Dairy Farmers Will Gain From Component Pricing and Higher Minimum Standards [1/]

Glenn Lake asked me to speak as an advocate of component pricing and of higher minimum standards. Usually, in Extension work, I have to try to balance the pros of an issue with the cons of the issue. That is why we sometimes hear the wish for a one-handed economist, i.e., an economist who isn't always saying -- On the one hand this, but on the other hand that. This afternoon I can talk with one hand.

Component pricing and higher minimum standards are almost, but not quite, two separate and independent issues. They are related in the sense that higher minimum SNF standards are necessary where component pricing is practiced if uniform raw product costs are to be a fact. That starts to sound complicated, so let's begin with some arguments supporting multiple component pricing.

1. One of the good arguments for component pricing simply is to understand how milk is priced now. Consider your own blend price. It is associated with 100 pounds of cow's milk. The pool is standardized to reflect a cwt. price that values 3.5 pounds of milkfat plus 96.5 pounds of skimmilk. The only deviation from the announced blend price for you is if your milk tests higher or lower

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[1/] Robert E. Jacobson, Professor, Department of Agricultural Economics and Rural Sociology, The Ohio State University, for presentation at 19th Annual Meeting of Great Lakes-Southern Milk, Inc., Louisville, Kentucky, September 6, 1978.

than the 3.5 percent fat standard. If it does, then single component pricing affects your pay-out, i.e., fat differentials in the 12-13 cent range per point come into play.

Just consider a blend price example for a moment. A typical blend price across GL-SM this fall will be around $11.00 per cwt. and the fat differential will be about 13.4 cents. Given those two factors--$11.00 blend and 13.4 cent fat differential--the following facts become automatic:

a. Out of the $11.00 blend, your 3.5 pounds of fat is worth $4.91, or $1.40 per pound.

b. The 96.5 pounds of skim is worth $6.09, or 6.31 cents per pound.

c. The fat is measured precisely and accounts for 44 percent of the value of the milk. The 96.5 pounds of skimmilk is also measured precisely and accounts for 56 percent of the value of the milk.

But consider that 96.5 pounds of skim for a minute. Its price ($6.09 or 6.3 cents per pound) is not affected by whether it carries 8 pounds or 9 pounds of SNF; its price is not affected by whether it carries 3 pounds or 4 pounds of protein. We worry like mad about the test of milkfat out to 3 decimal points, but we have no idea at all about the SNF or protein test of the milk we sell. We don't know, and we don't care, because the SNF and protein don't have explicit values. A pound of skim is a pound of skim is a pound of skim. Let me ask you - does that make sense when 56 percent of the value of the milk is tied up in the skim portion?

2. One of the standard and at least partly true observations we hear in conversations about component pricing is that it doesn't mean any more money for milk producers--it's just another way of dividing up the pool. That always reminds me of the coop director who stopped by the pizza parlor on Route 23 and ordered a pepperoni pizza. The clerk asked him if he'd like it to be cut into 4 pieces or 8 pieces; and the director thought a minute and said, "Well, you better cut it into 4 pieces - I don't think I can eat 8 pieces!" That kind of sounds like there might be more money in the pool -- not just re-distribution.

Let me first say something about dividing up the pool -- then something about the size of the pool.

Component pricing is at least a different way of cutting up the pie -- even if the total size of that pie is unchanged. But let me ask you, "Isn't it important that the money paid out of the pool to dairy farmers be paid as closely in relation to the value of product as possible?" That's what equity, or fairness, in milk pricing is all about. Consider cattle sales for a moment. You don't sell prime beef at the Good price, and you don't sell cutters and canners at the Good price. Why then are you ready to sell skimmilk at the Good or average price? You get 54 cents for prime beef and 34 cents for cutter beef because the prime beef has more value. By and large, I'd also observe that higher solids skimmilk carries more value than does lower solids skimmilk. Therefore, why not reward the higher solids and penalize the lower solids skimmilk in the same way that you accept this procedure for beef, and for milkfat.

I know that some people start arguing when I say that skim testing higher in SNF has more value than does skim testing lower in SNF. But let's consider the matter for a moment. In 1977, 57.3 percent of the U.S. milk supply was used for manufactured dairy products. We all accept the fact that yields of manufactured product from 100 pounds of milk increase with higher SNF-protein tests. Cheese, cottage cheese, and NFDM are obvious examples of the relationship. Since milk at the manufacturing plant is worth more or less depending on the SNF test, then the milk price to the producer should be higher or lower depending on the SNF test.

The fluid milk market is less clear-cut. But let me remind you that in 1977, Class I utilization in the federal order program averaged only 52.8 percent. In fact, 68 percent of all of the dairy products manufactured in the U.S. last year were made from Grade A milk. I cite these numbers only to emphasize how important component pricing could be to the fluid milk industry and to the cooperatives represented here.

The Class I market is a tougher proposition

Let's talk about whether component pricing can mean more money for milk producers - first without any SNF fortification - then with higher minimum SNF standards for Class I fluid milk products.

Any hope that protein-SNF pricing by itself can mean more money to dairy farmers in the Class I market rides on the premise that component pricing can help give fluid milk a protein-calcium-nutrition image in place of the fat image that at least whole milk currently holds. I am persuaded that there is some evidence supporting this premise. I am still surprised and impressed with the 1970 survey of 2,200 households by the USDA that showed that --

(1) Only 8 percent of homemakers could tell you how much fat there was in whole milk;

(2) 67 percent of the homemakers estimated that whole milk tested higher than 20 percent in milkfat.

(3) As for lowfat milk, 35 percent of the homemakers estimated that it was higher than 6 percent in milkfat.

I don't think that milk should be indicted for its fat content or its assumed fat content. I think milk is more than 96 percent fat free and I think everybody should know that and should buy milk knowing that. Just since that 1970 survey, per capita consumption of whole milk has dropped from 214 pounds to 167 pounds in 1977; and increased sales of lowfat-skim fluid products have not been sufficient to offset that loss. Our present pricing arrangements

(cwt.-milkfat) are not the culprit, but they are one important element in the total picture. If we are going to get people to recognize that --

-- fluid milk is not a high calorie item;

-- fluid milk is not a high saturated fat, animal fat, cholesterol type item;

-- and that fluid milk is a protein, calcium, and nutrition related item --

Then at least one place to come to grips with that image is to start testing and pricing the SNF or protein back at the farm level. Why shouldn't consumers think of milk as a fat product when we continue to hand out 700 pound fat awards at DHIA banquets and continue to adjust producer prices and plant raw product costs only on the basis of milkfat? Can testing and pricing milk on a protein or SNF basis help? Why not try?

California went on component pricing in 1962. In the 1970 to 1977 period we have just noted, per capita consumption of all fluid milk products in California jumped by 5 percent at the same time that per capita fluid sales were dropping by 3 percent in the rest of the United States. Component pricing doesn't explain all of that, or even a big chunk of it. But component pricing was in the picture, and furthermore component pricing helped open new doors for generic promotion and for improving the quality of dairy products by generating momentum for higher SNF standards. I think component pricing in California has made that pie - that pool - a little bigger. Why shouldn't milk producers in the rest of the country expect a similar impact and see some of the slack taken out of the demand for fluid milk products?

So there are a couple of fundamental purposes served by component pricing --- (1) a more equitable distribution of proceeds, and (2) maybe some more money in the pot. It's worth a try.

Let's pick up on the higher minimum standards topic at this point. Presently, the annual average test of producer milk in the U.S. is 3.67 percent milkfat, and milk is estimated to run about 8.55 or 8.6 percent SNF. Protein gets close to accounting for about 40 percent of the SNF, so an average protein test on producer milk is about 3.3 percent.

The 8.55 percent average SNF test is substantially above the 8.25 percent minimum defined in the official Standards of Identity by FDA for fluid milk drinks. You may be interested in knowing that in California, where they have hard information on SNF tests, the average SNF test of producer milk in 1977 was 8.67 percent (3.57 percent milkfat). Please note that California's average SNF test of producer milk is below the minimum standards for fluidmilk drinks in California (essentially 8.7 percent minimum SNF for whole milk, 9 percent for skim milk, and 10 percent for lowfat milk). Fortification of all fluid milk drinks with additional SNF is normal in California.

Now let me point out some contrasts.

(1) In 1977, per capita consumption of lowfat-skim products in California was 45.3 quarts, or 4.2 quarts more than the U.S. average.

(2) In 1977, per capita consumption of whole milk in California was 83 quarts, or 5.2 quarts more than the U.S. average.

(3) Furthermore, all of the fluid milk products in California reflect the higher SNF minimums. In the rest of the U.S., we have been experiencing a continuing and substantial reduction in the amount of total milk solids, and especially SNF, being utilized in fluid milk products. Just in the period from 1970 through 1977, the following consumption trends occurred in fluid milk sales in the U.S., not including California:

a. As a proportion of total fluid milk sales, whole milk sales dropped from 76.1 percent in 1970 to 61.1 percent in 1977;

b. Skim and lowfat sales jumped from 19.4 percent in 1970 to 34.1 percent of total fluid sales in 1977.

c. But here is what hurts.

In 1970, 73 percent of the lowfat milk was fortified, but in 1977, only 35 percent of the lowfat milk was fortified.

In 1970, 74 percent of the skimmilk was fortified, but in 1977 only 53 percent of the skimmilk was fortified.

I believe that the reason why there is a decrease in fortification is obvious. Milk processors simply have rejected paying the price of fortifying. A CCC purchase price of 71 cents a pound for nonfat dry milk today as compared to 23.35 cents per pound in 1970 tells us a lot very quickly about that situation. Here is one observation -- Consumers are purchasing something they aren't especially interested in -- low solids milk -- because they aren't willing to pay the price for something they would really prefer - high solids milk. And as a corollary, processors, in spite of the California experience, have been afraid to challenge

the market with a fully priced high solids fluid milk product. I say all of this in part because I don't like plain (unfortified) skimmilk and I don't like plain lowfat milk, and consumer studies indicate that most people respond about that same way.

There are different and important purposes that can be served by going to higher minimum standards.

1. Improved nutrition as a goal has to rank towards the top. The nutritional superiority of fortified fluid milk drinks as compared to plain fluid milk drinks is obvious and substantial. Isn't it a paradox that in this day of a national nutritional food policy and Carol Foreman pronouncements that we continue to permit some erosion of the nutritional composition of fluid milk products because of diluted standards?

2. A second goal for higher minimum standards would be to put fluid milk products on the market that are more attractive to consumers --- that would generate a stronger taste preference for fluid milk products. In part, I believe that this has been the California experience - that higher quality fluid milk products have commanded a stronger demand. This is one of the bases for thinking that component pricing accompanied by higher minimum standards can mean more money for milk producers.

3. A third purpose to be served by higher minimum standards is that it greases the skids for component pricing. A complete component pricing plan, by definition, is one that both charges handlers and pays producers on the basis of the specified components. One of the problems in moving to component pricing at the

present time is that if processors are charged for components, then those processors that are receiving milk testing 8.7 percent SNF, or 3.5 percent protein, are going to be paying quite a bit more for raw milk than those receiving milk testing 8.4 percent SNF, or 3.2 percent protein.

Under our present cwt.-butterfat procedure, processors receiving milk of different test can be put on the same raw product cost basis because butterfat can be standardized down as well as up. For example, two handlers selling whole milk can both put out a 3.25 percent milkfat product even though receipts at one plant test 3.8 percent and receipts at the other plant test 3.5 percent.

The same is not true for SNF or protein. You can't standardize skimmilk down, except by adding water -- and that's illegal. You can standardize up -- by fortification with condensed skim milk solids or nonfat dry milk. That's why we hear talk about double standardization or higher minimum standards when we talk about component pricing. Higher minimum standards, for SNF or protein, can mean equal raw product costs to processors, and equal raw product costs can open one big door to component pricing. That's a pretty good reason, in my view, to push for higher minimum standards.

I also have a short list of purposes that should not be pursued in the quest for higher minimum standards. We shouldn't push for higher standards in order to force a commercial outlet for more milk solids. We shouldn't push for higher standards to reduce the amount of powder in CCC stocks. And we shouldn't push for higher standards to generate more cash receipts for dairy farmers. In

fact, I think all of these things will happen, but in the public arena, they are not acceptable arguments for higher minimum standards.

At the Southern Dairy Conference in Atlanta last February, Bill Blakeslee of Mid-America Dairymen, Inc. reported on their analysis of raising minimum standards for milk. By raising SNF standards to 8.75 percent for whole milk, and 10 percent for both lowfat milk and skimmilk, the Mid-America analysis indicated that --

(1) On an annual basis nationally, the usage or market for nonfat dry milk would increase on a net basis by 145.6 million pounds. That would represent about a 20 percent jump in the commercial nonfat dry milk market.

(2) CCC purchases and holdings of nonfat dry milk would decrease by a like amount (145.6 million pounds).

I think these estimates are worth noting because they provide some calculated impact of what higher SNF standards could do to the milk market. Obviously, the three negative purposes I've just mentioned would all be served, but that's OK.

A lot of other things can be said about both component pricing and higher standards. --- Testing methods, testing costs, SNF or protein, how high the standards, what about milkfat, pricing complexities, breed competition, impact on breeding programs, milk composition in the long run, legal strategy, and on and on.

But I think we've focused appropriately on the priority questions at this meeting -- Will dairy farmers gain from component pricing and from higher minimum standards? The answers are yes ---

--- Component pricing is a fairer pay-out method.

--- Component pricing can mean more money.

--- Higher standards can help introduce component pricing.

--- Higher standards will mean more sales of milk products.

--- Component pricing and higher standards taken together will be a positive factor for milk producers in the dairy market.