

## **USDA should not delay FMMO reform due to risk management**

My name is James DeJong and I am currently the Senior Director of Dairy Economics, Risk Management, and Sales Planning for Glanbia Nutritionals (GN), whom I am representing today. My background and the business activities of Glanbia are set forth in my other written testimony. I am addressing in this testimony those who have argued that implementation of order revisions should be delayed.

### **NMPF and IDFA agree that timely increases in make allowance are needed**

Petitions and testimony coming from both the National Milk Producers Federation (NMPF) coalition and the International Dairy Foods Association (IDFA) coalition have made it abundantly clear that 1) outdated make allowances are a source of disorderly marketing, 2) and there is an urgent need for reform.

Specifically, NMPF states in their petition that, “There are consequences to setting make allowances too low relative to the actual cost of manufacturing under a system of PPFs. Inadequate make allowances challenge manufacturing operations’ abilities to pay minimum announced milk prices and still operate their facilities at reasonable rates of return. This discourages the plant investment needed to provide market demand on a daily, seasonal and annual basis.”<sup>1</sup> Further, NMPF quotes USDA in its 1999 Final Decision on FMMO reform in saying, “The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit.”

Dairy cooperative members have also spoken to the need for urgent action. Rob Vandenheuvel of CDI, in his written testimony, noted, “The issue of establishing appropriate manufacturing cost allowances, hereafter make allowances, in the Federal Order formulas is of critical importance to CDI...”<sup>2</sup> He further noted, “...the immediate adjustments reflected in Proposal Number 7 in this hearing process are also a critical need for the industry. The risk of inaction or delayed action is simply too great to put the issue off any further.” Other witnesses, such as Carl Rasch of Michigan Milk Producers Association in his written testimony, also acknowledge the need for “urgent” action<sup>3</sup>.

### **USDA has been telegraphing for years reforms could be coming**

USDA has changed FMMO regulations and pricing formulas multiple times over the decades. With USDA commissioning the 2021 Stephenson Cost, which collection efforts began in earnest in 2020, should have clued in market participants that change could be coming. Further, the existence of this hearing, and a likely Final Decision roughly not expected until late 2024, should act as another indicator for market participants that risk factors are changing. Stakeholders acknowledge this. In the Chicago Mercantile Exchanges (CME) last annual Form 10-K filing, which provides a comprehensive view of a

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<sup>1</sup> [NMPF National Hearing Petition \(usda.gov\)](https://www.usda.gov/nmpf-national-hearing-petition)

<sup>2</sup> [FMMO NMPF 18.pdf \(usda.gov\)](https://www.usda.gov/fmmo-nmpf-18.pdf)

<sup>3</sup> [FMMO-NMPF-17 \(usda.gov\)](https://www.usda.gov/fmmo-nmpf-17)

publicly traded business financial condition, they specifically acknowledge regulatory change is a risk for their business model<sup>4</sup>.

#### **CME crush traders/arbitrage traders will adjust their models to deal with Class III/IV change risk**

So called “crush traders” or “arbitrage traders”, will often take short or long positions in cheese, whey, butter, NFD, Class III milk and Class IV milk derivatives to profit off the mathematical relationships. For example, if the combination of selling \$1.20 NFD futures and \$2.20 butter futures created an implied Class IV futures price of \$17.47 per cwt., but Class IV futures could be bought at \$17.35 per cwt., an arbitrage trader could execute these available derivatives to lock in a \$0.12 per cwt. profit. Whether the market goes up or down, their margin is secure as long as the milk formula remains constant. The same principles apply to Class III and its market components.

If, for example, make allowances were to change, the relationship between the market prices and milk prices would also change. In this case, the arbitrage traders would change their buy/sell formulas to reflect the IDFA or NMPF make allowance changes for the beginning of 2025, or near that time period. The make allowances they would choose in their models (IDFA vs. NMPF) would depend on what gave them the larger margin cushion depending on what side of a trade they were on. Given the make allowance proposed by IDFA 2025 and the NMPF only differ by \$0.19 per cwt. for Class III milk, and \$0.15 per cwt. for Class IV, this should give arbitrage traders a reasonable level of confidence to adjust their risk models accordingly. While USDA could technically set make allowances substantially outside what the major industry groups are petitioning for, the chances seem low.

#### **The dairy industry can hedge with individual commodities, not just Class III and IV milk derivatives**

In a worst case where dairy producers, for example, were having a hard time finding liquidity to sell Class III and IV milk futures or options due to lack of arbitrage trader’s liquidity, they could also hedge with individual commodity prices directly. In fact, GN’s Idaho direct ship producers typically hedge directly by selling CME CSC cheese futures (settles to NDPSR cheese price). Given the cheese price is typically the vast majority of their milk pay price, the hedges are effective. This allows them to correlate their mailbox price to the CME derivative regardless of make allowance changes. Producers in different orders can hedge with more NFD, butter or dry whey to reflect their mailbox milk price.

Figures 1 through 3 show the USDA Mailbox milk price correlations for risk management for individual dairy commodities versus hedging the Class III and IV milk prices. The analysis shows that effective hedges can be created using only the commodity futures/options. Risk management brokers or the producer’s milk handler can easily provide guidance on the appropriate weightings and volumes of the commodities the dairies should hedge with.

#### **CME makes money by transaction counts – is sensitive to needs of arbitrage trading community**

One reason CME’s testimony is sensitive to “liquidity providers” is due to the amount of fee revenue they generate. In their last Form 10-K filing, CME states, “Our revenue is substantially derived from fees for transactions executed and cleared in our markets”<sup>5</sup>. Given that crush traders are taking multiple parts of dairy markets and figuratively “crushing” them together requires multiple transaction to

<sup>4</sup> [Form 10-K for CME Group INC filed 02/27/2023](#) – Page 15

<sup>5</sup> [Form 10-K for CME Group INC filed 02/27/2023](#) – Page 15

accomplish. For example, crushing a Class III milk contract could involve buying a Class III milk contract and selling cheese, dry whey and butter derivatives at the same time. This is 4 transactions the CME benefits from. For dairy farmer managing their risk using only cheese derivatives, or maybe only one or two additional commodities, there are less transactions involved.

While this section of the testimony is not meant to say CME is nefarious for charging for their valuable services, or that CME market liquidity is not very important for the industry, it is meant to point out their interests are not always aligned with the broader dairy industry.

### **Conclusion**

We urge USDA to not delay reform implementation due to risk management concerns. The industry knows change is coming – within a reasonable level of certainty in scope – and dairy producers should still be able to hedge. The CME's concerns about liquidity impacts are worth noting, but their concerns are not necessarily rooted in the health of the broader industry.

If USDA ultimately decides to delay the implementation, GN would support skipping the IDFA proposed 4-year phase-in approach to make allowance reform and instead move straight to the maximum 2028 proposed levels.

## Appendix

**Figure 1: Correlation of using multiple CME traded dairy derivatives to hedge USDA Mailbox milk prices**

Effectiveness of hedging Mailbox prices using individual commodities: May 2013 to April 2023				
	Wisconsin	Michigan	Northwest states	West Texas
Cheese weighting	57%	25%	34%	46%
NFDM weighting	15%	26%	21%	18%
Butter weighting	12%	20%	24%	19%
Whey weighting	15%	28%	21%	18%
<b>Total weighting</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>R-squared coefficient of hedge</b>	<b>0.949</b>	<b>0.947</b>	<b>0.967</b>	<b>0.958</b>

*Methodology: Testing the R-squared coefficient using different weightings of CME traded dairy commodities versus the announced USDA Mailbox milk price. The percent weightings of each commodity were established using the Microsoft Excel Solver add-on that tests every possible weighting to find the highest correlation to the indicated Mailbox price region.*

**Figure 2: Correlation of using Class III or IV milk to hedge USDA Mailbox milk prices**

Effectiveness of hedging Mailbox prices using Class III or IV: May 2013 to April 2023				
	Wisconsin	Michigan	Northwest states	West Texas
R-squared coefficient of Class III	0.923	0.748	0.792	0.853
R-squared coefficient of Class IV	0.753	0.901	0.904	0.833

*Methodology: Testing the R-squared coefficient using Class III or IV milk versus the announced USDA Mailbox milk price.*

**Figure 3: Correlation of using a weighting of Class III and IV milk to hedge USDA Mailbox milk prices**

Effectiveness of hedging Mailbox prices using Class III and IV: May 2013 to April 2023				
	Wisconsin	Michigan	Northwest states	West Texas
Class III weighting	74%	37%	43%	58%
Class IV weighting	26%	63%	57%	42%
<b>R-squared Class III&amp;IV</b>	<b>0.964</b>	<b>0.946</b>	<b>0.966</b>	<b>0.954</b>

*Methodology: Testing the R-squared coefficient using different weightings of CME traded Class III and IV milk versus the announced USDA Mailbox milk price. The percent weightings of each Class milk were established using the Microsoft Excel Solver add-on that tests every possible weighting to find the highest correlation to the indicated Mailbox price region.*