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**UNITED STATES DEPARTMENT OF AGRICULTURE
AGRICULTURAL MARKETING SERVICES
(Dairy Programs)**

Milk in the Northeast and)
Other Marketing Orders) Docket No. AO-14-A73 et al.
) DA 03-10
Fluid Milk Product Definition)
7 C.F.R. § 1000.15)

Hearing in
Pittsburgh, Pennsylvania
June 20 - 23, 2005
70 Fed. Reg. 19012 (April 12, 2005)

POST-HEARING BRIEF:

**Proposed Findings of Fact and Conclusions
On Behalf of H.P. Hood**

September 6, 2005

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Proponents of expansion or clarification of "Fluid Milk Products" to be included in Class I pricing under Federal Milk Marketing Orders asked the Secretary to hold this hearing to protect existing Class I products and markets from competition by beverages containing milk ingredients, and to protect producer revenue from being eroded by dairy beverages in Class II use. Based upon the record and evidence received at the four-day hearing in Pittsburgh during June 2005, it is abundantly clear that the Fluid Milk Product definition of Federal Milk Marketing Orders should not be changed. Proponents of National Milk Producers Federation ("NMPF") Proposal No. 7 have not met the burden of proof required of them by the Administrative Procedure Act ("APA") or the Agricultural Marketing Agreement Act ("AMAA"). NMPF did not even attempt to meet this evidentiary burden, explaining that substantial record evidence for Proposal 7 presumably lies in some past hearing record, and that is enough. Cryan, Tr. 210-211.

There is no marketing or competitive disorder that merits a regulatory remedy. The remedy in NMPF Proposal No. 7 would not advance competitive equity between handlers, nor would it enhance producer revenue (if that is the purpose or desirable policy result of the proposals). Rather, it would impede development of new products and new uses for dairy ingredients in beverages, and depress dairy farm revenue. Proposal 7 would also create non-uniform Class I pricing, contrary to the mandate and authority of 7 U.S.C. §608c(5)(A).

The record does reveal, however, that there is misunderstanding and confusion within the dairy industry about the Secretary's authority to create "use classifications" for

producer milk, about the history and economic foundation for classified pricing in the federal milk order system, about the standards (economic, competitive, and legal) that necessarily underlie any classification or price discrimination in that system, and about the manner in which current rules are interpreted and administered by USDA.¹

H.P. Hood submits this post-hearing brief and proposed findings to summarize the evidence in support of retaining the current language of rule 1000.15, and lack of evidence supporting NMPF's proposed rule, in the context of statutory authority, regulatory history, and economic reasoning that must guide USDA's decision making.

PROPOSED FINDINGS OF FACT AND CONCLUSIONS

H. P. Hood proposes the following findings and conclusions, and requests the Secretary to make a ruling on each proposed finding as required by law. 5 U.S.C. §557(c); 7 C.F.R. §§900.12(b)(2) and .13a(b).

I. THE SECRETARY HAS AUTHORITY TO CLASSIFY AND UNIFORMLY PRICE PRODUCER MILK ACCORDING TO ITS USE AND USE VALUE.

1. Throughout the hearing, witnesses, including many Proposal 7 proponents, repeatedly maintained that "form and use" of milk is the standard for classification of products in Federal Milk Orders. This is not an accurate paraphrase of the AMAA. Proposal 7 proponents then maintained that proof of "beverage" form or use of a dairy product is all that is required for Class I classification and Class I pricing. Cryan, Tr.182-184, 350-51. This is wrong as a matter of administrative law and economic law.

2. The AMAA authorizes the Secretary to classify producer milk according its *use by handlers*. Classification may only be based on "form in which or the purpose for which it is used," and within each use classification the regulated milk price charged to handlers must be "uniform." 7 U.S.C. §608c(5)(A). "In applying the language of the Act, we here consider the form and purpose of use for both [the product] and the milk ingredient

¹ Dairy industry representatives who attended the hearing had an opportunity to gain a better understanding of USDA's current interpretation and application of the fluid milk product definition from testimony and agency guideline exhibits not previously made public. However, public knowledge of the agency interpretations in practical application, and of possible non-uniformity from market to market, remains very incomplete. Appendix A hereto attempts to compile, from this record, the agency's current interpretations and guidelines. This, we believe, is useful as a reference to evaluate proposals that would change the fluid milk product definition and those that purport to retain status quo interpretation.

content of [the product].” (34 Fed. Reg. 16881, 16882 (Oct. 18, 1969) (USDA filled milk decision). “Federal milk marketing orders establish minimum prices that regulated handlers must pay for Grade A milk based on its use. **** There are four classes of milk under Federal orders; each class depends on how the milk is used.” U.S. Department of Agriculture, *Economic Effects of U.S. Dairy Policy and Alternative Approaches to Milk Pricing* (Report to Congress July 2004) p. 41.

3. USDA has effected this classification authority by placement in Class I producer milk “disposed of in the *form* of fluid milk products,” and placement in Classes II through IV producer milk “*used* to produce” other dairy products. 7 C.F.R. §1000.40. The current system does “not classify products per se, but rather the skim milk and butterfat disposed of *in the form* of a particular product or *used to produce* a particular product.” 39 Fed. Reg. 8712, 8714 (fn. 1)(Mar. 5, 1974). The focus of AMAA classification authority, and its implementing regulations, is on handler use of milk by form or purpose, not on ultimate consumer use.

Economic Justification for Classified Price Discrimination: Legislative History and Administrative Practice.

4. Classification of raw milk in various uses, with resulting price discrimination, however, is not authorized in an economic or competitive vacuum. The history of the AMAA and its administration by USDA demonstrates that classified price discrimination must be rationally supported by objective economic evidence that the classification of milk in a high class and high price use is justified by higher market value of that use compared to lower class/lower price uses of raw milk.

5. The authority given by Congress to the Secretary in the 1930’s to classify milk based on “form in which or the purpose for which it is used” was built on a foundation of discriminatory (classified) pricing of milk by dairy cooperatives for several decades prior to enactment of the AMAA. “The use of classified pricing for milk pre-dates the establishment of Federal Milk Marketing Orders by at least four decades. Our interpretation of the history is that producers and their organizations realized that fluid markets were able to sustain higher prices and generate higher returns to producers. Classified pricing was implemented to take advantage of this opportunity, recognizing that

other product markets would have to receive a lower price to ensure that the markets cleared.” Stephenson, Tr. 563-64. *See also*: USDA, *Report to the Secretary of Agriculture by the Federal Milk Order Study Committee* (April 1962) (“Nourse Report”) Part I, pp. 12-13; and Black, John D., *The Dairy Industry and the AAA* (The Brookings Institution, Washington, 1935);² *Nebbia v. New York*, 291 U.S. 502, 517 (1934) (“[P]rices which can be realized for ... [milk in] other uses are much less than those obtainable for milk sold for consumption in fluid form or as cream.”).

6. As recently reaffirmed by USDA, the relative inelasticity of demand for packaged fluid milk, and relative elasticity of demand for other dairy products, is one of the primary reasons the dairy industry and government regulators have applied price discrimination for raw milk in the form of classified pricing for the purpose of stabilizing or enhancing producer revenue. “[T]he elasticity of demand for the various dairy products is significantly different, creating different consumer responses to the changing prices for various dairy products. The Federal milk orders have attempted to address these issues through classified pricing. This system allows a higher price to be applied to milk used for Class I uses due to inelastic demand for Class I products.” Federal Milk Order Reform Decision, 64 Fed. Reg. 16026, 16102 (April 2, 1999).³ Thus, placement of a dairy product or milk use in Class I requires an objective and rational determination of the ingredient value of raw milk in that use, and its milk value relative to other uses, by elasticity measures and other factors. Stephenson, Tr. 578-80.

7. A number of economic standards and competitive factors have been employed by USDA over seven decades of Milk Marketing Order regulation to ascertain the value,

² The Nourse Report is reproduced on the CPDMP website, <http://www.cpdmp.cornell.edu/>, under “miscellaneous publications.” John Black’s study of the dairy industry and the AAA may be found online in Cornell’s Core Historical Literature of Agriculture collection, <http://chla.library.cornell.edu/c/chla/index.html>.

³ This rationale was reinforced in last year’s report to Congress, US Dairy Policy ’04 at p. 40: “Discriminatory pricing, to the extent that prices differ by more than the additional transportation and other costs entailed in meeting Class I demand, can increase revenue by charging a higher price in a market with more inelastic demand (where consumption is relatively unresponsive to price changes), and a lower price in a market with less inelastic (more price-responsive) demand (Tomek and Robinson, 1972; Manchester, 1983). Demand for fluid milk tends to be more inelastic than the demand for manufactured products. Thus, increasing the fluid price can increase total producer returns.”

comparative value, and proper classification of milk in particular uses. For Class I uses, which apply to milk products distributed in beverage form, these have included:

- (a) Is the product or use subject to a fluid milk standard of identity by state or federal food regulators?
- (b) Do food safety regulators require that the product to be made from Grade A milk?
- (c) Does the product require a constant supply of locally-produced fresh milk due to short shelf life or other reasons?
- (d) Is consumer demand for the product relatively inelastic, as it is for fluid milk?
- (e) Does the product compete substantially and directly with fluid milk products in Class I? For this purpose, USDA and dairy economists look at a number of subsidiary factors.
 - (i) Is the product marketed as a substitute for fluid milk to consumers who would otherwise buy fluid milk?
 - (ii) Does the product have sufficient market share to constitute a threat to established fluid milk sales?
 - (iii) Is the product offered at a lower price than fluid milk?
 - (iv) Does cross-price elasticity analysis demonstrate actual product substitution or fluid milk market cannibalization?
 - (v) Has the product been marketed long enough to determine its competitive impact under actual market conditions?
 - (vi) If competitive problems are demonstrated, are they minor or are they significant?
- (f) Is the product marketed from individual manufacturing or processing plants locally (like fresh milk) or nationally (like manufactured products)?
- (g) Does the manufacturer have a milk ingredient cost advantage in the new product over raw milk costs to processors of Class I milk products?
- (h) Would a lower-priced classification of the product defeat or undermine the objectives of classified pricing?
- (i) Would the requirement of uniform pricing to handlers be advanced by Class I classification of the milk use?
- (j) Would Classification of the product in Class I enhance producer revenues?
- (k) Is Class I classification required to serve the objectives of an adequate but not excessive milk supply?

These factors are discussed and applied in: 64 Fed. Reg. 16026 (April 2, 1999) (FMMO Reform Decision); 39 Fed. Reg. 8202 (March 4, 1974), 39 Fed. Reg. 8712 (March 6, 1974), and 39 Fed. Reg. 9012 (March 7, 1974) (uniform classification decisions); 58 Fed. Reg. 12633, 12634-35 (March 5, 1993) (national hearing decision); 34 Fed. Reg. 16881 (Oct. 18, 1969) (filled milk decision); and 33 Fed. Reg. 188 (Jan 5, 1968)(adopting skim milk and butterfat accounting after New York and New Jersey authorized standardization of milk for fluid uses); Craig Alexander, Tr. 435-36; Olsen & Ledman, Tr. 510-12; Box, Tr. 661-62. The ultimate "objectives of classified pricing are uniformity of pricing [to handlers]

according to form or use and providing an adequate return to producers for the fluid market.” 34 Fed. Reg. at 16883.

II. FACTORS ADVANCED, DISCOUNTED AND REJECTED BY NMPF PROPONENTS FOR ADOPTION OF PROPOSAL NO. 7.

8. Proposal No. 7 proponents (collectively referred to as “NMPF”) rely on some of the standards employed in the past, discount the importance of other factors to this hearing, and suggest new reasons for product classification.

9. Proposal No. 7 would establish a 2.25% milk protein content standard of identity for milk beverages to be priced in Class I use.⁴ Under the current fluid milk product definition, NMPF argues, handlers making new technology beverages using milk protein ingredients could account to producers for only 60% of the milk or milk protein in raw milk. Cryan, Tr. 290-91. As explained by NMPF, the proposed identity standard for a fluid milk product would provide for protein accounting in Class I uses consistent with “full component pricing” of milk in other uses because milk protein is currently “undervalued.” Cryan, Tr. 154, 219. This aspect of the proposal would also have the effect of pricing Class I milk on a “used to produce” basis, as currently employed for Class II – IV uses, without an express conforming amendment to 7 C.F.R. §1000.40(a). Cryan, Tr. 164, 166. As a result, milk components in the finished Class I product as well as byproduct components removed from raw milk before the product is finished would all be attributed to the content of the finished product and classified as Class I. By these pricing and accounting methods, NMPF maintains that the “real value” of milk will properly be regulated. *Id.*, 164, 167.

10. NMPF also maintained that its proposal is for clarification only, and would not really change the current system. Proponents believe that “there are no products that will change classification from the way that the USDA is presently treating them.” Hollon, Tr 100; Cryan, Tr. 150, 212, 244-45 (“status quo” would be maintained); Alexander, Tr. 302-

⁴ As illustrated by the New York-New Jersey skim milk and butterfat accounting decision upon which NMPF relies, 33 Fed. Reg. 188 (Jan. 5, 1968), federal order product classification commonly *follows* the establishment or amendment of composition, identity and sanitary standards by food safety regulators. The FDA is charged with regulating standards for milk. Ironically, the FDA and USDA (FSIS) are concurrently engaged in rulemaking to amend food identity and composition regulations to “better promote honesty and fair dealing in the interest of consumers and protect the public, [and] allow for technological advances in food production....” 70 Fed. Reg. 29214 (May 20, 2005).

04 (“National Milk’s proposal simply provides additional clarification to the de facto administration of the rules.”). For some NMPF participants, this observation is apparently sufficient by itself to justify the adoption of Proposal No. 7 without substantial record evidence addressed to competitive and economic factors that underlie milk classification decisions. *E.g.* Ben Yale cross-examination of Bob Yonkers, Tr. 889 – 890; Hollon, Tr. 145-47 (for dairy beverages currently in Class II versus Class I, there is no need to justify, distinguish or compare competitive and economic characteristics supporting the proposed classification because “they meet the definition of things that are there now.”).

11. While expressing a belief that product classification would not change by their proposal, NMPF proponents and many other participants admit that they are not sure how USDA is currently administering the fluid milk product definition, or expressed an understanding in direct conflict with USDA’s current internal guidelines (Ex. 30-D) for its administration. Hollon, Tr. 93, 97-98; Cryan, Tr. 176, 249, 290, 293. They were further uncertain about what classification USDA applies to specific dairy beverages, the classification of which may be affected by its proposals.⁵

12. A number of established milk classification factors (see finding No. 7) were simply not addressed by NMPF. Other factors were discounted by NMPF proponents as not applicable or of little consequence in evaluation of the merits of its proposal. These include:

- (a) Grade A milk or ingredients. Cryan, Tr. 183-84, 234-35 (it does not matter for purposes of Proposal 7, except possibly for beverage yogurt, whether the Class I dairy beverage requires Grade A milk or can be made from Grade B or imported milk and dairy ingredients).
- (b) Producer revenue impact or enhancement. Hollon, Tr. 81, 86 (not really concerned with producer revenue impact of the proposal, though it may be

⁵ USDA keeps a product classification list, but its contents are unknown to the record because the agency deems classification of specific products to be confidential. Classification secrecy has, apparently, not always been USDA’s policy. *C.f.*, 63 Fed. Reg. 4801, 4924 (Jan. 30, 1998) (“At the present time, for instance, products such as “Sportshake,” “Powergetic,” “Carnation Instant Breakfast,” “Resource Dairy Thick,” “Ready Care Thickened Dairy Drink,” and “Ultra Slim-Fast” are classified as “meal replacements.”). The names of dairy beverages are, of course, public knowledge, as is the plant and plant location coded on the package. The classification of standard products, such as 2% milk and fluid cream are also known and spelled out in Federal Order Rules. Classification of some dairy beverages can also be inferred by USDA’s identification of plants, such as Dannon’s plants in Texas and Utah, as distributing plants. It is unclear why USDA now keeps secret from the industry the classification of some miscellaneous dairy beverages, but it is clear that such secrecy may breed doubt that a processor has the same classified price as a competitor producing a similar product, particularly where there is no assurance of uniform administration among market administrators of the fluid milk product definition.

significant in other classification decisions); Hollon, Tr. 102-03, 177-78 (the proposal “would be close to revenue neutral” on producer revenue); Cryan, Tr. 242, 338 (producer prices “not necessarily relevant” or “appropriate” to consider in this hearing).

- (c) Adequate supply of fresh Grade A milk. As an apparent corollary to its revenue neutral observations, NMPF witnesses made no effort to link its proposals to the statutory objective of a “sufficient quantity of pure and wholesome milk.” See: 7 U.S.C. §608c(18); 34 Fed. Reg. at 16882 (’69 filled milk decision).
- (d) The demand elasticity of new products. Cryan, Tr. 305-306 (NMPF eschewed product demand and elasticity studies as fancy, complex, and unnecessary).
- (e) Product substitution and cross-price elasticity between specific dairy beverages and standard fluid milk products. Hollon, Tr. 88-90, 107 (proposal No. 7 does not depend on whether there is actual product substitution, although some products captured in Class I by the proposal would presumably be substitutes for milk); Hollon, Tr. 84, 122-25 (do not have data on substitutability of existing fluid products; do not have data showing any loss of Class I sales to specific dairy beverages, such as yogurt or wellness drinks; “that’s not why we’re here.”); Cryan, Tr. 301-303 (don’t have data demonstrating specific dairy beverage substitution for fluid milk or marketing in competition for fluid milk); Cryan, Tr. 307 – 12 (NMPF didn’t think it necessary to secure any cross-price elasticity study, although that would admittedly produce more valid, “statistically significant results” for demonstrating product substitution.).
- (f) Whether existing dairy beverages have been marketed long enough or achieved sufficient market share to apply other classification factors. Hollon, Tr. 84 (don’t have data on market share or market penetration of dairy beverages); Cryan, Tr. 231 (the new technology beverages targeted by Proposal 7 “don’t represent a large share of the market.”). The original proposal by DFA for this hearing was made in June 2003, concurrent with the introduction of some new low-carbohydrate soft drink dairy beverages, and the hearing was three years premature of the 5-year period ordinarily required to measure full market potential of a successful new product. (Stevenson, 561, 571-72, 613, 643).
- (g) Whether dairy beverages have a milk ingredient cost advantage over traditional beverage milk. NMPF is apparently indifferent to this factor, and offered no data in support of Proposal 7 to suggest or demonstrate that the cost or price of new technology milk protein ingredients in dairy beverages would create a competitive advantage for these beverages over milk (or milk protein) costs in traditional fluid milk products. One NMPF witness reported that a milk protein ingredient (caseinate) used in dairy beverages recently cost \$3.60/lb – a price considerably above recent Federal Milk Order Class I protein or skim milk equivalent prices – and urged caution to avoid serious cost disadvantage for milk proteins in competition with soy and vegetable protein sources for beverage use. (Alexander, Tr. 411-14).

13. In a few respects, however, NMPF witnesses gave at least lip service to some established statutory and administrative classification factors. At the top of this list is beverage “form and use” of Class I products: “Form and use of a product should be the primary guideline which the Secretary uses in classifying products.” Hollon, Tr. 70-71, 132-33; Cryan, Tr. 182 (the “physical characteristics” of a product are more important to a classification rule than economic and competitive factors); Cryan, Tr. 243 (“the underlying principal is to clarify form and use as the basis for the Class I classification). *See also*, Cryan, Tr. 183-84, 301-02 (explaining why beverage yogurt should be in Class I); Cryan, Tr. 350 –51 (explaining why milk ingredients should be treated like fresh skim milk in dairy beverages – “If it’s going to be used in a beverage, then why not include it?”).⁶

14. NMPF also maintains that the primary purpose of the proposal – fixing a protein standard to define fluid milk products – is protection of existing Class I products against competition by substitute dairy beverages in form and use similar to traditional fluid milk products and to protect Class I revenue. Hollon, Tr. 87-88, 120 (“That’s why you have a fluid milk product definition.”); Cryan, Tr. 212 (that’s “the primary role” of NMPF’s protein composition standard). Competing and substitute dairy beverages, NMPF explained, can now be made with milk protein products produced by new technology. Hollon, Tr. 64-67. If new technology dairy beverages are able to avoid Class I classification under the current fluid milk product definition, the Federal Milk Orders and classified pricing would be undermined (Cryan, 153-54, 156, 230, 235) and “serious inequity” may result. Cryan, Tr. 155.

15. Protection of U.S. milk producer income from competition by imported milk proteins used in dairy beverages is another factor advanced by NMPF for Proposal No. 7. Because a “significant share of milk proteins in these products... have been imported, “producer revenue would be reduced” if these products are assigned to Class II. Cryan, Tr. 179-80. This appears to be the first time that U.S. foreign and international trade policy has

⁶ At least one NMPF proponent, O-AT-KA, gave conditional support for a clarifying amendment to the fluid milk product definition (Alexander, Tr. 401 - it “might be necessary”), motivated by desirability of “consensus within the National Milk Producers Federation” (*id.*). This lukewarm support was conditioned upon the understanding that *status quo* would be maintained, its own line of dairy beverages would continue to be exempt from Class I classification, and only dairy beverages made by others might be more costly to produce. Alexander, 399 – 447. DFA, similarly, professed the desirability of maintaining Class II classification for dairy beverages it produces. Hollon, Tr. 73-74, 93-94.

been advanced as a significant decision-making factor for milk use classification pursuant to 7 U.S.C. §608c(5)(A).

III. NMPF's SUPPORTING EVIDENCE.

16. NMPF expressly rejected the need to offer substantial record evidence to prove that the Proposal 7 protein standard should be adopted to protect the Class I market from dairy beverage product substitution. NMPF believes that evidentiary support and rational decision-making exists in some past rulemaking record. "We presume that the record at the time it was established is reasonable." Cryan, Tr. 211. NMPF's presumption of product substitution applies generically to unidentified beverages now treated as Class I under USDA's current interpretation of the fluid milk product definition, as well as specifically identified products. *E.g.*, Cryan, Tr. 179 ("we assumed" that Lactaid milk and low carbohydrate dairy beverages "are a very strong substitute for one another."); *Id.*, Tr. 183, 301 ("It's my presumption" that yogurt beverages are close market substitutes for flavored milk). These presumptions in lieu of record evidence, NMPF maintains, are sufficient to support inclusion in Class I of dairy beverages containing 2.25% or more milk protein, as well as exemption for dairy beverages with less milk protein.

17. NMPF's presumptions of Class I product substitution, based on some past administrative record, extend as well to Class I placement of new technology dairy beverages that may be introduced in the future. Cryan, Tr. 178-98 (NMPF believes that any future product captured as Class I under proposal No. 7 "would be of similar form and use to and a substitute for current Class I products.").

18. Likewise, market penetration of future dairy beverages containing 2.25% milk protein is presumed by NMPF. Hollon, Tr. 65 (it is "certain that new products will get wide distribution and market penetration" in the future); Cryan, Tr. 190 (U.S. consumers could respond to a specialty lactose-reduced dairy beverage, like one introduced in Finland, so that this new technology product could be "something in the neighborhood of 10 or 15 percent of the market..."); Cryan, Tr. 249 (other dairy beverages that "are coming down the pike" from new technology "ultimately could be a very substantial share of fluid milk sales.").

19. NMPF did not offer substantial evidence on the cost of imported milk protein products, nor of the comparative cost of imported milk proteins to domestic milk protein sources. However, anecdotal evidence and data published by USDA reveal higher costs for imported milk proteins than for protein in producer milk.⁷ A hidden tariff in the form of a Class I up-charge on use of imported milk proteins would tend to reduce imported milk protein use in milk beverages, and consequently reduce the production of such beverages, regardless of whether current prices for them are greater or lower than federal milk order prices for milk protein.

20. The primary focus of NMPF's testimony was addressed to carbohydrate-reduced dairy beverage products, such as Carb Countdown[®] produced by H.P. Hood, that contain less than 6.5% nfms. By Proposal 7, NMPF seeks to maintain continued Class I classification of Carb Countdown under Dairy Program's current interpretation (*see* Appendix A) of the fluid milk product definition. "[O]nly some of the low-carb products would perhaps change classification [under Proposal No. 7], and they are currently being regulated [as] Class I." Hollon, Tr. 100-101, 156. NMPF offered in evidence retail sales data analysis compiled by IRI (Ex. 14-E, Ex 30-E and Ex 34), and a confidential survey of 1,400 consumers prepared by NPD Group "solely for use by NPD clients" (Ex 14-F), prepared for Dairy Management Inc. ("DMI"). NMPF asserted that these exhibits, received over objection by H.P. Hood,⁸ show that carb-reduced dairy beverages should come within the Class I "fluid milk product" definition, even if they do not contain 6.5% nfms. NMPF claims that this is necessary in order to protect fluid milk sales, particularly lactose-free

⁷ As noted above, one NMPF supporter reported a recent price for casein at \$3.60 per pound. This was above recent FMMO protein prices reported for component pricing markets. The Dairy Market News, published by Dairy Programs, <http://www.ams.usda.gov/dairy/mnocs/weekly.htm>, reports weekly market prices for casein sold in the U.S. For the first 7 months of 2005, reported casein prices averaged over \$3.29 per pound, considerably in excess of the prices for protein in producer milk, which ranged from \$2.46 to \$2.70 during the same period. <http://www.ams.usda.gov/dairy/mmos.htm>. Not all milk proteins are imported. A Fonterra plant in New Mexico produces MPC, and sells to US buyers at a premium over imported MPC. Tucker, Tr. 455.

⁸ Objections to Exhibits 14-E and 14-F, for reasons expressed by Hood counsel and the IDFA representative in Tr. 206 – 209, and elsewhere in the record, are reaffirmed. Additional shortcomings to the IRI conclusions are exposed in <http://www.brandweek.com/brandweek/images/pdf/TheMythsandDangersofACV.pdf>. Pursuant to 7 C.F.R. §§900.8(d)(2) and 900.9(b), the Secretary is requested to reject consideration of these exhibits as providing any support for Proposal No. 7. Because these exhibits were received, however, it is necessary to address their evidentiary content in this brief. H.P. Hood does not intend, by so doing, to waive or compromise its objections.

milk, from product substitution. Cryan, Tr. 156-57, 179-80, 278-80 (“we assumed” that Lactaid and Carb Countdown are close substitutes for each other.).

21. The IRI and NPD exhibits summarize retail sales during a 12-14 month period ending October and December 2004, and consumer survey responses during early January 2005, for carbohydrate-reduced dairy beverage products. Applying relevant economic and policy factors that have guided UDSA milk classification decisions in the past, these data demonstrate that the products should not be in Class I.

- (a) The product is marketed as a “dairy beverage,” not as “milk.” Ex. 14-F.
- (b) The product “is considered a niche product,” targeted to low-carbohydrate dieters, filling “a very specific need” – “a diet need, a sugar reduction need.” Ex. 14-F; Ex 30-E (p. 9).
- (c) Low carb dieters consume 29% less milk than the general population, and have “less interest in consuming milk. Ex. 30-E (p. 2).
- (d) The target population for low-carb dairy beverage sales-- people on low-carbohydrate diets -- peaked at 8% of the population in January 2004, and represented only 4% of the population by April 2005. *Id.*
- (e) U.S. sales of low-carb dairy beverages, similarly, peaked at about 160,000 gallons/week during late-spring 2004, and dropped to about 90,000 gallons/week by December 2004. The low carb milk segment is “no longer growing.” Ex. 14-E (p. 2).
- (f) Low carb dairy beverages have low market penetration – only 1% of households purchased the product. Ex. 14-F; Ex. 34 p.4 (P.Pt. 19) (0.9% of households purchased Carb Countdown during Oct 03 – Oct 04).
- (g) The retail price of low-carb beverages is much greater than that of conventional white milk. During the 4th quarter of 2004, low carb beverages sold by H.P. Hood and Dean Foods averaged \$3.27 and \$3.41 per half-gallon, while white milk averaged \$2.01 per half-gallon.
- (h) Carb Countdown’s market share, expressed as a share of all fluid milk sales during the October 2003 – October 2004 period, is **0.0%**, rounded to the nearest 1/10th percent in one IRI report, Ex. 34, *supra*. Another IRI paper reported that all low carb product sales accounted for 5.9 million gallons, or **0.18%** of total 52-week sales of all products in the fluid milk category. Ex. 14-E (p. 6).
- (i) IRI reported that consumer-purchasing behavior indicated a high level of product substitutability between Carb Countdown and Lactose Reduced/Free milk. Ex 14-E (p.9). Data from the 2003-2004 period revealed, however, that lactose free/lactose reduced milk was the only category of conventional fluid milk products to grow (by 3.5%) in sales. Sales of fluid milk products generally dropped by 4.6% (156.6 million gallons) during the same period.
- (j) 98% of Carb Countdown sales are attributed to consumers who switched from standard milk to Carb Countdown for reasons of weight loss diet. Ex 14-E (pp 8-9), Ex. 34 (p. 4). Since low carb dieters would ordinarily severely cut or eliminate milk from their diet altogether, IRI concluded that its study implied that “new low carb milk beverages recently introduced appear to have retained milk consumption among low carb dieters.” Ex. 30-E (p. 10).

IV. OTHER RELEVANT EVIDENCE IN OPPOSITION TO PROPOSAL NO. 7.

22. Proposal No. 7 advocates a 2.25% milk protein standard for defining “fluid milk products” and pricing skim milk and skim milk equivalent ingredients used to produce dairy beverages meeting this standard as Class I (with a few exceptions). FDA standards of identity for beverages that can be called “milk” requires 8.25% milk solids not fat, which contains about 3.2% natural milk protein. Traditional fluid milk, accordingly, has 30% more milk protein than beverages that NMPF would propose to be called “fluid milk products” for Federal Milk Order Class I pricing purposes. The target of the proposal was on emerging beverages using milk protein and protein fraction ingredients from “new technology,” and assessment of an up-charge based on skim milk equivalent content derived from the milk protein ingredient. Much of the opposition testimony, accordingly, addressed the negative impact of the proposals on milk product development, new beverage innovation, use of non-milk alternative ingredients, competition between Class I dairy beverages and Class II dairy beverages, and competition between dairy beverages and non-dairy beverages. The chilling effect of the fluid milk protein standard on dairy product development and dairy ingredient use increases as the protein content threshold decreases from protein observed in natural milk, as described by the witnesses for O-AT-KA and many others. Alexander, Tr. 405-411 (giving six reasons why non-Class I classification of beverages containing lower milk protein “provides positive benefits to the dairy industry and dairy producers”).

23. Class II classification of low-protein dairy beverages allows continued use of dairy ingredients at prices that will permit handlers to be more competitive with soft drinks, juice and coffee beverages. Alexander, Tr. 405.

24. Additional regulation of dairy-derived ingredients (by Class I classification of products using the ingredients) would discourage use of dairy ingredients, to the detriment of producers. Alexander, Tr. 405; Ledman, Tr. 522; Stephenson, Tr. 575-79.

25. Additional regulation of dairy-derived ingredients would also create high cost of tracking ingredients, and of auditing plants and ingredient suppliers, and regulatory paperwork for processors, further depressing dairy ingredient sales and discouraging their use in beverages by food manufacturers. Alexander, Tr. 405, 410; Ledman, Tr. 517; Taylor, Tr. 984.

26. Milk protein may often be replaced by soy protein in beverage applications, increasingly so as soy protein product technology advances. Soy protein is currently much less costly to manufacturers than milk protein, and soy protein sales have increased at a much greater rate than milk protein sales. Additional regulation of dairy-derived ingredients, or their use in beverages, will cause substitution of soy and vegetable proteins for milk proteins. The consequence for U.S. milk producers will be loss of market share, and depressed milk prices. Alexander, Tr. 410-411; Tucker, Tr. 456-58; Ledman, Tr. 517-18; Box, Tr. 656-67; Waldron, et al., Tr. 753-54; Suever, Tr. 917; Taylor, Tr. 972, 980.

27. Dairy beverages are commonly distributed nationally rather than just locally or regionally. Dairy beverages produced in California are classified as Class 2 products.⁹ Expansion of the federal Class I product category to new dairy beverages would create raw product and dairy ingredient cost disadvantages, and production disincentives, for federally regulated handlers in competition with unregulated manufacturers and with California-regulated handlers. Alexander, Tr. 411, 425-27; Ledman, Tr. 521; Box, Tr. 650, 689; Suever, Tr. 922, 934.

28. Inclusion of whey protein ingredients to identify a Class I product by milk protein content (but not for skim-equivalent pricing purposes), would have a chilling effect on milk protein or casein use in some applications, and on whey protein use in others. Where whey protein and caseinates can be substituted for each other, MPC and other milk

⁹ California's standards for Dairy Beverages are contained in California Food & Agric. Code §§ 39901-39912, reproduced in Appendix B hereto, include many products for which Proposal No. 7 would create Class I use in Federal Order Markets. To assure that dairy beverages are not mistaken for fluid milk, the statute also contains labeling and advertising regulation. USDA's unexercised authority to include milk marketing order provisions regulating "unfair methods of competition and unfair trade practices" (7 U.S.C. §608c(7)(A)), may similarly offer alternatives to protect Class I products from product substitution if consumers are not sure about the nature of products without "milk" in the product name. The California experience demonstrates, moreover, that orderly marketing and protection of classified pricing may be maintained without including dairy beverages in Class I classification.

protein markets would suffer, as processors seek cheaper whey protein ingredients not subject to a Class I up-charge. Whey protein ingredient use in a beverage, along with milk or other dairy derivatives, may contribute enough additional milk protein to place a beverage in Class I, thereby increasing the cost of non-whey dairy ingredients. In such cases, processors would have a strong incentive to avoid purchase of whey protein and use substitute soy or vegetable protein ingredients, if at all possible. In either scenario, the market value of whey by-products or Class IV protein products will suffer, as will their considerable contribution to producer milk prices in all classes of use. Alexander, Tr. 411; Waldron, et al, Tr. 752-53; Taylor, Tr. 980, 990-91 (a penny reduction in the whey price produces a 4.4 cent reduction in producer prices).

29. In short, the proposals would discourage the development and marketing of new-technology dairy ingredients, discourage the development of new beverages using dairy ingredients, and depress sales of Class III and IV domestically-produced milk protein products, damaging milk producer and milk handler interests. Tucker, Tr. 458-59; Ledman, Tr. 522; Box, Tr. 666-67; Suever, Tr. 916-97; Tipton, 1035-37; Stephenson, Tr. 578-79.¹⁰

30. New dairy product development is very risky, and very costly even without regulatory disincentives such as Class I pricing of milk ingredients. Ledman, Tr. 517-18; Suever, 929-30. Most (80%) of new food products fail within the first two years of

¹⁰ Many of the arguments advanced by opponents of Proposal 7 were adopted by the Secretary in the course of federal milk order reform (63 Fed. Reg. at 4924):

Fluid milk products that contain less than 6.5% nonfat milk solids are excluded from the current and proposed fluid milk product definition. Consideration was given to eliminating or lowering this standard because there are some products that resemble fluid milk products but are excluded from the fluid milk product category because their nonfat solids content falls slightly below the 6.5% standard.

Several comment letters were received opposing any adjustment of the 6.5% standard. Some interested parties pointed out that elimination of the 6.5% nonfat milk solids standard would greatly expand the fluid milk product category to include many essentially non-milk products that contain very little milk in them. This could greatly increase market administrator auditing costs in following these products and could regulate several new facilities that would not reasonably be considered to be milk plants. In addition, several dairy product manufacturers argued that their products would be detrimentally affected as other shelf-stable competitive products would gain a substantial economic advantage. The letters stated that the increase in cost associated with the Class I price would force manufacturers to reformulate their products so that no fluid milk or substantially less fluid milk would be used.

After carefully weighing these arguments, it is concluded that any competitive problems that may now exist as a result of the 6.5% standard are very minor and that no change in the standard is warranted at this time.

The questions now are: (1) have new competitive problems emerged since federal order reform, (2) if so, are they major? The answer to these questions is "no" on this record.

introduction (*id.*), as illustrated by the demise of Swerve, Jakada, LeCarb, and other products perceived by DFA to be a threat when its proposal was first made to USDA in June 2003. Cryan, Tr. 258-59; Stephenson, Tr. 613-15. Five years are required for a *successful* new product to reach market potential. Stephenson, Tr. 571.

31. Reasonable consideration of new product classification cannot be done until sufficient time is given for market penetration, product substitution, and competitive impact to be measured. Yonkers, Tr. 882-86. As explained by the Secretary in the 1974 uniform classification decision: “A refinement of such [fluid milk product composition] standards may be appropriate once there has been an opportunity to evaluate their applicability [to new products] under actual market conditions.” 39 Fed. Reg. at 8716. When filled milk was uniformly placed in Class I in Federal Milk Orders, for example, the product had been produced for over 50 years, it was targeted to the general milk-drinking population, it had a decided ingredient cost advantage over traditional milk, it created competitive disadvantage among handlers, it had gained market share by true product substitution (cannibalization), and had achieved significant market share (up to 10.3% of total Class I disposition) in some markets. 34 Fed. Reg. 16881 (Oct. 18, 1969); *U.S. v. Caroline Products Co.*, 304 U.S. 144 (1938); J. B. Siebert, *Trends and Economic Incentives in the Sales of Filled Milk*, (Berkeley, Calif. Agr. Ext. Serv., 1968). Even greater market share of standardized milk and demonstrable handler milk price inequity or milk cost inequality provided foundation for the New York-New Jersey skim milk and butterfat pricing decision, 33 Fed. Reg. 188 (Jan. 5, 1968) – a decision that NMPF espouses as the model for adoption of Proposal No. 7. Cryan, Tr. 163-64, 292 (“The issues are practically identical” according to NMPF, and the “exact same logic” should be followed).

32. The debate over dairy beverages in Class I versus Class II classification involves a very small category of current product sales in either class. For 2002, USDA reported that Class I “miscellaneous milk products”¹¹ – i.e., products such as beverage yogurt, kefir, and carb-reduced beverages not labeled as “milk,” buttermilk or eggnog

¹¹ The “miscellaneous milk product” growth between 2002 (pre-Carb Countdown) and 2004 (post-Carb Countdown) was 89.3 million pounds, or 10.3 million gallons, by federally-regulated handlers. If one were to assume without further data that all of this growth could be attributed to carb-reduced beverages (contrary to IRI estimates of 5.9 million gallons nation-wide, finding 21(h), *supra*), carb-reduced milk beverages would represent less than 0.2% of Class I sales. NMPF’s assertion of nationwide sales of 584 million pounds of milk (67 million gallons) in carb-reduced products during 2004 (Cryan, Tr. 166) is revealed to be pure fiction.

under FDA identity standards – totaled 262.8 million product pounds, 0.6% of total Class I sales of 45.9 billion product pounds. For 2004, “miscellaneous” sales in Class I totaled 357.5 million pounds, 0.8% of total Class I sales of over 44.7 billion pounds. FMOS 2002 (Table 42) and 2004 (Table 45), <http://www.ams.usda.gov/dyfmoms/mib/fmoms.htm>. Based on inferences from published USDA statistics, beverages in Class II use represent, at most, 10% of Class II use, or 1.4 billion pounds (Ledman, Tr. 518), and are probably closer to 0.3% of Class II use. Suever, Tr. 930-31; Ex. 12. The record, unfortunately, is undeveloped and not susceptible to reasoned conclusions on beverage reclassification between Class II and Class I.

33. In addition to very small market share of carb-reduced beverages, there is no evidence of substitution of these beverages for, or “cannibalization” of, traditional fluid milk products. H.P. Hood’s records reveal, consistent with IRI data, that many consumers switched to Carb Countdown from fluid milk. This purchasing behavior was not “substitution” or “cannibalization” in the economic or competitive sense. Consumers did not buy Carb Countdown (at a higher price) where they would otherwise buy lower priced milk. Rather, they had decided to reduce or eliminate milk from their diet as part of a low-carbohydrate diet regimen. Carb Countdown allowed them (and the industry) to retain dairy beverage consumption, providing a market for producer milk that would otherwise have been lost, and preserved a higher value for producer milk than the surplus Class IV alternative. Suever, Tr. 918-922; Exhibits 30-A and 30-B. Carb Countdown also helped preserve the milk beverage habit for these consumers, so that when their diet is over, they are more likely to return to traditional fluid milk products. Carb Countdown performed as intended in sales to the limited population of consumers to which it was targeted. As one IRI report concluded, Carb Countdown “retained milk consumption among low carb dieters.” Ex. 30-E (p. 10). There is no substantial record evidence that Carb Countdown sales were gained at the expense of fluid milk product sales to low carb dieters.

ARGUMENT

NMPF’s case for proposal No. 7 begins and ends with hypothesis. NMPF perceived or “presumed” that its evidentiary burden was met in some past hearing, by some other proponent, by some prior decision of the Secretary. That should dictate the necessary conclusion of the agency on Proposal No. 7: NMPF has not met its burden of proof.

Section 7(c) of the Administrative Procedure Act says that "[e]xcept as otherwise provided by statute, the proponent of a rule or order has the burden of proof." 5 U.S.C. §556(d). For several decades after passage of the APA, courts and agencies believed "burden of proof" to mean only the burden of production or "going forward" with evidence. See *NLRB v. Transportation Mgmt. Corp.*, 462 U.S. 393, 404 n.7 (1983). However, only a decade ago, in *Greenwich Collieries* the Court concluded that the "burden of proof" in § 7(c) was more demanding, and additionally meant "the burden of persuasion." *Director, Office of Workers' Comp. Programs v. Greenwich Collieries*, 512 U.S. 267, 276 (1994). It is now understood that combination of "burden of proof" and "substantial record evidence" standards in formal "on the record" hearings under the APA – as is the case for this hearing -- impose a traditional "preponderance of evidence" burden on the party or agency proposing a rule or order. Kenneth Culp Davis and Richard J. Pierce, Jr., *Administrative Law Treatise* §10.7 (3d ed. 1994).

In other words, if NMPF proposal No. 7 is to be adopted and promulgated as law by the Secretary, proponents must first provide the Secretary with essential facts proving their case, *Fairmont Foods v. Hardin*, 442 F.2d 762 (D.C. Cir. 1971); *Puerto Rico v. Federal Maritime Commission*, 468 F.2d 872, 879-81 (D.C. Cir. 1972). Alternatively, the agency may come forward in the hearing with its own evidence to support the rule. *Abbotts Dairies Div. v. Butz*, 389 F. Supp. 1, 8-9 (E.D. Pa. 1975); *Hess & Clark v. FDA*, 495 F.2d 975 (D.C. Cir. 1974).

In this case, as in *Lehigh Valley Farmers v. Block*, 829 F.2d 409 (3rd Cir.1987), objective evidence of competitive problems alleged to support the proposal is absent, notwithstanding a lengthy record.

[T]he testimony of the proponents...consisted of extremely general and speculative opinions. The experts were not able to provide specific examples of the problems they alleged were occurring as a result of the failure to regulate Cf. *Borden v. Butz*, 544 F.2d 312, 319 (7th Cir. 1976) (there was no substantial evidence to support the Secretary's decision when the testimony "consisted of hortatory, conclusory and speculative opinions and predictions").

The “evidence” proffered by NMPF is of the same character that upon which USDA unlawfully relied in *Lehigh Valley, Borden, and Fairmont*.¹²

NMPF sought to avoid its evidentiary failures with the claim that all it intends by Proposal No. 7 is to retain status quo and clarify existing practices. But a hearing is not necessary merely to interpret current rules. If Proposal No. 7 intends a rule change, substantial record evidence is required. Such evidence is lacking, as is evident in Findings 8-21, which gives NMPF the benefit of its own arguments, and as is reinforced by all opposing evidence (Findings 22-33).

Even if NMPF has overcome its evidentiary hurdle, or the agency decides that it does not apply, Proposal No. 7 must nevertheless be rejected because it would violate the mandate of uniform class prices to handlers, 7 U.S.C. §608c(5)(A), as applied and explained by the Secretary in past Milk Order Decisions. In the 1968 filled milk decision, the Secretary explained why filled milk made from reconstituted skim milk should be classified as a Class I product. “Uniformity of pricing could not be achieved if some handlers have a lower cost by substituting a surplus class product... for a Class I use.” 34 Fed. Reg. at 16883. In this case, NMPF makes no claim that dairy beverage manufacturers using “new technology” milk protein ingredients, which the focus of NMPF claims (Hollon, Tr. 66-67; Cryan, Tr. 151-52), have a lower milk ingredient cost than processors using fresh producer milk. This element of classification factors is conveniently overlooked by NMPF.

Evidence on new technology milk ingredient costs in this record, although not extensive, reveals that new technology milk proteins are *more* costly than fresh milk or

¹² This observation holds particularly true for NMPF’s reliance on its own *ipse dixit* and IRI/NPD data presented without benefit of a foundation witness to opine on consumer motives when they buy Carb Countdown, and to conclude that this behavior represents product cannibalization in the economic sense. Similar speculative evidence, where consumer motives for buying a product with dairy ingredients were at issue, was unequivocally rejected in *Cream Wipt Food Products Co. v. Federal Security Administrator*, 187 F.2d 789 (3rd Cir. 1951): “Although Lepper was identified as “a government chemist with 37 years of experience in food law enforcement”, nothing appears to show expertise in customer reactions to salad dressings or to the presence of cream or milk therein. It does not appear upon what basis the witness concluded, as his testimony necessarily implies, that consumers purchasing salad dressing are influenced substantially by notions of the relative nutritive values of competitive products. Certainly, common experience leaves reason for question - not answered in this record - whether consumers may not select these savory sauces as they do condiments rather than nutrients.”

protein in fresh producer milk. Findings 12(g) and 19. This pre-existing cost disadvantage to processors adversely affected by Proposal No. 7 is created by market prices and by manufacturing costs to produce new technology milk proteins, not by Federal Order Pricing. However, if the Secretary imposes a classification up-charge on these ingredients in the face of pre-existing higher ingredient costs, classification regulation would be used to create an even greater ingredient cost disadvantage for such new technology proteins.¹³ The resulting *regulated* disadvantage would violate the uniform pricing requirement of the AMAA.

While H.P. Hood agrees with yogurt makers, Hormel Foods, and others that there are a number of milk beverages now in Class I that should be in other classes for reasons of limited distribution, low volume sales, lack of direct competition with fluid milk, depressing effect on dairy product sales, and other established factors (Findings 6-7, *supra*), reclassification of such products will better be considered in another hearing forum. If any amendment is made as a result of this hearing, and we join others in chorus urging that this proceeding be terminated, it should be limited to conforming the agency's non-transparent interpretation process to established classification factors, as proposed by H.P Hood.

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¹³ One of NMPF's express reasons for Proposal No. 7 is that imported proteins are depressing producer prices. While this contention is the subject of much debate (*e.g.*, Congressional Research Service, Dairy Policy Issues, Milk Protein Concentrate Trade Issues, May 26, 2005), the hidden tariff proposed by NMPF on imported proteins, in the guise of a milk classification rule, could violate U.S. trade law obligations. And if MPC produced in the US is thereby limited from some domestic markets, the resulting rule could also violate trade barrier prohibitions of 7 U.S.C. §608c(5)(G).

**THE FLUID MILK PRODUCT DEFINITION, 7 C.F.R. 1000.15,
AND CURRENT AGENCY INTERPRETATION OR APPLICATION THEREOF
RELEVANT TO THE JUNE 20 – 23, 2005, FEDERAL MILK ORDER HEARING**

I. The text of the current rules.

§ 1000.15 Fluid milk product.

(a) Except as provided in paragraph (b) of this section, fluid milk product means any milk products in fluid or frozen form containing less than 9 percent butterfat that are intended to be used as beverages. Such products include, but are not limited to: Milk, fat-free milk, lowfat milk, light milk, reduced fat milk, milk drinks, eggnog and cultured buttermilk, including any such beverage products that are flavored, cultured, modified with added nonfat milk solids, sterilized, concentrated, or reconstituted. As used in this Part, the term concentrated milk means milk that contains not less than 25.5 percent, and not more than 50 percent, total milk solids.

(b) The term fluid milk product shall not include:

- (1) Plain or sweetened evaporated milk/skim milk, sweetened condensed milk/skim milk, formulas especially prepared for infant feeding or dietary use (meal replacement) that are packaged in hermetically-sealed containers, any product that contains by weight less than 6.5 percent nonfat milk solids, and whey; and
- (2) The quantity of skim milk equivalent in any modified product specified in paragraph (a) of this section that is greater than an equal volume of an unmodified product of the same nature and butterfat content.

A definition of "fluid milk product" is necessary to determine the quantity of producer milk and other source milk classified as Class I and subject to Class I pricing under 7 C.F.R. § 1000.40(a), which reads in relevant part as follows:

§ 1000.40 Classes of Utilization.

Except as provided in § 1000.42, all skim milk and butterfat required to be reported pursuant to § -- --.30 of each Federal milk order shall be classified as follows:

(a) Class I milk shall be all skim milk and butterfat:

- (1) Disposed of in the form of fluid milk products, except as otherwise provided in this section;
- ****

II. Agency interpretations of the fluid milk product definition.

1. Section 1000.15 (a): Subpart (a) of the rule provides a somewhat objective reference to milk products subject to FDA standards of identity to illustrate "milk products... intended to be used as beverages." These are clearly fluid milk products. Skim milk and butterfat disposed of in the form of these products are therefore in the Class I pricing category. Although DFA proposal No. 1 and Continental/Select Proposal No. 4 proposed amendments to subpart (a), these proposals were abandoned or not supported during the course of the hearing. Subpart (a) interpretive issues, therefore, are not considered relevant to this proceeding.¹

¹ While subpart (a) seems relatively clear, we are aware of interpretive issues surrounding the phrase "intended to be used as beverages." In some circumstances, products otherwise meeting the subpart (a) definition that are packaged and marketed for use other than "as beverages" have been nevertheless been classified as Class I. Though this application of the rule has not been the subject of general notice to the public, it is also beyond the scope of the hearing for which this Appendix is prepared.

2. Section 1000.15(b)(1) – the “dietary use (meal replacement)” exemption: This term is subject to much uncertainty in the industry (Taylor, Tr. 1011, Tipton, Tr. 1138), but is not otherwise defined in the Orders or any interpretive rule made public by USDA. It is reportedly applied by the agency not only to dairy beverages enriched with meal-equivalent RDA vitamins (Tipton, Tr. 1071), but also to high protein milk drinks intended as meal additions for body-builders that do not forego meals. Alexander, Tr. 406, 439. In 1998, USDA provided a partial list to illustrate products in this exemption, including “`Sportshake," `Powergetic," ``Carnation Instant Breakfast," ``Resource Dairy Thick," ``Ready Care Thickened Dairy Drink," and ``Ultra Slim-Fast." 63 Fed. Reg. 4801, 4924 (Jan. 30, 1998). It does not apply to meal replacements in non-hermetically-sealed containers (Waldron, Tr. 741-803), nor to dairy beverages made for special medical use, such as for the elderly in nursing homes, that are not full “meal replacements.” Roberts, Tr. 1147.
3. Section 1000.15(b)(1) – the exemption for “any product that contains by weight less than 6.5 percent nonfat milk solids”: The 6.5% nfms exemption is the focus of various proposals and issues.

Although the exemption has been unchanged for 31 years, the agency’s internal interpretation and application has varied considerably during this period. Many milk derived ingredients, other than concentrated or dried skim milk, were expressly excluded from inclusion in the category of “nonfat milk solids” when the rule was adopted in 1974, and during decades following. These milk-derived ingredients not counted as nfms included, for example, sodium caseinate. 39 Fed. Reg. 8712, 8716 (March 6, 1974); Rourke, Tr. 45-46; Wilson, Tr. 1231. These long-standing interpretations have recently been overruled and changed within AMS-Dairy Programs in two critical respects: (1) expansion of the milk-derived ingredients to be included in determining whether a dairy beverage contains 6.5% nfms, and (2) employment of an nfms-equivalent formula for at least some of these ingredients, and counting the nfms-equivalent solids as if contained in the product. The nfms-equivalent, in turn, is converted to skim milk equivalent for purposes of Class I pricing.

Expansion of milk-derived ingredients to be included in the 6.5% nfms calculation.

In 2004, AMS-Dairy Programs instructed Market Administrators that milk derivatives, including but not limited to the following should be included “in determining the level of nonfat milk solids in a beverage-type product”: “dried milk protein concentrate (MPC), liquid MPC, milk protein isolate, protein serum, whey protein concentrate, lactose, casein, and calcium caseinate.” Exhibit 30-C.

Addition of calculated nfms-equivalent solids to the content of the dairy beverage.

Concurrently with the expansion of ingredients to be tallied for purposes of the 6.5% nfms standard, Dairy Programs (or at least some Market Administrators) used nfms-equivalent formulas to determine the nonfat milk solids in milk used to produce milk derivatives, such as MPC and casein. The derived nfms, in turn, is attributed to the dairy beverage for purposes of the 6.5% nfms standard, and the skim milk equivalent of the derived nfms is priced as Class I. Wilson, Tr. 1230, 1238-39, 1244; Ex. 35, p. 3. Unlike the list of ingredients to be included in the 6.5% nfms calculation, the record reveals no written direction from AMS concerning or limiting this practice. It is therefore not clear whether the current

nfms-equivalent/skim milk equivalent procedure is used uniformly for all ingredients, including whey protein and lactose in the same manner as casein and MPC. It might be inferred from NMPF's express presumption, unrebutted by the agency, that Proposal No. 7 would maintain "status quo", that whey protein in a beverage is counted to identify a "fluid milk product" for purposes of the 6.5% nfms standard, but that nfms-equivalent/skim milk equivalent calculations are not done for whey protein or lactose. Such an inference would be risky, however, since the agency's witness was unwilling to compare current agency practice to practices proposed by Proposal No. 7. Wilson, Tr. 1240.

4. Section 1000.15(b)(1) – the "and whey" exemption. As described in the Dairy Program's instructions to Market Administrators (Ex. 30-C), dairy beverages containing whey products are not exempt for reasons of that ingredient. Whey-derived ingredients are now measured as part of the 6.5% standard.

CALIFORNIA DAIRY BEVERAGE STANDARDS*
CALIFORNIA FOOD & AGRICULTURE CODE, §§ 39901-39912

39901. Dairy beverages are milk and dairy food beverages resembling milk or milk products. However, dairy beverages do not conform to the compositional standards for milk or milk products as established in this code or Title 21 of the Code of Federal Regulations because they contain safe and suitable ingredients or combinations of ingredients not specified in those standards. Dairy beverages are products intended for consumption as a beverage. Milk or the components or milk shall comprise at least 15 percent of the product on a dry matter basis or at least 2 percent on a total weight basis.

For purposes of establishing compliance with the minimum dairy ingredient criteria, dairy ingredients shall include all products components, and derivatives of milk, including, but not limited to whey and whey products and caseinates specified in subdivision (c) of Section 135.110 of Title 21 of the Code of Federal Regulations, but excluding added lactose.

39902. The product may not contain any added fats or oils other than milkfat, except those fats present in incidental amounts that are naturally occurring in, or contributed by, flavorings or characterizing food ingredients. When the product contains water as an ingredient, water shall be declared in the ingredient list.

39903. The product shall be pasteurized, ultra-pasteurized, or UHT processed and packaged, pursuant to the specifications and procedures for the applicable process contained in the Code of Federal Regulations. The labeling shall comply with any applicable labeling requirements contained in the Code of Federal Regulations applicable to the heat treatment used on the product.

39904. The product may be cultured with safe and suitable bacterial cultures following pasteurization, ultra-pasteurization, or UHT processing.

39905. This article does not apply to any product regulated under Chapter 6 (commencing with Section 38901) as a product resembling a milk product or any dairy product for which a standard is established in this division.

39906. The label of all products subject to this standard shall be submitted to the secretary for approval prior to sale. In addition to the labeling requirements specified in this article, the secretary may, by regulation, require or prohibit any other information, format, or design for the label that the secretary determines to be in the public interest.

39907. (a) The term "dairy beverage" or "a dairy beverage" may appear on the principal display panel of the product only when milk and the components or derivatives of milk comprise at least 30 percent of the product on a dry matter basis, or at least 4 percent on a total weight basis.

(b) When the term "dairy beverage" or "a dairy beverage" appears on the principal display panel, it shall be in letters not exceeding the height of the largest letters on the principal display panel.

(c) Notwithstanding subdivision (a), when the term "dairy beverage" or "a dairy beverage" appears on the information panel of the label of the product, it shall be clearly and conspicuously labeled in bold type and of a type size equal to that used in the ingredient list.

39908. The product shall be labeled with a common or usual name of the beverage or a fanciful name that does not mislead, deceive, or confuse the consumer. Use of the name "dairy beverage" or "a dairy beverage" is restricted to products that conform to the requirements of Section 39907. The name shall not cause the consumer to believe that the product is a milk product for which a standard is established in this division.

39909. Each container that contains the product shall be labeled with the name and address of the manufacturer or distributor, and in the event the address is not the address of the manufacturer or final packaging plant, the label shall include the national uniform federal information processing standards state code number to be immediately followed by a hyphen and the plant number assigned by the appropriate state regulatory agency.

39910. If the product is labeled "Grade A," all dairy ingredients shall be derived from market milk.

39911. The label of the product may contain references to, and comparisons with, a milk product if those statements, symbols, marks, designs, or representations are reasonable, relevant, truthful, complete, and not deceptive or misleading. The secretary may require satisfactory proof of the compliance of any label with this section.

39912. No product subject to this standard shall be advertised, displayed for sale, or sold in any manner or under any circumstances or conditions that are likely to mislead, deceive, or confuse consumers into believing the products are products defined in this division. The secretary may require satisfactory proof of the compliance of a dairy beverage with this section.

* Note: The California Food & Agriculture elsewhere regulates the content, labeling and marketing of "imitation milk" and "products resembling milk products," defined in Cal. Food & Agric. Code §§ 38912, 38914.