

CLASS II PRICING UNDER FEDERAL MILK ORDERS

*Robert Cropp**

Federal milk marketing orders establish minimum prices that buyers (handlers) are required to pay dairy producers for grade A milk. These minimum prices are established according to the use of milk. Twenty-nine of the now existing 32 federal orders establish four use classifications.¹ Class I is for milk used for fluid (beverage) uses; class II, for soft manufactured products; class III and III-A, for hard cheese, butter, whole milk powder, evaporated and sweetened condensed milk, cream cheese, and other spreadable cheeses.

More specifically, Class II includes skim milk and butter fat contained in fluid cream products; bulk concentrated fluid milk products, cottage cheese and any similar soft, high-moisture cheese, milkshake and ice milk mixes, frozen desserts, and frozen dessert mixes; aerated cream, frozen cream, sour cream, sour half-and-half, sour cream mixtures, yogurt, eggnog, custard, puddings, pancake mixes, formulas prepared for infant feeding or dietary uses, candy, soup, bakery products, and sweeten condensed milk. Class II products are neither as perishable as fluid milk products nor perform a balancing function in the market as do class III and III-A products.

This leaflet concerns itself with the pricing of milk used for class II products.

What Are The Issues With Class II Pricing?

Class II milk pricing has not been without controversy. The procedure for establishing minimum class II prices has changed several times through amendments

to the orders. Major issues have been the level of class II prices, advanced class II pricing, "add-back" provisions, whether or not class II prices should track class III prices or class I prices, and shipping requirements. Each of these issues are discussed in turn.

Level of class II prices: The rationale for pricing class II milk higher than class III is based on several factors. First, most class II products are made from grade A milk at or near the same facilities that process class I beverage products and have similar distribution channels. Thus, a higher price is required to attract grade A milk supplies to class II uses. Second, a higher class II price along with a higher class I price add to producer blend prices under the order. With a higher class II price, not all of the pressure is on the class I price to generate a blend price that encourages producers to produce a sufficient amount of grade A milk for order needs. Third, it has been argued that the price elasticity of demand for class II products is more inelastic than for class III products, and therefore, class II milk can economically be priced higher. A more inelastic demand for class II versus class III products may be questionable today.

Federal milk marketing orders operated several years with a targeted class II differential of 10 to 25 cents above the M-W price until April, 1995. At this time, through a federal order amendment, the procedure was changed to price class II milk 30 cents above the M-W price² for second preceding month. It was argued that the 10 to 25 cent differential no longer was adequate

*The author is a Professor in the Department of Agricultural Economics at University of Wisconsin-Madison and an Extension Dairy Marketing Specialist at the University of Wisconsin-Extension.

¹The other 4 orders have three use classifications where milk used for class III includes both the class III and class III-A products.

²As of May 1, 1995, the M-W price was replaced with the Basic Formula Price (BFP).

to attract grade A milk for class II uses. Handlers for most federal order markets were paying premiums for class II milk resulting in an effective class II differential of about 30 cents above the M-W price. Even at 30 cents some handlers claim difficulty in attracting sufficient supplies of grade A milk for class II use. They favored a differential as much as 80 cents above the M-W price. But higher class II values may pose problems. Some class II dairy ingredients compete with the same ingredients made from lower priced unregulated grade B milk, and/or class III-A nonfat dry milk. Higher class II prices may also reduce consumer demand for these products. Some consumers may shift to less expensive nondairy substitutes.

As of December, 1994, class III-A pricing became effective in 29 of the then 38 federal milk marketing orders. A product-price formula that considers the market price of nonfat dry milk and its yield from a hundred-weight of milk is used to determine the class III-A price. Class III-A prices have been below class III prices most of the time. This situation has created an economic incentive to use nonfat dry milk in place of class II fresh milk or condensed milk solids as ingredients for some dairy and other food products. The higher the class II price relative to class III-A the greater the economic incentive to substitute nonfat dry milk for fresh milk or condensed milk solids for these products.

Advanced class II pricing: In the mid-sixties, for most federal milk marketing orders the class II price was based on the M-W price of the current month. Because the M-W price, now the BFP, for a given month is announced on or before the 5th of the following month, the minimum class II price for a given month was also announced at this same time.

By the early 1980s, there was a call for advanced class II pricing, as had been the procedure for class I pricing.³ Milk handlers charged that class II products were more like class I products and unlike class III products in that they were sold and moved into the commercial market channels in a relatively short period after being manufactured. Therefore, the existing class II pricing procedure put handlers in a difficult position in pricing and selling class II products when they did not know their raw milk cost until the 5th of the following month. Federal milk marketing orders were amended

and advanced class II pricing has been used since 1981

“Add-back” provision: The initial procedure for advanced class II was to establish a tentative advanced pricing for class II milk. The class II price for a particular month was announced on a tentative basis by the 15th of the preceding month. Because the class II price could not be less than the class III price, the final or effective class II price was still not known until the 5th of the following month when the class III price was announced.

Under this revised class II pricing procedure, the tentative class II price for the month was determined by adjusting the M-W price for the second preceding month by an updating formula, resulting in a basic class II formula price to which a class II differential was added. The updating formula was a product price formula that determined changes in the gross values of milk used to make cheddar cheese, butter and nonfat dry milk. The class II differential varied on a monthly basis to yield a class II price that, on the average, would maintain what had been a normal 10¢ relationship between the class II price and the class III price.

This class II pricing procedure worked quite satisfactory until fall 1989 when relatively large month-to-month increases in dairy product prices, and in turn M-W prices, were observed. November, 1989, was the first time that large monthly increases in the M-W price resulted in a class II price less than the class III price. As a result, the tentative November class II price, which was announced on October 15th, had to be revised upward.

This need to adjust upward the final class II price brought forth major complaints by handlers resulting in a further amendment to the class II pricing procedure effective January, 1990. The amendment did not change the procedure for determining the class II price, except that the class II price for a given month announced by the 15th of the preceding month was now a final, not a tentative, class II price. Thus, this amended procedure was advanced class II milk pricing. In place of adjusting upward the final class II price for a given month when the tentative class II price was less than the class III price for the same month, an “add back” provision was used. Under the “added back” provision, if the announced class II price for a given month was

³The minimum class I price for a given month is the BFP two months previous plus a class I differential. For example, the March class I price is the January BFP plus the differential applicable to the order. Thus, the current month class I price is announced on the 5th of the preceding month. In this example, the March class I price is known by February 5th.

lower than the class III price for the same month, the difference was added to the class II price two months hence. There was no provision to “subtract back” when the class II price exceeded the class III price by more than the usual class II differential. This procedure continued advanced pricing of class II milk, but still required that the class II price could not, on the average, be less than the class III price.

The “add-back” provision was discontinued with the April, 1995 federal milk marketing order amendment. The class II price now can fall below the class III price with no further adjustment.

Should class II prices be coordinated with the class III price or the class I price? Up until federal milk marketing orders were amended April, 1995, the objective was to coordinate class II prices with class III prices. This was accomplished by having a targeted differential between class II and class III prices. It was claimed that a higher class II price is needed to attract sufficient amounts of grade A milk from class III cheese use to class II uses. Further, there is a need to coordinate class II prices with class III prices because class III and III-A products could be used as an alternative source of ingredients for class II use. This was in reference to nonfat dry milk and evaporated and sweetened condensed milk. Since class III-A was established, nonfat dry milk is now a class III-A product and, as already indicated, it is being used as an alternate source of ingredients for class II products.

But the 1995 amendment made a major change. As of April, 1995, the class II price is coordinated with the class I price. Both classes are based on the BFP price two months previous plus a fixed differential, 30 cents for class II and a higher differential that varies by market order for class I. Class II prices now move in the same direction and magnitude each month as do class I prices.

Previous to this change, when advance class II pricing was used in conjunction with the “add-back” provision, rather large M-W price movements in the past few years have resulted in the movement of class II prices in a magnitude and direction often in the opposite direction of class I and class III prices. These volatile and opposite-moving price relationships have limited class II processors in their ability to sell products on a forward contract basis and confused their customers. Since class II and class I products are closely interrelated it is argued that class II and class I milk prices should move together. Further, as previously indicated, class II products are often made in the same plant as

class I products and have similar distribution channels as class I products. Therefore, it is argued that for more efficient marketing and efficient pricing of milk, both class I and class II prices should reflect movements in the BFP at the same time, of the same magnitude, and in the same direction.

Shipping requirements: Federal milk marketing orders have had provisions that establish shipping requirements for supply plants. Shipping requirements have been used to ensure an adequate supply of class I milk. Supply plants would be required to ship a specified percentage of their grade A milk receipts for class I purposes. A similar shipping requirement has been proposed for class II use.

The purpose of shipping requirements is to assure ample supplies of grade A milk to meet class I or class II needs. The class I and class II differentials may not be adequate at times to encourage supply plants to pull grade A milk away from manufacturing (class III) use to meet class I or class II needs. This situation could occur during periods of seasonal low milk production and strong demand for grade A milk by cheese and other manufacturers to maintain manufacturing plant capacity. Unless, these manufacturing supply plants are required to ship a percentage of their milk during these time periods, they may choose to keep the grade A milk for manufacturing rather than supply class I or class II needs. If a milk plant does not comply with the shipping requirement, it would lose its association with the order and the benefits received from the order. The benefits for a manufacturing milk plant associated with an order is the ability to draw out of the federal order pool the difference in the market-wide blend price and the class III price. The manufacturing plant is able to add this pool draw money to its revenue received from selling manufactured dairy products. This process enables manufacture milk plants to compete for grade A milk supplies for manufacturing use.

Class II Utilization

The percentage of grade A milk under federal milk marketing orders utilized for class II ranges from about 3 percent to over 20 percent with an average of about 11 percent for all orders. The class II utilization, as does the utilization for all classes, depends on the amount of grade A milk associated with an individual order. Orders with the higher class II utilizations may be orders where grade A milk supplies are closer in balance with both class I and class II needs for the specified market

area. These orders are located for the most part in the Northeast and Southeast. The lowest class II utilizations are found in those federal milk orders where grade A milk supplies far exceed class I and class II needs, such as the Chicago Regional and the Upper Midwest (Minneapolis) orders.

But there is more to class II utilization percentages. Some orders have a relatively high class II utilization simply because a relatively large capacity class II plant is located within the order. Other orders may have a relatively small class II utilization, yet the quantity of milk used for class II is large. But because of the total volume of milk associated with the order, class II utilization is still a low percentage.

Summary

The procedure for class II pricing for federal milk marketing orders has been amended on several occasions. The most recent amendment being April, 1995. Federal orders have been amended to reflect the relationship between class III and class I prices. Since class II products could use lower priced class III and class III-A milk products for ingredients, class II prices need to recognize this potential substitution. Further, class II prices need to recognize that many class II products may be manufactured from lower priced grade B milk. Despite these relationships to class III and class III-A, more recent views are for class II prices to be coordinated with class I prices. Since class II and class I products are closely interrelated in that they are often manufactured in the same plant or nearby location and

have similar distribution channels it is argued that class II and class I milk prices should move together.

Since class II products are more like class I products in that they are sold and moved into the commercial market channels in a relatively short period after being manufactured, advance pricing is important to handlers. Handlers are better able to sell class II products since they know in advance the cost of milk to make the products.

The objective is to have class II prices higher than class III prices. But when the BFP price moves up rather sharply the class II price may fall below class III prices. An “add-back” provision would recoup this short fall by adding back the difference to a future month’s class II price. Producers would benefit through higher blend prices when class II prices did fall below class III prices. But unless a “subtract-back” provision is also used to reduce future month’s class II prices when class II prices are above class III prices by more than the targeted relationship handlers do not receive the same price protection as do producers.

Since manufacture milk plants compete with class I and class II handlers for grade A milk supplies, at times of tight supplies the class II prices may not attract sufficient grade A supplies for class II purposes. To assure an adequate supply of grade A milk for class II needs, manufacturing milk plants (supply plants) may be required to ship a specified percentage of their grade A milk for class II needs in federal milk marketing orders to retain their association with and benefits from the order pool.

Additional copies of this leaflet or other published leaflets in the series can be obtained by written request to:

Wendy Barrett
Program on Dairy Markets and Policy
348 Warren Hall
Cornell University
Ithaca, NY 14853-7801

If you have access to the Internet, e-mail Wendy at gjb2@cornell.edu and/or visit our web site at: <http://cpdmp.arme.cornell.edu>