Understanding Milk Pricing- If That's Even Possible: Part 2

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In the previous article, we discussed the history of milk pricing in the United States, the equations that govern milk price and how end-product pricing works. This article will be the final part of a two-part series where we will look at the make allowance and Producer Price Differentials (commonly referred to as PPD's); arguably two of the more controversial parts of the milk pricing process.

Understanding the Make Allowance

A make allowance is an estimate of a dairy processing plants cost to turn milk into a commodity such as cheese or butter. The cost includes things such as labor, utility costs, ingredients like salt or cultures, product packaging and quality control testing. It does not include the cost of the milk itself. In an oversimplification, the make allowance covers the cost of production for the processor and that amount is allowed to be taken off the pay price for the milk. Some people look at it like the dairy producer covers the processing plants cost of operation with the lower milk pay price they receive.

How is the make allowance calculated? Processing plants fill out voluntary surveys where they report their costs of operation. These surveys are collected and compiled by the USDA's Agricultural Marketing Service (AMS), who then uses the reported data to calculate the make allowance. Make allowance calculations are done infrequently with one being done in 2008 and the most recent one being done in 2023.

- It is important to understand that the AMS has multiple roles. It is responsible for the weekly collection and independent verification of commodity prices, such as butter and cheese. AMS has the regulatory authority to provide independent oversight that the commodity pricing reported is verified to be accurate.
- In stark contrast, AMS claims that it does not have the regulatory authority to provide independent verification of the operational costs reported by processors in the voluntary surveys. Thus, the operational expense numbers reported by the processors are not verified to be accurate. These unverified operational expense numbers are then used to calculate the make allowance.

In speaking with a USDA AMS employee about this discrepancy, I was told that the AMS does not need to independently verify the processors reported costs of operation because a) "its been done like this for a long time" and b) he (the USDA employee) was confident that the processors were being "truthful in their reporting". At one time, California used to independently verify the processor cost reporting within their state and the USDA/AMS would use that data, however, California no longer verifies processor's reported costs. The University of Cornell has also been involved with analyzing the cost of operation data reported by the processors, however, Cornell does not independently verify the reported costs either. The price of milk paid to the dairy farmer is then reduced by the amount of the make allowance. Given the importance of the make allowance and its direct impact on the pay price for milk, why wouldn't the USDA AMS want to verify the processing plants reported operational expenses?

If processors cannot operate within the set make allowance to make a profit, they have the opportunity to either control their costs, lower the premiums paid, or de-pool their milk to avoid the FMMO regulated minimum prices. Compared to dairy farmers, the processors have options, while the dairy farmer has only the option to control their input costs.

It's important to note that this is not a dairy farmer vs processor issue. Processors need dairy farmers, and dairy farmers need processors. It's a symbiotic relationship where both parties need to remain profitable for the other to survive.

Understanding Producer Price Differentials

Milk pricing is a complicated and hard to understand issue. Within the enigma that is milk pricing, the PPD is probably the most confusing part of it all. According to retired dairy co-op executive, Calvin Covington, the PPD is defined as "The total dollars in a federal order pool available for producer payment, minus the total dollars paid to producers for their milk production at the Class III component values for butterfat, protein and other solids. The sum is divided by the total cwt of producer milk. The result is the PPD per cwt."

The topic of PPD's can be confusing. However, in an oversimplification, you can think of it as the PPD is a factor related to the difference between Class I fluid milk pay price and Class III cheese pay price. If Class I milk is significantly higher than Class III milk, the PPD will generally be positive and will grow as the difference between Class I and Class III milk grows.

It's not only the pay price of Class I milk, but the volume of milk in the pool that was sold under Class I as well that impacts the PPD. Larger volumes of milk in the pool that are sold as Class I milk will generally also increase the PPD.

While there are outlier situations that will upend the broad statements above, they are generally useful in trying to understand the PPD.

In conclusion, milk pricing is a complex process that uses end-product pricing and takes factors such as make allowances and PPD's into account. There is no clear solution to a simpler and more effective milk pricing scheme, however, understanding the process is the first step to creating positive change. Hopefully these articles have helped shed some light on the often dark and confusing topic of milk pricing.