

From Class III milk prices to MPP-Dairy Margins

I do not know a single dairy producer whose milk check is exactly equal to the Class III milk price. Yet, ask any producer from Idaho to New York what prices are expected next year, and the first thing they would do is look up the latest Class III milk futures. Class III milk price, in other words, is our main mental anchor. And now we are asked to develop intuition about a whole new benchmark – MPP-Dairy margins. So a logical question to ask is – what is the Class III milk price that would make MPP-Dairy margins be as low as \$4.00 or \$6.50/cwt?



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The answer, of course, depends on what the feed prices are. But let's not make this more complicated than it needs to be. First, recall the MPP-Dairy margin formula: U.S. All-Milk Price

– (1.0728 x NASS Corn Price (\$/bu) + 0.00735 x AMS Soybean Meal Price (\$/ton) + 0.0137 x NASS Alfalfa Hay (\$/ton)). If you are interested in why these coefficients were used, see my blog at <http://bit.ly/MPPMargins>. What is important is to understand that it is just three commodities that enter into the feed ration used in MPP-Dairy: corn, soybean meal and hay. Let us start by assuming some nice, round numbers. Also, since most of us think of corn prices as Chicago board prices plus basis, let's start by using a CME corn price of \$3.75/bu. Next, let us assume a CME soybean meal price of \$330/ton. Historically, the NASS announced average corn prices received by farmers were about 15 cents lower than the corresponding CME corn prices. And, since the MPP-Dairy soybean meal price is measured in Central Illinois, on average it is neither higher nor lower than the CME soybean meal price. Finally, assume that the USDA hay prices are at \$200/bu. Before we continue, I want to emphasize that I am not forecasting that these will be the feed costs in 2015. I am simply using some reasonable levels to start building our intuition. At the end of the article, we will discuss how the situation changes if feed prices rise or fall.

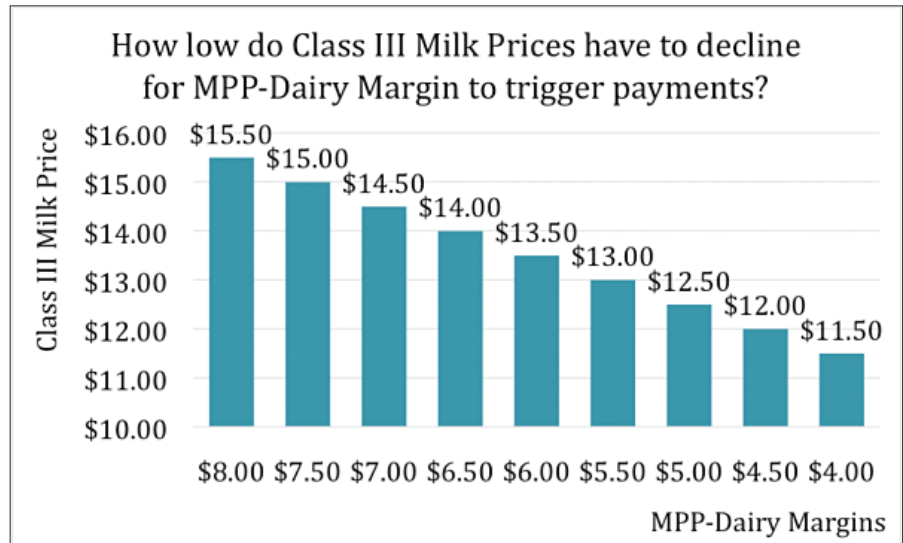
If you multiply these feed prices by the coefficients listed above (first reducing corn by 15 cents to account for the basis between CME and USDA), you will end up with a feed cost of \$9.03 per hundredweight of milk produced. From January 2008 through September 2014, the U.S. all-milk price was, on average, \$1.53 higher than the Class III milk price. Therefore, to find which Class III milk price corresponds to the \$8.00 MPP-Dairy margin at these feed costs, you would need to add \$9.03 and \$8.00 then subtract the basis of \$1.53. That is equal to \$15.50/cwt. In other words, if the Class III milk price ends up being \$15.50, then the U.S. all-milk price is likely to be \$17.03, or exactly \$8.00/cwt higher than the \$9.03/cwt feed costs.

In the chart here, I have listed all the MPP-Dairy coverage levels you can choose – from as low as \$4.00/cwt to as high as \$8.00/cwt. At the assumed feed prices, these margins correspond to Class III milk prices of \$15.50/cwt (\$8.00/cwt margin) down to \$11.50 (\$4.00/cwt margin).

How much would the Class III milk price floors increase if feed prices go up? The precise measure can, of course, be easily obtained from the coefficients in the MPP-Dairy margin formula. But is there a quick and dirty way to change these Class III milk prices if feed costs change much, something that is easy to memorize? Yes, and here is my proposed rule of thumb. For every \$1/bu increase in corn prices, increase the Class III milk price floors by \$1.00/cwt. For every \$100/ton increase in soybean meal prices, increase the Class III milk price floors by \$0.75/cwt. And, for every \$100/ton increase in hay prices, increase the Class III milk price floors by \$1.50/cwt.

So, the bottom line – if you are only going to choose the free \$4.00/cwt coverage, at these feed prices that is like protecting a \$11.50/cwt Class III milk price floor, while the \$6.50/cwt MPP-Dairy

coverage level corresponds to a Class III milk price of \$14.00/cwt. As I am writing this, the summer 2015 Class III milk futures are oscillating around \$17.00/cwt, so it would take quite a disturbance to trigger payments for the \$6.50/cwt MPP-Dairy coverage level, and \$4.00/cwt would indeed correspond to a catastrophic decline. But, if history has taught us anything, markets can change a lot, and in a hurry. Let us hope for the best, but plan for the worst.



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