

New world auction forecasts milk prices

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(excerpts)

It's getting on toward Christmas as I write this article, and it's going to hit 90 degrees here again today for the fourth day in a row. No, I'm not in Florida or Arizona. I'm in Australia where I have been for a couple of months working on a project. I'm not here because the climate, travel, and research sounded like a nice change (although I have enjoyed the people and my experiences very much). I am here because the U.S. dairy industry can no longer enjoy the relative simplicity of living within its domestic markets.

We have outgrown them, and a price forecast today requires consideration of world markets.

Twenty years ago when I was first thinking about milk and dairy product prices, our domestic prices for cheese, butter, and nonfat dry milk were more than double the so-called world prices at that time.

Today, our prices reflect the opportunities that exist to sell the product domestically or overseas. Over the past two decades, our prices haven't really come down to world prices. What has happened is that world prices have come up to intersect with our own.

For a very long time, Oceania (Australia and New Zealand) and Europe had been the major suppliers to the world. Occasionally, we had an opportunity to sell some powder — or perhaps the need to reduce inventories — but we were only a bit player.

Europe basically set the tone of world prices for commodities with policies that kept their domestic prices high by selling surplus product with export incentives. As low-cost milk producers, Oceania followed by selling product at the market clearing prices. When the European Union no longer could afford the post World War II agricultural policies, it began a process of embracing the WTO (World Trade Organization) goals of removing trade distorting policies. As less product was offered to the world market, world prices came up.

What are the implications?

As low-cost producers, Oceania responded to rising world milk prices over the past two decades by expanding production about as quickly as they could. New Zealand has wonderful pasture-based resources for producing milk, but they are quite land constrained. Land was bid up, making Oceania a high fixed cost, low variable cost producer of milk.

The United States has a very different milk production system based on intensive management and confinement. This is a high variable cost, relatively low fixed cost production system. The total cost of production in both areas is about the same and so is the milk price.

Let's think about operating a system with those different kinds of cost structure. Our own electrical grid provides a good example. A power company will operate its nuclear plants at full capacity all of the time. These are very high fixed, low variable cost plants. The generators that are powered by natural gas are low fixed, high variable cost plants, and they are used to balance the electrical demand on the grid. Both plants receive the same price for the electricity sold.

The implication is that Oceania is going to produce all of the milk that it can all of the time. The U. S. is going to bear the brunt of balancing world supplies and demand for milk and dairy products. Indeed, we seem to be able to respond with astonishing speed when milk prices are high. But it really hurts when we need to contract as during the past year.

Oceania operates a large-scale internet auction for dairy products. This new auction sells whole milk powder and anhydrous milkfat. The auction takes place once monthly and, although the auction is for the actual sale of products, it is for the delivery of products in the future. At each auction, there are three

delivery time periods. Within the third month after the auction, delivery over a three-month time period starting in the fourth month, and for delivery over a three-month time period starting in the sixth month after the auction. Five days before the auction, the trading manager posts forecasts of future quantities, and, perhaps most importantly, information on the actual quantities and starting prices of the upcoming auction. Bidders don't bid on price — they bid on the quantity of product that they want to purchase at the announced prices. When the auction begins, buyers submit their quantity bids. If all the product is bid for, then a new round is begun at a higher price and bids are taken again. This continues until all of the product that was offered for sale just clears the market at the highest price possible.

The auction is of real value to buyers and sellers in determining a market price for dairy products. It also provides an element of risk management for buyers and sellers. It also helps the U. S. to understand where our future milk prices may be headed.