, low dollar exchange rate, increase in use of soy oil for bio-diesel production, more ethanol and feed usage for corn, low world carryover stocks and high export demand, may support the prices. After hurricane Katrina's effect, the latest weekly export sales reports are indicating return to normal levels and export movements are getting restored. There was no significant loss of trade to competing countries such as Brazil and Argentina in the aftermath of the hurricane. Following the harvest, once the crop size is known, the prices react more to the demand side factors. This year the expectation is that the demand side will stay strong during the post-harvest season.

Summer months offered significant pricing opportunities for both old and new crops. In summer months (May, June, July and August) significant price rallies occurred and prices reached levels that provided several opportunities for producers to make cash or forward sales of old crop. The harvest time futures price for corn (December contract) and soybean (November contract) reached their high levels. These summer price levels have given hedging and forward pricing opportunities for new crop. December corn futures prices have reached as high as \$2.70 levels in July and are currently trading around \$2.07. November soybean futures prices have reached as high as \$7.70 levels in late June and are currently trading around \$5.74. Cash prices were also strong during this same time period.

The focus this month, October, will be on the size of the corn and soybean crops. The USDA estimates peg the production at high levels. This means higher carry over stocks from 2005/06 into next year with low prices prevailing during this year.

Wisconsin corn production for 2005/06 year is estimated at 380.80 million bushels with an average yield of 136 bushels per acre. This crop is going to be 7.6% greater than previous year that has received an average price of \$2.00 per bushel. For soybeans, WI crop production during this year is estimated around 56.52 million bushels with an average yield of 36 bushels per acre. This crop is going to be 4.2% higher than previous year that has received an average price of \$5.20 per bushel.

Both the crops have matured early this year triggering early harvest. Due to early maturity, the quality of beans is going to be a concern this year. During 2005/06 harvest period, high energy costs and extremely low cash prices will subject many WI producers to cost-price squeeze.

Currently, the cash prices are low for both commodities. Corn cash prices are around \$1.50-\$1.60 at most of the local markets in WI. These prices are below the loan rate of \$1.88 for corn and most of the PCP's (posted county prices) are below this loan rate with significant LDP (loan deficiency payments) opportunities. Soybean cash prices are around \$5.30- \$5.40 per bushel.

In most of the WI markets basis levels were weak compared to the historical levels. The basis is expected to become much weaker until the middle of the October. Post-harvest prices will follow a normal seasonal pattern with significant basis improvements. The distant futures prices are indicating to good storage returns.

Right now the best approach to market crops is to utilize LDP's or non recourse loans for immediate cash needs and put the crops in storage. Wait till spring for the basis improvements. During storage period you should use hedging to protect storage returns.

Rami Reddy is an Assistant Professor of Agricultural Business at the University of Wisconsin-Platteville and the University of Wisconsin-Extension.

Focus on Cattle Economics with Brenda Boetel

The border to Canadian cattle was opened on July 18, 2005, and there has been less downward price pressure than previously expected, and it will probably continue to be small in the coming months. The small impact is likely due to the following reasons. First, keep in mind that Canada has increased their packing capacity and is now nearly self-sufficient. Although the border was closed to cattle for over two years, beef continued to come across in the box. This implies that Canadian producers had maintained some semblance of the US market. Second, the Canadian dollar has grown stronger, relative to the U.S. and freight costs have increased, limiting Canadian imports into the US. Third, Canada will likely maintain a cost of gain advantage relative to the U.S. due to abundant feed supplies, again limiting imports into the US. Finally, although the border is open, it does not mean that Canadian cattle can freely move across the border. There are special import forms to be completed and filed and many new regulations to follow. Fed cattle coming across must go straight to the slaughter facility. Feeder cattle must move directly to a feedlot, which in turn can be the only feedlot of residence prior to harvest. The new regulations can be found as the following website:
<http://www.aphis.usda.gov/lpa/issues/bse/bse.html>.

On the other hand, downward price pressure will occur if US export markets do not expand. Domestic demand is no longer increasing, whereas supply will soon be increasing due to the larger calf crop, more cattle on feed, and heavier weights. Non-increasing demand implies that packers will no longer be able to increase beef prices so as to maintain the required margin, and the increased supply implies that packers will have more choice in their inputs. According to James Mintert from Kansas State University, beef supplies are expected to rise by about 6 to 7 percent over the next 12 months compared to the previous 12 months. Finished steer prices are expected to average about \$82 compared to over \$86 in the past 12 months. Calf prices are expected to be lower as well.

Brenda Boetel is an Assistant Professor of Agricultural Economics at the University of Wisconsin-River Falls and the University of Wisconsin-Extension.

Upcoming FARM Program Team Educational Events

The Management Assessment Center for Dairy Farm Owners and Managers: Dairy farm owners and managers participate in fun activities where they are assessed in nine business management attributes deemed critical to dairy farm management. The results are used to determine professional development activities for the participant to engage in to help improve their management acumen. The Assessment Center will be held at Luther Park in Chetek, WI on November 8 and 9. The registration fee is \$50, which includes lodging and meals. Interested parties should visit <http://cdp.wisc.edu/MAC.htm> for more information.

Crop/Livestock Insurance and Crop, Livestock and Milk Marketing In-Service: This is a professional development activity sponsored by the UW-Extension FARM Program Team for UW-Extension personnel, farmers, agricultural business personnel, agricultural lenders or anybody that would like to learn more about crop/livestock insurance and agricultural commodity marketing. This in-service will be held on November 17 at the Portage County Extension Office from 10:00 – 3:30 PM. Interested parties should contact Kevin Bernhardt at 1-608-342-1365.

AgVentures Building a Vision for Beginning Farmers: The UW-Extension FARM Program Team and DATCP's Farm Center will be hosting two workshop series for beginning

farmers. The AgVentures Building a Vision for Beginning Farmers program assists participants in developing financial analysis, strategic planning, mediation and negotiating skills. The 3 day workshops will be held in Barron County at Rice Lake on January 25, February 15, and March 1, 2006 and in Clark County at Thorp on February 1, March 1, and March 15, 2006. Interested parties should contact their local agent, Jenny Vanderlin (jmvander@wisc.edu, 1-608-263-7795) or Gwen Garvey (gwen.garvey@datcp.state.wi.us, 1-800-942-2474) for more details.

Focus on Ag Law with Philip E. Harris

When livestock producers in Wisconsin and those who occupy land next to them have a conflict, they need to know their rights and responsibilities regarding building and maintaining fences. Wisconsin law is similar to the law in most states in the eastern half of the United States. In those states, the general rule is that livestock owners have a duty to use reasonable care to keep their livestock fenced-in. However, there are some exceptions to those rules that affect livestock owners and their neighbors.

Fencing-In Rule

The general fence rule in Wisconsin requires livestock owners to use reasonable care to keep their livestock fenced-in. If they breach that duty of reasonable care, they can be held liable for damages caused by their livestock. To collect from the livestock owner, the victim of the damage must prove that the landowner did not use reasonable care to keep the livestock fenced-in, that the lack of reasonable care caused the damage, and the amount of the damages.

Stating the general rule another way, if a livestock owner uses reasonable care to fence in livestock, then he or she is not liable for damages caused by the livestock. For example, consider damage caused by Abe's cows when a thunderstorm frightened them and they bolted through the fence, ran down the road and onto Barb's property (which is not adjacent to Abe's property) where they trampled her sweet corn. Abe had maintained good fences, checked his cows daily and rounded them up as soon as he knew they had escaped. In that case, Abe is not likely to be liable for the damage to Barb's sweet corn even if she can prove the amount of the damage because Abe used reasonable care to keep his cows fenced-in.

Exceptions

Wisconsin statutes provide two exceptions to the general rule. One is for damage caused by certain livestock and the other is for damage done to neighboring property when the neighbor failed to maintain a partition fence.

Certain livestock. Under the first exception, owners of stallions over one year old, bulls over six months old, and boars, rams, and billy goats over four months old are liable for damages they cause if they escape regardless of how much care the owner used to keep them fenced-in (Wis. Stat. §172.01). Under Wis. Stat. §90.04, the construction of a lawful partition fence does not relieve the owner of swine, horses, sheep or goats from liability for any damage they commit upon the enclosed premises of an adjoining owner. If Abe had a bull that escaped during the thunder storm instead of cows as in the previous example, he would be liable for any damage Barb could prove was caused by his bull.

Neighbor's duty. The second exception to the general rule is not as straight forward as the first. This exception says that the owner or occupant of land next to the livestock owner cannot claim damages caused by the livestock if:

1. The neighbor of the livestock owner failed to maintain a legal fence on his or her half of the boundary line, and
2. The livestock escaped as a result of that failure.

This exception to the rule that livestock owners must keep livestock fenced-in is part of another rule that requires landowners to maintain half of the fence between their land and the neighbor's land if the land on either side is used for to raise crops or graze livestock. The purpose of this second rule is to remove the incentive for landowners to wait until all of their neighbors have built fences and then use those fences to keep their own livestock in. Details for this exception such as how the fence is divided between the landowners and the definition of a legal fence are included in Chapter 90 of Wisconsin Statutes. To illustrate this rule, assume that Carl neglected to maintain his share of the partition fence between his land and the land of his neighbor, Diane. Diane's cows escape through a hole in Carl's portion of the fence and cause some damage on Carl's land. Carl cannot recover damages from Diane.

Note that this exception applies only to the neighbor next to the livestock owner. The livestock owner's duty to others is not affected. If Diane's cows escaped through a hole in Carl's fence and ran across Carl's land onto Edith's land, Diane could be liable for damage to Edith's property.

Conclusion

Good fences are necessary to prevent damage by livestock. Wisconsin statutes require livestock owners to keep their livestock fenced in but also impose a duty for maintaining fences on owners of neighboring property.

Phillip Harris is a Professor of Agricultural and Applied Economics at the University of Wisconsin-Madison and the University of Wisconsin-Extension.

Focus on Farm Management

Government Income Payments and Wisconsin Dairy Farm Financial Performance

2002 - 2004

by

Gregg Hadley

The federal, state and local governments play very important roles in our agricultural industry. Examples of how the government assists agriculture include (among others) financially assisting beginning farmers, chartering and providing oversight protection for the farm credit system, helping underwrite crop insurance programs, assuring the availability of market information, subsidizing commodity exports, and providing price support to farmers when market conditions are poor. With the upcoming Farm Bill about to be debated, I thought it important to examine just how government income payments, cash directly received by the farmer from government programs, has affected the financial performance of Wisconsin dairy farms.

To do this, the financial records of the Wisconsin dairy farms enrolled in the UW-Extension's and the Center for Dairy Profitability's Agriculture Financial Advisor (AgFA)

program were examined. The AgFA program generates financial statements and financial performance analyses for participating Wisconsin farms. Between 2002 and 2004, there were on average 670 dairy farms participating in AgFA (Table 1). These farms had a three-year average size of 123 cows and 359 grain and forage acres.

In 2002, the average milk price received by the AgFA farms was \$12.75 per hundredweight and the average price that Wisconsin farmers received for corn was \$2.22 per bushel. The AgFA farms generated \$377,855 in total farm income. Of this, 5.57 % – \$21,590 – came from government income payments. This amount was equivalent to 59.49 % of the average AgFA farm's family living expenses. In 2003, the below average market conditions in the dairy industry again caused government income to be an important source of funds for the AgFA dairy farms. Government income payments comprised 6.70 % – \$29,032 – of the typical farm's total farm income, which was equivalent to 69.47 % of the average family living expenses. In 2004, the average dairy price went up to \$16.72 per hundredweight, but the average corn price received decreased to \$2.00 per bushel. In 2004, government income dropped to 2.38 % of total farm income, or an average of \$13,133 per farm, because milk income is generally larger than grain income on these AgFA dairies. This amount was equivalent to 28.99 % of the typical AgFA farm's family living expenses. Thus, even in the high milk price year of 2004, government income payments comprised a significant portion of total farm income, especially when you compare this amount to family living expenses.

Another way to look at how government income affected the AgFA dairy farms is to examine its effect on farm financial performance. In 2002, the average AgFA dairy farm earned \$21,206 in net farm income from operations (NFIO). 476 out of the 679 farms earned a positive NFIO. If government income was deducted from the financial performance of the farms, average NFIO would have decreased to a -\$384 and the number of farms with a positive NFIO would have reduced to 372. In 2003, average NFIO increased to \$50,783 and 546 farms earned a positive NFIO. If government income would not have been available, the average NFIO would have been \$21,701 and 452 farms would have earned a positive NFIO. In 2004, NFIO averaged \$103,666 and 643 of the 675 farms earned a positive NFIO. Without government income, the average NFIO would have been \$90,532 and 627 farms would have earned a positive NFIO.

NFIO does not include a charge for the farm owner's and his or her family's unpaid labor. The rate of return on assets (ROROA) and rate of return on equity (ROROE) do charge for unpaid labor. In 2002, the ROROA would have decreased from 2.33 to 0.20 % without government income. The ROROE would have decreased from 0.37 to -2.89 % without government income. In 2003, the average ROROA would have fallen by 2.67 percentage points without government income, and the average ROROE would have decreased from 3.97 to -0.24 % without government income. In 2004, the average ROROA was 7.88 % with government income and 6.79 % without government income. The average ROROE would have decreased from 9.42 % to 7.72 % without government income.

Decisions will be made soon concerning how involved our government should be in supporting market prices during the upcoming Farm Bill debate. It will be up to elected officials to decide whether to continue to do this and, if so, how. As can be seen in this research summary, their decision will have profound effects for Wisconsin dairy farms. Government income payments played a significant role on the financial performance of these Wisconsin AgFA dairy farms from 2002 through 2004, especially when you compare the amount of government income payments received to the typical AgFA farm's family living expenses.

Table 1. Farm, Price, Income and Family Expense Information 2002 - 2004

	2002	2003	2004
Number of Farms	679	652	675
Average Herd Size	116	122	132
Average Grain and Forage Acres	337	369	372
Average Milk Price Received (\$/cwt)	\$12.75	\$12.92	\$16.72
Average Corn Price (\$/bu) ¹	\$2.22	\$2.35	\$2.00
Average Total Farm Income (TFI)	\$377,855	\$433,110	\$551,821
Average Government Income (GI)	\$21,590	\$29,032	\$13,133
Average GI as a % of TFI	5.71 %	6.70 %	2.38 %
Average Family Living Expenses (FLE)	\$36,912	\$41,790	\$45,307
Average GI as a % of FLE	58.49 %	69.47 %	28.99 %

¹ USDA – NASS. *Agricultural Statistics 2005*. p. 1-27.

Table 2. Farm Financial Performance Measures With and Without Government Income (GI)

	2002		2003		2004	
	With GI	Without GI	With GI	Without GI	With GI	Without GI
Average Net Farm Income from Operations (NFIO)	\$21,206	-\$384	\$50,783	\$21,701	\$103,666	\$90,532
Farms with Positive NFIO	476	372	546	452	643	627
Rate of Return on Assets (ROROA)	2.33 %	0.20 %	4.57 %	1.90 %	7.88 %	6.79 %
Farms with a Positive ROROA	431	318	517	452	603	571
Average Rate of Return on Equity (ROROE)	0.37 %	-2.89 %	3.97 %	-0.24 %	9.42 %	7.72 %
Farms with a Positive ROROE	344	241	454	294	554	517

Gregg Hadley is an Assistant Professor of Agricultural Economics at the University of Wisconsin-River Falls, University of Wisconsin-Extension, and Center for Dairy Profitability.

Focus on Risk Management

Price Risk Management – It's a Mindset!

by
Kevin Bernhardt

"This price risk management stuff doesn't work! My forward contract price was lower than the cash price and I lost money! You won't catch me ever doing that again! After all, I'm already practicing price risk management since I sell every month!"

(John Frustrated, dairy producer, 2004)

- Sound familiar?
- Did John Frustrated lose money?
- Is selling every month price risk management?
- Does John have the right mindset in his thinking about the role and purpose of price risk management?

Each of these questions will be addressed, but first let's clearly set the stage - the primary role and purpose of price risk management is to assure or protect a price that meets an established business or family objective. Note, the word "high" did not appear in that definition! The primary purpose is not to assure the "highest" price, just "a" price. To the producer with the right mindset, the eventual cash price is of little concern, because he went into it with the mindset of just assuring or protecting a price that meets a pre-established objective. John Frustrated does not have the right mindset!

Sound familiar?

Securing a top third historical price for the 18 months from January 2002 to June 2003 would have resulted in marketing gains over the cash price in all 18 months. Price risk management and the messenger who talked about price risk management were heroes, a great asset to John's dairy business.

BUT!!! It is not 2002. For 2004 and 2005 John's "this price risk stuff doesn't work" statement has probably been all too familiar. With prices well into the top third of the historical market for most of the months and at record levels in some months, any amount of forward pricing likely resulted in a lower price compared to the announced cash price. In such a climate, the use of price risk management tools, and the messenger who talks about them, will likely be criticized and dismissed, especially among those who do not understand the role and purpose of price risk management.

Is it true, did this producer lose money?

YES! This is not perhaps the answer you expected. In the past, you have likely heard I and others say something like, "No, you got the price you contracted, so it was never your money anyway" or "No, that was just lost opportunity not actual lost dollars." Well, I'm changing my mind; let's call a duck a duck. If a producer forward contracts for \$12.25/cwt* and the cash price turns out to be \$13.00/cwt, then yes, that producer lost 75 cents due to his price risk management action! Worse yet, the producer who contracted for \$13.83 in May 2004, the historical maximum price for that month, lost \$6.75

compared to the record high \$20.58 price! It is hard to sugar coat that other than a frank admittance that yes you received what you contracted and it was \$6.75 less than what your neighbor received that did no price risk management! Anyone's mindset on the usefulness of price risk management will be challenged in this extreme case. On the other hand, the flip side of this story can be told - a \$12.10 forward contract price in May 2003 (the maximum that was available that year) would have resulted in a net gain from marketing of \$2.39 compared to the \$9.71 cash price.

Selling every month is already price risk management?

Yes and no. This is a strategy that has often been promoted to grain producers. Unlike milk, grain producers have a physical product to sell once a year, at a time when prices are generally their lowest. The grain producer who is forward pricing each month is saying that they are not willing to just accept whatever the market is willing to give at the seasonally low time of harvest; rather they want to manage and set their own price. One strategy is forward pricing some each month resulting in an "average" price that generally will be higher than the seasonally low price at harvest – a reasonable price risk management strategy for grain producers.

In the case of the dairy industry, selling the product every month is automatic; it is how the system of buying, selling, and handling milk is set-up. Thus, producers do not have to actively implement price risk management strategies to get the average price for the year, it's automatic. Said another way, John would have automatically received the average price for 2004 of \$15.39 without doing any deliberate price risk management. On the flip side, he also received the average price in 2002 of \$10.42.

The point is that milk is not grain. The milk producer indeed sells each month, and by the nature of the system of milk production and sales, he is securing an average price. However, there is no deliberate price risk management taking place, no taking control of price or protecting your price. The producer in this case is a price taker subject to whatever the whims of the market are willing to provide.

Does John have the right mindset in his thinking about the role and purpose of price risk management?

NO! The role and primary purpose of price risk management is to manage your future price by assuring what price you will be paid for your product. You are protecting "a" price, not the "highest" price. Price risk management tools and strategies give the producer the ability to reduce or eliminate price variability and meet a pre-established objective, but not secure the highest price.

Should every producer be assuring their price via price risk management tools? NO. If a producer wants to reduce the unknown, protect a pre-established price objective, and will be satisfied with assuring a certain price then price risk management is a great tool to have in the management toolbox. If a producer can't live with the idea of assuring a price that could be lower than the cash price, is a risk-taker at heart, and/or has plenty of financial leverage to withstand low price times then he is not likely to be happy with price risk management. If the goal is to get the highest price, then the tools of price risk management are like cutting a board with a screwdriver – wrong tool!

A Look At Some Strategies

Hindsight is always 20/20, but perhaps we can glean some lessons from the past. What would the gain or loss from marketing have been in the past had certain strategies been used. Various strategies with marketing actions triggered by an a priori set of trigger

THE FOCUS

prices were employed over the time period January 2000 through June 2005. Settlement prices for CME futures were used to set the maximum pricing opportunity that was available for at least 10 trading days. This established whether or not a 20-30 cent out of the money put was available or not. The PUT option premium was set at 30 cents. Forward contracting at a 10 cent discount was assumed. The case farm was selling 1,833 cwt. of milk per month. The analysis allowed flexibility for setting different triggers for a PUT in the first 6 months versus the last 6 months of the year thus providing some capability to capture seasonality. Milk could then be forward contracted in three successive 25% increments (450 cwt.). Table 1 shows the results for the gain/loss in marketing over the 66 month period if the triggers as shown were strictly followed.

Table 1. Scenarios	Trigger Prices							
	1	2	3	4	5	6	7	8
Jan-Jun PUT	11.00	11.00	11.00	11.00	12.00	11.00	12.00	11.00
Jul-Dec PUT	11.00	11.00	12.00	12.00	13.00	11.00	12.00	12.00
1 st 25% FC	12.00	13.00	13.00	13.50	14.00	---	---	---
2 nd 25% FC	13.00	14.50	14.00	15.00	15.00	---	---	---
3 rd 25% FC	14.00	16.00	15.00	16.50	16.00	---	---	---
Cumulative Marketing Gain (\$)	-15,767	-1,785	18,634	28,376	6,543	27,420	48,560	53,900
Average Annual Gain in Marketing (\$/year)	-2,867	-325	3,388	5,159	1,190	4,985	8,829	9,800
Average Monthly gain in price (\$/cwt)	-.13	-.01	.15	.23	.05	.23	.40	.45

There is a danger in playing the “would have, should have, could have” game of looking backwards. What would have worked in the past may or may not be good for the future. It also takes our eyes off the ball of the primary role and purpose of price risk management – assuring/protecting a price. All of the scenarios in Table 1 accomplished that mission. All had time periods where they resulted in more income than the cash price. All had time periods where they resulted in less income than the cash price.

*Note, all prices and scenarios are based on Class III prices.

Kevin Bernhardt is an Associate Professor of Agribusiness with the University of Wisconsin-Platteville, the University of Wisconsin-Extension, and Center for Dairy Profitability.