

Land O'Lakes, Inc.

4001 LEXINGTON AVE. N., ARDEN HILLS, MN 55126-2998

Mailing address: P.O. Box 118, Minneapolis, MN 55440-0118
Telephone: (612) 481-2222



Land O'Lakes Dairy Foods

July 26, 1996

Mr. Myron R. McKinley
Chicago Regional Milk Marketing Order
PO Box 4469
Lisle, IL 60532-9469

Dear Mr. McKinley,

This letter presents the views of Land O'Lakes, Inc. with respect to the adoption of a new basic formula price under Federal Milk Marketing Orders.

We support the proposal of the Upper Midwest Coalition to adopt a measure of prices actually paid for Grade A and Grade B milk used to produce manufactured dairy products. Such prices should be surveyed only in regions where there is vigorous competition for milk for manufacturing. Any price adopted under Federal Orders should represent the results of a competitive market and not those of an oligopsonistic or monopsonistic market.

An alternative approach to get the same results is the use of milk futures prices. Here are arguments to support the idea.

1. Futures prices represent the value of milk, not the products of milk and other ingredients.
2. Futures markets are competitive. Anyone and everyone can choose to buy or sell milk on futures markets based on his or her perception of the value of milk. Anyone who believes that milk is undervalued can buy futures and profit from it if the belief is correct. Anyone who believes that milk is overvalued can sell futures and profit from it if this belief is correct. Buyers and sellers of milk futures will pursue such profits, and, in the process, move the price toward competitive equilibrium.
3. Futures market prices automatically and simultaneously take into account judgments about the supply of milk, the demand for milk, the composition of milk, the costs of converting milk into products, and the value of products made from milk. From all these factors, opinions are formed about the value of milk. These opinions are then expressed by a willingness to buy or sell milk at the prevailing price.



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4. There is no need to estimate or calculate all the forces embodied in the price of milk and then express them in a product formula price. At any point in time some or all of the factors in the formula will depart from actual market conditions, and the formula price will be wrong.
5. Futures markets provide a measure of milk prices in advance. For example, milk that will be produced and delivered in the month of August, October and December, 1996 and February, April and June 1997 is being bought and sold today. There is a price at which anyone can buy or sell August (or any other futures contract month) milk today.

It is doubtful that futures market prices can be used directly as the basic formula price. We have enough experience to know that they exceed the amount paid to Grade A producers in the Upper Midwest. They represent the value of milk sold from a plant in Southern Wisconsin and Northern Illinois, so they take into account the price paid to farmers, the cost of procuring and assembling the milk, and the opportunity value of spot sales from the plant.

The difference between farm level pay prices and futures prices is called the "basis". So far, only three futures contracts have matured, so we have too little experience to accurately estimate the basis. However, by the time a new basic formula price is adopted, we will have five times the experience we have today. It is likely that at that time we can forecast the basis with reasonable accuracy.

To make the futures price usable as a basic formula price, it will be necessary to deduct the Upper Midwest basis. As with using the competitive A/B price survey, it also would be wise to deduct a factor representing the value of performance premiums for quality, composition and volume.

To summarize, futures prices represent a superior form of price discovery for milk. They represent that broadest base of competitive interest and information, they are simple to acquire, they are accurate, and they do not require any technical judgments about samples, survey accuracy, yields, composition, product prices or processing costs.

We urge your consideration of using either the competitive A/B survey price, or the futures price for the basic formula price in consolidated Federal Milk Orders.

Sincerely,



Paul G. Christ

Vice President, Dairy Planning & Analysis