GUEST COLUMNIST

CMN Exclusive!

Perspective: Dairy Markets

Mike McCully is owner of the The McCully Group LLC, New Buffalo, Michigan. He contributes this column exclusively for *Cheese Market News®*.

The evolution of dairy price discovery and risk management

While still new in some parts of the world, dairy futures trading started in the early to mid-1990s in the United States at both the New York Coffee, Sugar and Cocoa Exchange and the Chicago Mercantile Exchange (CME). By the late 1990s, the CME had become the central marketplace for futures and cash trading of the main U.S. dairy products. Since that time, cash markets have transitioned from weekly to daily, futures trading hours have expanded to 23 hours per day, and futures and cash trading have moved from open outcry in the pits to electronic platforms.

The CME spot market has long been the central price discovery point for cheese and butter. A few years ago, the nonfat dry milk (NDM) trading rules were modernized and that market became relevant as well. In 2013, only 120 loads of spot NDM were traded at the CME. In 2016, nearly 800 loads of NDM traded and 170 loads traded in the first quarter of 2018. This trend is seen in total dairy spot trading as well. In 2013, 1,715 spot loads were transacted for the year. In 2017, nearly 4,700 spot loads of cheese, butter and NDM traded following the transition to the electronic platform. While there was concern by some about losing liquidity, it is clear electronic trading has been a boon to dairy markets.

In addition to cheese, butter and NDM, advances are being made in price discovery for several whey products. In March, the CME launched a new spot dry whey contract. The goal is to provide a timelier price signal to the whey market. By making the weekly USDA National Dairy Products Sales Report dry whey price more responsive to current market conditions, it also will help improve the effectiveness of dry whey futures by reducing basis risk.

In addition to the new spot whey market, Global Dairy Trade (GDT) recently launched a U.S. multi-seller pool for lactose. After consulting with participants in the whey industry, there was an identified need for improved price discovery for whey products. Lactose was chosen given that the high volume of U.S. exports aligns with GDT's customer base. A multi-seller pool was developed that aggregates volumes and prices across multiple sellers. Early results have reflected lackluster demand for lactose, but the goal is to develop a credible, market-based reference price for U.S. lactose.

For the other whey products, more work needs to be done to improve the price discovery process. Opportunity exists in whey permeate, whey protein concentrate (WPC) and even whey protein isolate. Some will say there is too much differentiation in those products to develop a commodity specification. However, price ranges could be reported, similar to today's Dairy Market News price series, to at least give indicative prices. For products like WPC-34 and whey permeate, there may be more interest in developing a spot/cash market similar to dry whey and lactose.

The United States is not alone in making improvements to price discovery for milk and dairy products. In Europe, the EEX trades futures contracts for butter, whey and skim milk powder (SMP). Unlike the United States, there is no "official" milk price on which to base a futures contract. Work is being done to develop some sort of centralized market or price report. In addition, futures trading and hedging are new concepts to dairy farmers in Europe, just like they were to most dairy farmers in the United States 20 years ago. As the U.S. example has shown, it will take time to develop the proper hedging mechanisms for farmers. However, Europe can use learnings from the United States and other commodities to fast-adapt and develop tools needed by the marketplace.

In Oceania, the New Zealand Stock Exchange, NZX, offers futures and options contracts based on several GDT products. Volume has grown over time, and as liquidity increases more market participants become involved as illustrated by the growth in the CME markets. The method of pricing milk is quite different than the United States, but NZX started a milk futures contract in May 2016 allowing farmers to hedge against the projected payout from Fonterra. In Australia, work is being done to improve price discovery and transparency for farmers. There are no futures contracts for dairy products, but research has been conducted to determine what other tools could be used to manage dairy price volatility.

While improvements are being made in price discovery and risk management tools, it should be pointed out that government policies, while well intentioned, can

Turn to MCCULLY, page 6 ⇨

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Perspective: Industry Issues

Michael Dykes is president and CEO of the International Dairy Foods Association. He contributes this column exclusively for *Cheese Market News®*.

Shared solutions succeed in Farm Bill

The International Dairy Foods Association is pleased to support the Agriculture and Nutrition Act of 2018 that was approved last week by the House Committee on Agriculture. Thanks to the efforts of House Agriculture Committee Chairman Mike Conaway, R-Texas, and the members of his committee, this farm bill provides new health benefits for consumers and empowers dairy processors and producers with key provisions that will allow us to enhance the American economy.

IDFA's economic impact tool, Dairy Delivers, shows that U.S. dairy products companies support nearly 3 million jobs, generate more than $39 billion in direct wages and have an overall economic impact of more than $200 billion. Our powerful engine for American jobs and economic stimulus will only continue to contribute and grow under this farm bill.

• Collaboration creates success

The dairy provisions included in the bill also represent the positive outcomes we can gain through sustained industry collaboration. In preparation for the farm bill debate, which began last year, IDFA worked closely with the National Milk Producers Federation, and we united behind shared solutions for dairy, which I outlined in my December column for *Cheese Market News* and which are now included in the bill.

We're hopeful that our efforts will help to smooth the ultimate enactment of a farm bill that offers enhanced risk management options for dairy processors and producers and establishes a retail incentive program in the Supplemental Nutrition Assistance Program, or SNAP, that includes fluid milk.

Working together, IDFA and NMPF made sure the committee members understood that the beverage case offers many options today and, in this competitive marketplace, it's important for milk producers and processors to be able to decrease milk price volatility through the kind of market risk hedging already available to the rest of agriculture. The bill approved last week would change the Class I fluid milk mover from the higher of Class III and Class IV to the simple average of Class III and Class IV, plus a $0.74 adjustor.

With this new pricing provision in place, both producers and processors would gain much-needed benefits from hedging fluid milk through the futures market.

The bill also would extend the Dairy Forward Pricing Program for all other classes of dairy products through 2023 and make additional changes to the Margin Protection Program beyond those included in the recently enacted omnibus funding bill.

Finally, the bill also includes a new voluntary retailer program within SNAP that would fund up to 25 percent of the cost of in-store incentives designed to encourage SNAP participants to purchase fluid milk, as well as fruits and vegetables.

We're fortunate that Chairman Conaway shares IDFA's view that a thriving agricultural industry is healthy for the American economy, and he understands the significant role that the dairy industry plays. In addition, House Agriculture Committee Ranking Member Collin Peterson, D-Minn., has worked to help the dairy industry and supports the shared solutions offered by IDFA and NMPF.

• What happens next?

Based on conversations we've had with committee staff members, we believe the House could consider the farm bill on the floor as early as the second week of May. We also know that the leaders of the Senate Committee on Agriculture, Nutrition and Forestry are continuing to negotiate a bill that could be introduced next month for consideration at the committee level.

The 2014 Farm Bill will expire Sept. 30, 2018, which is the end of the government's fiscal year. The last time Congress passed a farm bill on time was in 1990, so it's possible that the current farm bill could be extended beyond September if Congress is unable to pass another five-year farm bill before then.

We hope an extension won't be necessary. For our part, IDFA and our members are committed to ensuring that all members of Congress understand the importance of these provisions to the nearly 3 million Americans in jobs supported by the dairy industry and to the overall health of the U.S. economy. We'll continue to advocate for the forward-looking provisions contained in this farm bill and encourage everyone working in or with the U.S. dairy industry to do the same.

As the House and Senate continue their efforts on the next farm bill, this is the perfect time for dairy leaders to share stories about how these critical policy issues and provisions directly affect your companies and communities. And if IDFA can help you with your outreach efforts, please be sure to let us know.

We truly value collaboration and are pleased to see the results of our joint efforts included in this farm bill. It's a shining example of what we can accomplish when we work together to make a positive difference for dairy. **CMN**

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MCCULLY

Continued from page 4

and will disrupt market signals. A visible example of this is the current situation with SMP stocks in the European Union intervention program. Similar to the old Commodity Credit Corp. and the U.S. support price program, the European Union intervention program stands as a ready buyer for surplus product — in this case, SMP. The goal in the short term is to provide support for farmers' milk prices. If the volumes entering the intervention program are small, they can be reintroduced to the market over time without much impact. However, the European Union program has built up a large stockpile of SMP, which has negatively impacted the global market for milk powders and will continue to do so until the inventory is absorbed. Politicians believe this intervention is helpful; in reality, these actions often end up prolonging the downturn in prices by interfering with market signals.

I grew up on a grain farm and worked in the grain industry before starting in dairy. In the grain markets, futures contracts have long been used for price discovery with local prices determined as a basis to futures. I am convinced the same could work for milk and dairy products. My vision has been to have fully functional, liquid futures markets for price discovery and commercial transactions. To achieve this vision, the industry needs timely and accurate market information, which includes government reports and spot market prices. The more we do to improve the quality and availability of market information, the industry will benefit from better price transparency throughout the dairy supply chain. **CMN**

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