GUEST COLUMNIST

CMN Exclusive!

Perspective: Dairy Markets

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Cheese futures: 14 months in … looking good

Before CME launched cheese futures and options on June 20, 2010, there was a healthy debate: Would this grow the dairy complex or would it "cannibalize" liquidity away from the flagship Class III contract? The verdict is in: Growth is prevailing.

I don't know that I would look at cheese volume and open interest numbers by themselves and decide it is time to bust out the champagne, but when you look at them along side Class III and Whey it is time to celebrate … at least a little!

The data tells us that since cheese futures and options have been listed, we have experienced phenomenal growth within the make spread (the "make spread" is what we are calling it until something is universally adopted). The combined Class III and Cheese open interest represents about 2.4 billion pounds of cheese (more than 1 million metric tons for my brothers and sisters abroad). Of course there have been other factors contributing to this growth over the last 14 months, but clearly cannibalization isn't occurring.

Complementing the data, it is our observation at Rice Dairy that the addition of Cheese contracts has attracted new participants to dairy trade and created additional liquidity from existing sources. Natural carriers of cheese price risk throughout the dairy value chain have begun using this market. It has been more of a trickle than a flood, but a comfort level is being established and the order flow has steadily picked up. This order flow has not gone unnoticed by speculative traders, who have been happy to provide liquidity on the make spread (Cheese & Whey against Class III).

So on behalf of dairy market participants everywhere, I would like to offer a thank you to our friends at CME Group who continue their commitment.

	Open Interest June 10, 2010	Open Interest Sept. 20, 2011	Difference	% Change
Cheese Futures	-	3,458	3,458	n/a
Cheese Options	-	581	581	n/a
Class III Futures	27,992	33,750	5,758	21%
Class III Options	38,958	80,747	41,789	107%
Whey Futures	1,819	1,946	127	7%
Whey Options	-	200	200	n/a
Make Spread Component TOTALS	**68,769**	**120,682**	**51,913**	**75%**

• What next?

While it is essential to reflect on what has transpired since listing and observe the accomplishment thus far … it is equally important to ask "what next"? Two things:

1. Ask CME to list a make spread
2. Ask that this spread trade "side-by-side"

As of now, all make spreads that are traded are executed via legging. If the exchange were to list the spread, a participant could enter or exit all legs of the make spread at once without risk of only getting part of the spread. This is the same concept as our listed packs — i.e. a January-December pack (listed spread) allows a participant to execute all twelve months at once. Just as the listed packs give participants extra confidence and ability to place orders and execute simultaneously, a listed make spread would offer a clean way to execute the whole spread at once. I cannot take credit for innovating on my own here; this would just be borrowing an idea from other markets where such spreads are traded. CME Group has an exchange listed spread for the soybean crush, among others. While we are at it I would propose listing the Class IV make spread as we have seen a significant increase in participation in this spread as well over the last year.

• Spread listed side-by-side

Side-by-side means listing a product for trade both on the screen and the floor. The obvious advantage here is that you get more exposure on alternate venues … more opportunity to execute a trade. Side-by-side listing has proven a very successful way to build liquidity by offering a much more dynamic process than screen-only or floor-only. Some leaders in the exchange world are beginning to view this process as a distinct competitive advantage over exchanges that cannot offer side-by-side. Let's not waste easy opportunities when we have them.

Getting these two things done will help maintain existing gains and promote further growth. This isn't just me asking for these things: It is the people that are carrying these positions that are asking for it.

• Cheese Futures: Avenue to global market

Since Class III milk doesn't exist outside the borders of the United States, it has been difficult to turn CME's most successful and liquid dairy market into a globally connected one. Cheddar cheese does exist beyond our borders, however, and the futures trade of this may not be far off. Fonterra's gDT auction began listing

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LETTER TO THE EDITOR

To the editor: How much longer will we think we need classified pricing, mandatory pooling?

To the editor:

It is so sad that we have become so accustomed to government choosing winners and losers that we think that a sign of good policy is when no one is happy! It is my conviction that classified pricing and mandatory pooling is now working to everyone's disadvantage (producers, consumers, and processors) and is thus contrary to the general welfare and the public interest. Lately, it seems, everyone in our industry thinks they must take a side, and the fighting and wrangling continues back and forth like a tug-of-war! Although there may be some economic adjustments required in order to align with the true market, all can, and should, have equal opportunity, justice, and equality under impartial law.

The gradual phase out of mandatory Class I differentials was first proposed way back in June of 1990. The Department of Justice (DOJ), who did not represent processors, producers, or consumers but instead represented the public welfare, provided strong economic and legal evidence to support this proposal. Similar proposals were submitted to the Antitrust Modernization Commission in July 2005, to the Dairy Industry Advisory Committee in July and October 2010, and again for consideration at the USDA/DOJ dairy workshop held in Madison, Wis., in December 2010.

It was not until April 18, 2011, 21 years after first being proposed, that the milk processor lobby voted to support a gradual phase out of classified pricing and mandatory pooling. Many within the producer and cooperative ranks mistrust proposals made by the processor lobby thinking that anything proposed by them must favor processors at the expense of producers. Although this may have been true in the past, in this instance the processor lobby is simply the first industry party to face the reality that I think all must eventually face. It is my belief that decentralization, deregulation and a restoration of constitutional principles is really the only way to go and that it is now only a matter of time before all ultimately come to that same realization.

Without a doubt, the efforts to develop, propose and defend the so-called Foundation for the Future are well intended. However, in my opinion, it simply adds another layer of complexity, bureaucracy, centralization, and market intervention that no longer works and that we can no longer afford. I feel that classified pricing, even just two classes, if adopted, will likewise ultimately fail and we will be back again faced with the similar results until we come to the realization that it is the very root of our problem. I believe that it really all boils down to be the violation of a constitutional principle.

FACT #1: The economic laws and

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Letters to the editor

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OPINIONS

STOKER

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principles of supply and demand and equilibrium dictate that any artificial support (above equilibrium) of a portion of a homogeneous product simultaneously creates an artificial price depression (below the equilibrium) for the non-supported portion of that product. This is an undisputed economic fact and was actually a primary reason for adopting the now discredited price support program for manufactured milk products. In truth, both of these conflicting programs (dairy support price and classified pricing/mandatory pooling) are mutually unsustainable.

For the past seven decades the policy of increasing both the volume and the price of fluid milk support (higher and higher Class I differentials on higher and higher volumes of pooled milk) has increasingly caused more frequent, severe, and prolonged price depressions to milk used for manufactured dairy products (increased volatility).

FACT #2: For the past four decades, the demand for fluid milk products has remained static while the national and global demand for manufactured dairy product has grown exponentially.

These two facts taken together increasingly compound the negative effects of this misguided milk pricing policy. Few dairymen understand that mandatory class pricing and pooling is the very root cause of our failing milk pricing system. It is a fact that can no longer be refuted or ignored, and, it is imperative that we learn from our past and not repeat or perpetuate the same gross mistakes that have brought us here! The severe price depression of 2009 (and those yet to come), are the indirect result of our continued use of these unsustainable policies.

The facts tell the truth! Using USDA and CDFA monthly pooling data allows a factual analysis of the trend pertaining to the monthly redistribution of pooled revenue. This combined pool data can be separated into the portions pooled and the revenues derived from the two distinct utilizations for raw milk, fluid and non-fluid (or manufactured) dairy products.

According to two independent economic studies, milk classification and the associated market intervention causes the fluid milk price to be between 8 and 9 percent above normal equilibrium and inversely causes the manufactured (non-Class I) milk price to be pushed down between 6 and 9 percent below equilibrium. Applying these percentages to the actual volumes and classes of milk pooled on the California and all federal order pools between January 2000 and July 2011 indicates that even pooled producers lost, on average, between $0.11 and $0.32/cwt. The trend during this period shows progressively greater losses each month with the greatest losses occurring in the most recent month of July 2011 at between $0.41 and $0.81/cwt. (with total losses between $58 million and $114 million in just July 2011)! These losses do not even account the cost of administration, market services, or transportation credits let alone the costs of compliance, inefficiency or profiteering by concentrated market power. These monthly losses will continue to increase until we recognize and solve the root problem.

How much longer will we keep thinking that we need classified pricing and mandatory pooling?

Randal Stoker
Woodbridge, Va

RICE

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Cheddar in their auction this year and a NZX futures contract is probably not far behind. Of course there will be barriers that will hamper pure price harmony between U.S. and New Zealand Cheddar, but I would not bet against a distinct price relationship forming. This will offer opportunity for many, and certainly for those who are paying attention and understand it.

In conclusion, adding cheese contracts has generated a solid win for our markets. I believe there is a lot more growth to come if we adopt a couple of these proposals and continue listening to the people using these contracts. **CMN**

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