

**Guest Columnists**

**With industry participation, new NDM contract has potential to deliver**

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Over the last few years, the Chicago Mercantile Exchange (CME) has been progressively developing and introducing new contracts to the CME Dairy Complex. In 2006 it was the Cash Settled Butter contract. In 2007 it was the Cash Settled Whey contract, and on April 20, CME introduced the Physically Delivered Nonfat Dry Milk (NDM) contract. I would like to take this moment to commend the CME for this action, and I think the dairy industry at large should too.

To begin with, the industry has been asking for this contract for several years. CME heard that demand and then worked closely with the potential market participants to try and develop a contract that would meet the general industry's specifications in terms of packaging, grading and delivery costs. While not perfect for everyone, many potential market participants whom I have spoken with seem to believe this new contract will capture the broad strokes of what the market was looking for, and most believe that CME has put together another good contract. In my opinion, this demonstrates CME's continued commitment to serving the Dairy Complex and their desire to see it grow.

More importantly though, I believe that there should be an actively traded NDM contract that both buyers and sellers can use to manage their NDM price risk. NDM represents a fairly large percentage of the annual milk crop here in the United States. During 2008, we manufactured a little more than 1.5 billion pounds of NDM. It takes about 11.5 pounds of milk to create 1 pound of NDM, so that means around 17 billion pounds of the 189-billion-pound milk crop was used to make NDM. That represents around 9 percent of annual milk production, and while that is not an enormous number, it is big enough for the price movements in NDM to have a large effect on the bottom line of companies that have dairy price risk. Because of that, I think those companies — both on the production and consumption sides of the equation — deserve a viable hedging mechanism to help manage that price risk.

This of course isn't the first or only NDM contract on the CME. There is currently a Cash Settled NDM contract that has been trading on the exchange for many years. However, it has not fared as well as our other contracts in terms of market participation. Using last year's 1.5 billion pounds of NDM manufactured as a benchmark, only about 2 percent of that is currently represented in the 2009 NDM futures complex. That is not a good showing by any means, and it is demonstrating that the industry is not using that contract.

So why do I think this contract will do any better than the current contract? To begin with, the industry asked for it. That alone is a great sign and it tells me that they want to use NDM futures; they just weren't using the cash settled contract. In my opinion, they weren't using the cash settled contract because at times it has proven to be a less than perfect hedging mechanism.

The settlement process for this contract is based on the government reported National Agricultural Statistics Service (NASS) values and there have been times in the past when that pricing mechanism has been slow to accurately reflect the current spot market conditions at that time. Those who had used NDM futures as their hedging mechanism against fluctuating NDM spot prices began to feel that the NDM futures were no longer a viable option. Others who chose to remain as market participants have been frustrated because the lack of participation of the other parties has created a liquidity problem. This makes it difficult to establish positions, even if you want to.

However, this new contract is a physically deliverable contract, which means that buyers of the contract have the option of taking delivery of product at expiration and sellers have the option of making delivery. As we move into the expiration period, the contract will have to have a very strong correlation to the current spot market conditions. If the futures are mispriced in terms of their relation to the spot market, traders will either buy or sell that mispricing and trade it against the current spot market. In futures markets we call this "convergence." As we discussed, the lack of convergence in the cash-settled NDM contract has hindered growth of that contract.

This type of price convergence should lead to the NDM futures becoming not only the viable hedging mechanism that the industry wants, but it will also give a more timely and transparent reflection of the current spot market conditions. The current NASS system can be difficult to extract timely price signals from and that isn't good for anyone. Market participants are slower to react to changes in market conditions and that leads to inefficiencies on both sides of the buyer/seller equation than there would be if they had a good gauge of current market conditions. I believe this contract will become that gauge, and I think that in turn will be better for everyone.

In closing, I'd like to acknowledge that this contract isn't perfect. There will be some people who won't/can't take or make delivery of the product traded in this contract. That means they will have to exit the contract before the expiration period ends. In reality, only a very small proportion of futures actually go into delivery in other markets such as Live Cattle or Crude Oil (typical delivery in mature futures markets ≈ 1 percent of trade).

I fully expect this contract to experience some growing pains and for liquidity to be light at first. This basis risk could be expensive and cause market participants to be frustrated and possibly not participate. While I understand that, I would also like to say that liquidity begets liquidity. I encourage any potential market participant to take a study of this new contract. Your participation should lead to another person participating and that will eventually lead to a vibrant, liquid marketplace for hedging NDM.

Again, I would like to congratulate the CME for continuing to build our Dairy Complex. The industry asked and they delivered. Now I think it is time for industry to deliver on their demand for this product, and I encourage them to remain committed to participating in this contract.

If you have any questions about the specifications of this contract or how you can use this contract as a hedging tool, I encourage you to contact either myself or someone else in the dairy price risk management industry. We are dedicated to making this contract viable, and we will work with you to help you find the best hedging solution for you and your organization.

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