

BEFORE AGRICULTURAL MARKETING SERVICE
UNITED STATES DEPARTMENT OF AGRICULTURE

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In the Matter Of:

MILK IN THE NORTHEAST AND OTHER
MARKETING AREAS; PROPOSED
AMENDMENT TO TENTATIVE
MARKETING AGREEMENTS AND
ORDERS

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: Docket No. AO-14-A73 *et al.*;
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POST-HEARING BRIEF OF FONTERRA (USA), INC.

Introduction

This post-hearing brief is submitted by Fonterra (USA), Inc., Lemoyne, Pennsylvania, a wholly-owned subsidiary of Fonterra Co-operative Group Limited (“Fonterra”), Auckland, New Zealand. Fonterra is a New Zealand based multinational dairy company that manufactures and exports dairy ingredients and consumer products to over 140 countries worldwide. Fonterra has a longstanding relationship with the U.S. market, as a supplier of quality dairy ingredients, and through the manufacture and export of dairy products produced in the U.S. from U.S. milk. In partnership with Dairy Farmers of America (“DFA”), Fonterra manufactures dairy products in ten sites across the U.S., and its Portales, New Mexico facility was the first U.S. plant to manufacture milk protein concentrate. Fonterra USA is headquartered outside Harrisburg, Pennsylvania.

In a Federal Register notice dated April 12, 2005, the Agricultural Marketing Service of the United States Department of Agriculture (“USDA”, the “Agency” or the “Department”)

announced the scheduling of a hearing to consider proposals seeking to amend the Class I fluid milk product definition in all federal milk marketing orders. *See Milk in the Northeast and Other Marketing Areas, Notice of Hearing on Proposed Amendments to Tentative Marketing Agreements and Orders*, 70 Fed. Reg. 19012 (Hearing Announced April 12, 2005). The hearing, held over four days, was to consider twelve different proposals for revision of the fluid milk definition submitted by various organizations. This post-hearing brief details Fonterra's concerns regarding certain of the proposed amendments, namely those that would revise the current exemption for products containing less than 6.5 percent nonfat milk solids from the definition of fluid milk.

The Proposed Amendments to the Definition of Fluid Milk

Currently, the Class I fluid milk product definition, as set forth in 7 C.F.R. §100.15 states, in pertinent part:

§ 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; ...

Fonterra addresses only certain of the proposed amendments to this definition in this brief. In particular, we believe that two proposals offered and/or supported by DFA and the National Milk Producers Federation (“NMPF”), and which were the subject of a large portion of the hearing testimony, would significantly modify the fluid milk product definition to the detriment of the overall dairy industry.¹

Proposal No. 2 (Dairy Farmers of America, Inc.)

This proposal seeks to amend the fluid milk product definition to include any dairy ingredient, including whey, when calculating the milk contained in a product on a protein-equivalent or nonfat solids equivalent basis.

Proposal No. 7 (National Milk Producers Federation)

This proposal seeks to amend the fluid milk product definition by removing the reference to the 6.5 percent nonfat milk solids standard and whey, and adopting a milk protein standard.²

Two additional proposals that would also adopt a protein standard, but with certain specific exclusions, are also problematic, namely:

Proposal No. 3 (O-AT-KA Milk Products Cooperative, Inc.)

This proposal seeks to amend the definition by adding a true protein standard. In determining the true-protein content and milk equivalent of a product, the proposal seeks to include all dairy solids—such as caseinates, milk protein concentrates and whey protein—and non-dairy sources while pricing only the milk equivalent of the dairy solids. Furthermore, the proposal seeks to add exemptions for alcoholic beverages containing dairy ingredients and formulas prepared for dietary use (meal replacements or nutritional supplements) having a true-protein content from any source greater than 6.2 percent on a protein equivalent basis.

¹ Proposal Nos. 8-11 would amend the fluid milk definition to exclude specific products. These proposals were offered, respectively, by The Dannon Company, Inc. (yogurt-containing beverages), General Mills, Inc. (drinkable food products with no more than 2.2 percent skim milk protein, provided the product contains at least 20 percent yogurt by weight), Novartis Nutrition Corporation (formulas prepared for dietary use that are packaged in hermetically sealed containers), and Hormel Foods, LLC (health-care beverages). *See* 70 Fed. Reg. 19012, 19014. Fonterra does not take a position on these specific proposals.

² Proposal No. 1, submitted by DFA, would simply remove from the definition of fluid milk product any exemption for products formulated using less than 6.5 percent nonfat milk solids. During testimony at the hearing, DFA abandoned Proposal No. 1 as “overly restrictive” and “causing excessive administrative costs to regulate beverages with minor percentages of dairy components.” Tr. at 72 (E. Hollon--DFA). DFA stated its support for Proposals Nos. 7 and 2. Tr. at 72-73 (E. Hollon).

Proposal No. 4 (Select Milk Producers Inc. and Continental Dairy Products, Inc.)

This proposal seeks to amend the fluid milk product definition by including only stand-alone beverages that are determined by a skim-equivalent standard, removing the 6.5 percent nonfat milk standard, and excluding other dairy products in fluid form that are not intended to be used as stand-alone beverages.

Proposal 5, offered by H.P. Hood, LLC (“Hood”), would have USDA include in Class I any product that, based on substantial evidence, as determined by the Department, directly competes with other fluid milk products and whose classification would enhance producer revenues. Alternatively, Proposal 6, also offered by Hood, would amend the fluid milk product definition by authorizing, but not requiring, the Department to determine a product’s nonfat milk solids content by applying a skim milk equivalent standard only with respect to dried dairy ingredients. *See* 70 Fed. Reg. 19012, 19013-14. While Fonterra does not take a position as to Proposal No. 5, Fonterra opposes any amendment, such as the one embodied in Proposal No. 6, that differentiates between dried and liquid forms of dairy ingredients.³

Summary

Fonterra is opposed to the proposals under consideration that would revise the current fluid milk definition set forth in 7 C.F.R. §1000.15 to lower, eliminate, or replace the threshold for exemption from fluid milk classification of any product that “contains by weight less than 6.5 percent nonfat milk solids, and whey.” Specifically, Fonterra’s concern is that the proposals under consideration will significantly complicate the current fluid milk standard without any tangible benefit to milk producers. Indeed, the principal proposals under consideration may

³ In particular, Fonterra objects to the fact that liquid forms of some dairy protein, such as MPC, are produced only domestically, while the dried form of the same dairy protein is imported. Such disparate treatment between different forms of the same product (one imported, one domestic) not only presents unnecessary administrative complications, but is likely impermissible pursuant to World Trade Organization agreements. *See* p. 14 below.

actually harm dairy producers by increasing prices for milk protein ingredients and encouraging processors to substitute lower cost non-dairy protein products.

Those who support a change to a protein standard from the current 6.5% nonfat solids minimum standard for classification of a beverage as a fluid milk product claim that they are not aware of a single product that such a revision would impact.⁴ *See, e.g.*, Tr. at 178 (R. Cryan--NMPF) (“As far as we have been able to determine, there would be no change to the current USDA classification of any established products. Any future impact would be very limited.”).⁵ Why then are we here? For very little or no benefit, and perhaps to the long term detriment of milk producers, the proposed revisions would convolute a clear-cut regulation that has been uniformly implemented since 1974. At the same time, the proposal would quash innovation in the development of products using dairy ingredients and open the door to alternative ingredients, thereby stifling significant potential growth in this area for dairy producers.

Revision of the definition, if warranted at all, is premature. The hearing was replete with testimony exemplifying the inability of the proponents of change to answer significant questions regarding the proposed changes. *See* Tr. at 888 (R. Yonkers—Milk Industry Foundation).⁶ For example:

⁴ That is, putting aside the processes already impacted by USDA’s improper modifications of its interpretation.

⁵ Not all of the witnesses agreed with Dr. Cryan’s statement. *See, e.g.*, Tr. at 977 (S. Taylor—Leprino Foods Company) (“The NMPF proposal has been characterized as an updating in the accounting under the orders to reflect advances in fractionation technology. Although the proponents of this proposal have stated that they do not intend that products currently priced as Class II be moved up to Class I, that is not the likely practical effect.”).

⁶ “Analyzing the economic impact of changing the fluid milk product definition requires actual market data and empirical analysis, not simply conjecture and speculation. Those data and analysis have not been presented at this hearing. There is, therefore, no justification for changing the fluid milk product definition at this time.”

- what, if any, products would be affected (*see, e.g.*, Tr. at 212 (R. Cryan) (“I’m not aware of any products whose current classification by the USDA would change. There may be some but I’m not aware of any.”));
- what, if any, practical benefit would be derived by producers (*see, e.g.*, Tr. 578-579) (M. Stephenson—Cornell University⁷);
- what the administrative costs to processors would be (*see, e.g.*, Tr. 982 (S. Taylor) (“Cost considerations include the direct procurement costs associated with regulation. The regulatory costs include payment obligations into the pool and the costs incurred to satisfy reporting and other requirements of the order. The impact of this regulatory burden should not be underestimated.”); *see also* Tr. 1052 (E. Tipton⁸) (“record keeping and reporting requirements ...are added burdens that many food processors would prefer to avoid.”));
- what consumer reaction would be (*see, e.g.*, Tr. 200-201 (R. Cryan) (agrees that study cited in support of amendment does not reveal anything about changes in consumer choice for reasons of price));
- how increased prices for milk protein products would affect new product development (*see, e.g.*, Tr. 939 (M. Suever) (“[W]e believe that Class I classification of dairy

⁷ “[I]n a dynamic and complex industry, what product classification would make producers better off? The answer to this question is that over a broad range of market and product characteristics, the impact of reclassification is likely to be small, less than, again, plus or minus one percent of discounted revenues. However, if there is substitution of nondairy ingredients for dairy components in response to reclassification, the negative impacts on dairy producer revenues are much larger, plus or minus 1.8 percent of discounted revenues.”

⁸ Mr. Tipton offered testimony on behalf of Bravo! Foods International Corp., Lifeway Foods, Inc., Pepsico, Starbucks Corporation and Unilever.

beverages that are not milk will discourage development of new products in the first instance...”); *see also* Tr. at 1077 (E. Tipton)⁹);

- to what degree increased costs of milk proteins would drive processors to use non-dairy proteins (*see, e.g.*, Tr. at 615 (M. Stephenson) (“[I]t would be speculation on my part...but...if product taste and functionality were identical and the price were less for a nondairy ingredient, I would expect food formulators to use the nondairy ingredient.”); Tr. at 656 (J. Box--The Dannon Company) (“We believe that if the Department finds it necessary to employ a protein specific threshold in the FMP definition, the industry may be encouraged to seek nondairy protein for formulating products.”));
- what growth trends exist in related markets (*see, e.g.*, Tr. at 33-34 (J. Rourke—Agricultural Marketing Service) (no data regarding lactose-free or reduced products); Tr. at 124 (E. Hollon--DFA) (no data regarding soy milk sales)); and
- how, exactly, to deal with the different types of whey proteins and how to account for them in calculating protein content (*see, e.g.*, Tr. 1176-77 (E. Hollon) (cannot offer a process for USDA to employ for the up-charge on an acid whey protein source, although, unlike sweet whey protein, it would not be exempt from an up-charge)).

Answers to all of these questions are key to any informed decisionmaking regarding this issue.

Simply put, not enough economic analysis on the perceived benefits to producers and the impact on the industry has been conducted for an informed decision on any revision of the fluid milk definition.

⁹ “[G]iven recent trends in sales of Class I milk, we believe USDA’s policies should be focused on promoting growth and innovation, especially in terms of new products within the dairy category. Any efforts to expand the reach of

Finally, revision of the fluid milk definition in this proceeding would be an unjustified end run around the impropriety of USDA's recent change in the treatment of milk derivatives in the calculation of the nonfat milk solids content of a beverage. USDA's long standing practice was to exclude from that calculation "milk derivatives" such as casein, sodium caseinate, lactose, whey solids, whey protein concentrate and milk protein concentrate. This practice was improperly changed in 2004, without notice and comment, by a simple stroke of the pen in a memo from the Deputy Administrator to all Market Administrators. The current proposals and USDA's conduct of the hearing improperly incorporate, without analysis or consideration, this policy shift.

The Statutory Intent of Commodity Orders Does Not Support The Proposed Amendments

The statute providing for orders to regulate the handling of agricultural commodities, including milk marketing orders, seeks:

(1) ... to establish and maintain ... orderly market conditions for agricultural commodities in interstate commerce as will establish, as the prices to farmers, parity prices...

(2) [t]o protect the interest of the consumer by (a) approaching the level of prices which it is declared to be the policy of Congress ... by gradual correction of the current level at as rapid a rate as the Secretary of Agriculture deems to be in the public interest and feasible in view of the current consumptive demand in domestic and foreign markets, and (b) authorizing no action under this chapter which has for its purpose the maintenance of prices to farmers above the level for which it is declared to be the policy of Congress ...

* * * *

(4) ... to establish and maintain such orderly market conditions for any agricultural commodity enumerated in section 608c(2) of this title as will provide, in the interest of producers and consumers, an orderly flow of the supply thereof to market throughout its normal marketing season to avoid unreasonable fluctuations in supplies and prices.

* * * *

Class I will have the opposite effect likely prompting reformulation with non-dairy ingredients and driving up the costs of products which new research shows to be increasingly price sensitive."

7 U.S.C. §602. In summary, the objective of the chapter is to effect an orderly exchange of commodities in interstate commerce in order to protect the interests of consumers and the purchasing power of farmers. *See Kyer v. U.S.*, 369 F.2d 714 (Ct. Cl. 1966); *see also U.S. v. Melenzyer*, 390 F.Supp. 960, 961. (W.D. Pa. 1975).

Any amendment to a marketing order must “tend to effectuate the declared policy” of the statute with respect to the subject commodity. *See* 7 U.S.C. §608c(3) and (4). For example, in considering a past proposed amendment to the 6.5 percent nonfat milk solid standard, USDA rejected the proposal when it “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.” *Milk in the New England and other Marketing Areas*, 63 Fed. Reg. 4802, 4924 (Proposed Rule Abandoned Jan. 30, 1998). In declining to adopt the proposed amendments USDA stated:

Fluid milk products that contain less than 6.5% nonfat milk solids are excluded from 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 products 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. *Id.*

Similarly, the proposed revisions to the definition of fluid milk under consideration currently have not been shown to be likely to effectuate any of the statutory goals. The current fluid milk definition is clear and relies on a straightforward nondiscriminatory mathematical calculation. The proposed revisions would cause disruption in the dairy market by changing a long established standard for classifying products as Class I; it would not benefit consumers, but could negatively affect them through higher prices for products with dairy ingredients; and finally the revisions would have little, if any, direct positive impact on dairy producers.¹⁰ However, by raising the costs to processors of using dairy proteins, the proposal would *discourage* development of innovative products using dairy proteins and *encourage* use of non-dairy protein substitutes. In so doing the indirect effects of the proposal on dairy producers are likely negative.

Even when there was a “justified concern [] over the potential for unfair and disorderly marketing conditions,” USDA has declined to adopt changes when such conditions have not manifested themselves with any demonstrable evidence of disorder in the market. *See Milk in the Texas and Southwest Plains Marketing Areas; Recommended Decision*, 54 Fed. Reg. 27179, 27182, 27184 (June 28, 1989) (USDA declined to adopt a proposed change to the “producer” definition when there was “no indication that orderly marketing has suffered”; where there was “insufficient evidence of market disorder attributable to producer-handler operations, there was no basis for adopting the proposal to regulate relatively large producer-handlers.”). Here, there is no justification for the concerns expressed by producers; no evidence has been offered to show

¹⁰ “As far as we have been able to determine, there would be no change to the current USDA classification of any established products. Any future impact would be very limited. For the types of products at issue, the difference in raw milk costs between Class I and Class II is a very small share of the retail price.” Tr. at 178 (R. Cryan).

either how the market is currently suffering or how the proposed amendment could alleviate any purported disruptions or disorder.

Increased Costs of Milk Protein Ingredient Prices Will Encourage Use of Substitute Proteins

Clearly, the increased costs created by the NMPF and similar proposals would promote the use of non-dairy proteins, such as soy, instead of milk proteins. *See, e.g.*, Tr. at 499 (D. Davis—American Beverage Association).¹¹ Whether they are supermarket chains or global food manufacturers, customers have two fundamental requirements of their suppliers. First is that the suppliers help them respond to consumer trends, and second that they do so cost effectively and profitably. Suppliers must also remain vigilant to competitive forces seeking to displace their market position. To see this, one need only walk through any supermarket and look at the products positioning themselves as dairy substitutes. For example, products made of soy, rice, nuts, grains and oils are marketed with names consumers have always associated with dairy. *See* Tr. at 456 (S. Tucker--Fonterra); *see also* Tr. at 633 (M. Stephenson).¹² Many of these products are aggressively marketed, some with scientifically based health claims being made and verified, to encourage demand and to position these products as a superior choice over dairy. The claim by the soy industry linking soy to reducing the risk of heart disease has FDA approval. Tr. at 456-57 (S. Tucker). Scandinavian authorities have approved a health claim for cheese where all the milkfat has been replaced by canola oil. Tr. at 457 (S. Tucker).

¹¹ “Products that are currently profitable may become unprofitable, while products that are marginally unprofitable but hold promise may simply be dropped. This would not only hurt companies and consumers, but it would also hurt producers by driving companies away from the use of milk as an ingredient in their products, leading to lower producer income.”

¹² “In discussion with food scientists , they are telling us that they are making headway almost at least as fast in vegetable proteins as they are in dairy proteins, and the concern is not where are we today necessarily but where we may be moving in a short period of time.”

Use of soy in beverage applications has expanded; with milk proteins increasing in price, soy becomes even more attractive. *See, e.g.*, Tr. at 981 (S. Taylor)¹³; Tr. at 113 (E. Hollon) (proposal “could conceivably increase” cost differences between soy and dairy ingredients “if solely cost was the only parameter.”). Just as proponents of the revision cite technological developments as the basis for a revision, technological developments are enabling the greater substitution of soy in traditional milk protein applications. *See, e.g.*, Tr. at 981 (S. Taylor). As illustrated by the following table, the use of soy protein in nutritional applications alone enjoyed an average annual growth of 16.5 percent between 1999 and 2003; milk protein increased by only 10.1 percent over the same period. Soy is clearly eroding the dominant market position once enjoyed by milk protein. *See, e.g.* Tr. at 458 (S. Tucker); Tr. at 411 (C. Alexander—O-AT-KA Milk Products).¹⁴

Protein Growth in Nutrition

	1999	2003	CAGR
Total Protein	76,350	119,505	11.9%
Milk Protein	56,580	83,137	10.1%
<i>Casein</i>	35,230	50,234	9.3%
<i>Whey</i>	21,350	32,903	11.4%
Soy	19,770	36,368	16.5%

Furthermore, making milk proteins liable for Class I up-charges will only discourage expansion of the market for beverages using these products. While new uses for milk proteins are currently being developed, thereby creating new markets for milk producers, further

¹³ “[W]ith the more recent development of low flavor soybeans and improved refining techniques, flavor is becoming less of a constraint on soy use. Most every marketer of soy proteins now market low flavor protein with reduced beanie flavor.”

¹⁴ “[S]oy proteins are used in many of our formulations, and the use of soy could increase if the beverage products become regulated as a fluid product, therefore reducing dairy ingredient usage. Already soy protein is a lower cost ingredient. For example, we purchased soy protein isolate recently at \$1.80 per pound as compared to caseinate at \$3.60 per pound.”

innovation will be stifled by milk protein costs increase. *See, e.g.*, Tr. at 974 (S. Taylor) (“I believe that product formulators are constraining their use of dairy ingredients in products that would otherwise be classified as Class I in order to avoid both the regulatory burden and the increased costs associated with the production and marketing of Class I products.”).

Alternatively, processors will look to less expensive ingredients as substitutes. Neither of these outcomes is good for the dairy industry. *See, e.g.* Tr. at 574 (M. Stephenson) (“New product introductions always benefit dairy farmers...They always benefit dairy farmers, increase cumulative discount revenues because they increase the demand for milk.”); Exhibit 23

(Testimony of M. Stephenson) at 6.¹⁵ Until more is known about the nature of competition in the overall beverage market and the position of various new beverages in that competitive framework, the proposed amendments might “level the playing field” with fluid milk in a tiny segment of the market, while creating a competitive disadvantage for milk protein ingredients in a much larger segment of the market - an outcome no producer would want.

No Whey Out

The treatment of whey protein in certain proposals (*e.g.*, Proposal Nos. 2, 3 and 7) is illogical and discriminatory. In essence, these proposals would count whey protein in calculating milk protein levels for purposes of classification of a product as Class I, but would not subject at least some whey protein to the Class I up-charge. *See* Tr. at 267 (R. Cryan). Put another way, while whey protein in a given product would be counted towards the minimum threshold for protein levels mandating Class I treatment; such whey proteins themselves would not be subject

¹⁵ “[T]he impact of reclassification (moving products from class II to class I pricing) is likely to be small—less than $\pm 0.1\%$ of discounted revenues ($\pm \$0.01/\text{cwt}$). However, if there is substitution of non-dairy ingredients for dairy components in response to reclassification, the negative impacts on dairy revenues are much larger, about -1.8% of discounted revenues ($-\$0.23/\text{cwt}$). One way to interpret these results is that there is little upside potential from reclassification, but significantly important downside potential.”

to the same up-charge as other milk proteins, notably casein and milk protein concentrates (MPCs). This disparate treatment of whey protein and casein/MPC defies logic -- indeed the record is devoid of any reasonable explanation for the difference. In fact, this proposal appears to be nothing more than a producer effort to “gerrymander” which protein products are subject to up-charges—excluding whey proteins that are typically domestic byproducts of cheese making, while including milk proteins such as casein and MPC, which are typically imported. *See, e.g.,* Tr. at 411 (C. Alexander) (“[T]he National Milk proposal supports reclassification but not pricing of whey protein. Therefore, the classification of skim milk solids, milk protein concentrates and caseinates to Class I when used in the currently exempt dietary use beverages would discourage use of these milk ingredients as compared to what would become relatively cheaper whey protein alternatives.”).

This *de facto* discrimination against imported products is a clear violation of the United States national treatment obligation under the General Agreement on Tariffs and Trade (GATT). Specifically, GATT Article III(2) provides that:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other *internal charges of any kind* in excess of those applied, directly or indirectly, to like domestic products. (Emphasis added).

Testimony during the course of the hearing illustrated how implementation and enforcement of the “no-whey up-charge” would be difficult and arbitrary. The definitions of whey discussed at the hearing do not adequately account for the various ingredients that contain whey protein, and there is manifest confusion between “whey” and “whey protein concentrate.” *See, e.g.,* Tr. at 269-271 (R. Cryan). According to NMPF, whey is the “liquid substance obtained by separating coagulum from milk, cream, or skim milk during the cheese making procedure and

may have the acidity adjusted by the addition of safe and suitable ph-adjusting ingredients prior to pasteurization” (Tr. at 174-175 (R. Cryan, citing 21 C.F.R. § 184.1979)), while whey derivative products include reduced-lactose whey, reduced-minerals whey, and whey protein concentrate. Tr. at 175 (R. Cryan). “Since whey and whey products must be derived from the coagulation of cheese, it does not consist simply of certain proteins separated out from milk by any process; rather, it must have been directly affected by the cheese-making process. As such, it is a substitute, but an imperfect substitute, for unaffected milk solids in a beverage.” *Id.*¹⁶

Why whey proteins from cheese making should be accorded treatment different than that accorded to other milk proteins, such as MPCs, especially when both have historically been treated similarly by USDA, was never credibly explained. Even more puzzling is the question why some whey proteins should be treated differently than others. Thus, when witnesses were confronted with the fact that whey protein can result from the production of products other than cheese, such as casein, and is a constituent protein in MPC, they struggled to explain what their proposal entails. *See* Tr. at 270-271 (R. Cryan). During the first hearing day, a NMPF witness agreed that only whey resulting from the coagulation of cheese would be exempt from the up-charge. Tr. at 223 (R. Cryan). Witnesses could not explain how whey from the manufacture of casein should be treated (Tr. at 270 (R. Cryan))¹⁷, but did opine that the whey component in milk protein concentrate would not be treated the same as whey from cheese making. Tr. at 270 (R. Cryan). Whey protein in MPC would be treated just like “protein in milk” (whatever that means)

¹⁶ Notwithstanding NMPF’s insistence that whey is an imperfect substitute for milk and not really competing with milk such that it should not be subject to an up-charge, one witness testified that “[w]ith recent advances in technology, whey protein could be formulated” into “applications using vegetable proteins (soy and wheat), caseins, and milk protein concentrate...” Tr. at 984 (S. Taylor). Proponents of the amendments cannot have it both ways—either whey should be subject to the same up-charge as other dairy ingredients or whey content should not count towards minimum protein levels for Class I treatment.

¹⁷ Although an NMPF witness stated that “the whey (from casein) would be priced lower because it’s a byproduct of the cheese process.” Tr. at 271 (R. Cryan).

and subjected to an up-charge. Tr. at 268 (R. Cryan). According to NMPF, an up-charge for the whey protein of MPC is calculable, while determining the up-charge for a whey protein from cheese making is problematic, even though such whey is used to make beverages. Tr. at 274-277 (R. Cryan).

Treating whey protein from cheese making differently from whey protein from other sources would require that processors and producers be able to differentiate between types of whey proteins, all of which would be counted to determine Class I status, but only some of which would be subject to a Class I up-charge. How this was to be accomplished *in situ* was never explained. On the last day of the hearing DFA attempted to supplement its previous statements regarding whey, but succeeded only in further confusing the issue. DFA claimed that “it is possible to distinguish between the whey produced from cheese-making, yielding sweet-whey, and acid whey which is produced from casein or cottage cheese manufacture.” Tr. at 1167 (E. Hollon). However, DFA also noted that “the whey component of MPC, milk protein concentrate, is more akin to sweet whey than to the acid whey” and that “while it is technically feasible to produce whey from milk protein concentrate, there is no domestic producer of whey from MPC of which we are aware, nor is there an international supplier.” *Id.* Despite the fact that MPC contains a whey protein identical to the sweet whey protein produced from cheesemaking, DFA opined that a product produced through whey conversion from MPC would “not be competitive with sweet whey produced from cheese-making.” *Id.* However, that is not the point – it merely obfuscates the fact that if MPC is used in a beverage, the whey protein which comes from the MPC is identical to the whey protein that would be in that beverage if the whey ingredient used came from cheese making. Moreover, on cross-examination, DFA had to acknowledge that the manufacture of some specialty cheese varieties results in acid rather than sweet whey production. Tr. at 1176 (E. Hollon). DFA ultimately acknowledged that all of the

they types from cheesemaking would not be eligible for exemption under the DFA proposal.

Id. (agreeing that whatever by-product is produced, acid whey would not be eligible for exemption).

Clearly, the proposed treatment of whey in the NMPF and similar proposals is unwieldy, and fraught with opportunities for misinterpretation, misapplication and misunderstanding. Adoption of any of these proposals would provide nothing more than an unjustified carve-out for whey that may serve the parochial interests of some producers but not the industry as a whole.

Adopting the Proposed Rule Would Unfairly Allow the USDA to Render Moot Rule Interpretations it Promulgated Improperly.

“Once an agency gives its regulation an interpretation, it can only change that interpretation as it would formally modify the regulation itself: through the process of notice and comment rulemaking.” *Alaska Professional Hunters Ass’n v. FAA*, 177 F.3d 1030, 1034 (D.C. Cir. 1999), quoting *Paralyzed Veterans of America v. D.C. Arena L.P.*, 117 F.3d 579, 586 (D.C. Cir. 1997). The procedures required for the USDA to modify a milk order (and thus also required to change its interpretation of a milk order) are extensive. The USDA itself has characterized this process as “formal, on the-record rulemaking,” requiring a public hearing which results in a proposed order which is subject to the review of milk producers and, to a limited extent, milk handlers. Brief for the Secretary of Agriculture, 2003 WL 22229098 at pp. 5-6, in *Alto Dairy v. Veneman*, 336 F.3d 560 (7th Cir. 2003). That the proposed rule would moot past administrative improprieties on the part of the Agency casts serious doubt on the Agency’s motives in proposing the rule change, as well as the propriety of the rule change itself. Of course, that the proposed rule bases the definition of a fluid milk product on the product’s percentage of milk proteins and not nonfat milk solids, makes the USDA’s procedurally

improper determination of what constitutes a milk solid moot. Nonetheless, the USDA should not engage in a *post hoc* justification for interpretations that were procedurally flawed.

Since 1974, the fluid milk definition included an exemption for products containing less than 6.5 percent nonfat milk solids by weight. See *Classes of Utilization*, 7 C.F.R. § 1000.40 (2005). The USDA has never amended the 1974 interpretation through the notice and hearing process. It refined the definition of “fluid milk” in 1993 pursuant to notice and hearing procedures, but left both the exception for products containing less than 6.5% nonfat milk solids and its interpretation of how this percentage was to be ascertained unchanged. 58 Fed. Reg. 12678. A 1993 Memorandum issued to Market Administrators implementing a final decision for milk markets reiterated the 1974 definition, and clarified that “[i]n determining the level of nonfat milk solids in a beverage-type product, do not include milk derivatives such as casein, sodium caseinate, lactose, delactose, whey solids or whey protein concentrate.” USDA Guidelines on National Hearing Amendments, July 1, 1993 at 15-16.

In a subsequent notice to Market Administrators dated January 31, 1994, the Director of Dairy Division provided certain updates to Classification and Policy Issues. Memorandum from W.H. Blanchard, Director, Dairy Division, USDA to All Market Administrators, USDA, (January 31, 1999). Among other issues, the memo addressed the classification of a shake-like product. The memo advised that the product, containing a milk protein concentrate known as MPC 56, should be classified as a “Class II product.” *Id.* The document stated:

Like casein and sodium concentrates, MPC 56 is imported. It is produced through an extensive ultra filtration/fractionation process whereby not only water and butterfat have been removed, but lactose and some of the minerals as well.

The notice referred the July 1993 Guidelines regarding the level of nonfat milk solids in a beverage-type product and considered the question of whether MPC 56 “should be considered in the same category as these milk derivatives” (casein, sodium caseinate, lactose, delactose, whey solids or whey protein concentrate), and thus excluded from calculation of the level of nonfat milk solids in a product. The notice concluded: “We believe it should be. Consequently, the level of nonfat milk solids-absent the MPC 56 – for this product is less than 6.5%, which eliminates [product] as a ‘fluid milk product.’” *Id.*

In 1995, USDA relied again on its previous position classifying a product with MPC 56 as a Class II product, but noted:

Further investigation into the nature of MPC 56 indicates that it is not of the same nature as casein, sodium caseinate, and whey protein concentrate. Unlike these products, MPC 56 represents all of the proteins contained in milk in the naturally occurring relationships in which they are found. Thus there may have been some merit to include MPC 56 in the calculation to determine if there were sufficient milk solids present in the final product for it to be defined as a fluid milk product. **However, we do not believe that there is a sufficient basis for reversing our previous determination without the benefit of an adequate hearing record.**

We would prefer to determine that these milkshake drink products are sold and intended to be consumed as beverages. **We very much believe, however, that a national classification hearing should be held to more clearly define the criteria for determining the classification of some of these somewhat “fringe” products that can be formulated specifically to avoid Class I classification.**

Memorandum from Richard M. McKee, Director, Dairy Division, USDA to All Marketing Administrators, USDA (Nov. 22, 1995)(emphasis added). In 1999, the USDA again adjusted the

definition of “fluid milk,” but left both the 6.5% exception and the test for calculating this percentage unchanged. 64 Fed. Reg. 47,898.¹⁸

On April 2, 2004, although it had not engaged in any notice and hearing process, USDA abruptly reversed its prior treatment of MPCs, along with other previously exempt dairy products, and issued a memorandum stating that milk derivatives should be used in the calculation of nonfat milk solids in a beverage:

The Federal order reform final decision published April 2, 1999 (64 FR 16122) adopted a fluid milk product definition that includes any milk product in fluid or frozen form containing less than 9 percent butterfat and more than 6.5 percent nonfat milk solids that are intended to be used as beverages. The definition states “such products include, but are not limited to, milk, skim milk, low 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.” Accordingly, in determining the level of nonfat milk solids in a beverage-type product, milk derivatives such as—but not limited to—dried milk protein concentrate (MPC), liquid MPC, milk protein isolate, protein serum, whey protein concentrate, lactose, casein, and calcium caseinate should be included.

Memorandum from Richard M. McKee, Deputy Administrator, Dairy Programs, USDA, to all Market Administrators, USDA (April 2, 2004).

¹⁸ In the 1999 Order, the USDA also approved the use of the skim milk equivalent test for determining the number of pounds of milk that were used in the manufacturing of a product for the purposes of charging for the product, but it did not authorize the use of the test to compute the product’s percentage of nonfat milk solids. 64 Fed. Reg. 16,131. Despite never utilizing any notice and hearing process to modify the test to be applied in determining the percentage of nonfat milk solids in a product, the USDA employed the skim milk equivalent test to classify HP Hood Inc.’s Carb Countdown product as a fluid milk (and thus a Class I) product. Letter from Richard M. McKee, Deputy Administrator, Dairy Programs, United States Department of Agriculture, to Paul C. Nightingale, Counsel, HP Hood, LLC (March 25, 2004) (on file with the USDA). Such a change in interpretation was impermissible without a notice and hearing process, and HP Hood has filed a challenge before an administrative law judge. Petitioners’ Post Hearing Brief and Proposed Finding of Fact and Conclusions of Law, *In Re: HP Hood Inc. et al.* 2004 Docket No. AMA-M-4-2. To now change the standard for determining whether a product is a fluid milk product from a test based on the product’s percentage of nonfat milk solids to a test based on proteins would make the USDA’s interpretation in the Hood case moot, and would allow the USDA to justify its improper interpretation through *post hoc* rulemaking.

In essence, without the hearing or record that USDA itself acknowledged it needed and lacked, USDA changed its guidelines regarding the calculation of nonfat milk solids contained in fluid milk products. The current hearing process is an inadequate mechanism for USDA to fill the void in record support for an action already taken by USDA in contravention of its own necessary and recommended process. The current proposed amendments and the USDA's conduct of the hearing improperly incorporate, without analysis or consideration, the recently adopted and unsupported April 2004 policy shift regarding the calculation of nonfat milk solids. The current hearing process cannot permit USDA to sweep its past deficiencies¹⁹ under the rug.

Conclusion

As fluid milk sales continue to lose ground to alternative beverages which are clearly outside the reach of milk marketing orders, such as bottled water, juices, and soft drinks (*see* Tr. at 1127 (E. Tipton)), the last thing the dairy industry needs is to create a disincentive to the use of milk proteins in beverages that can compete with these alternatives. The proposed amendments discussed in this brief would likely do precisely that. At best, there would be little or no impact on producer revenues; at worst, there would be a decrease in producer revenues as beverage manufacturers switched to competing sources of protein such as soy.

Milk protein content should not be the basis for the Class I classification of beverages. The principal reason offered for adopting such a revised standard is the need to "update" the fluid milk definition to take into account the new technologies that are being used to make products with dairy ingredients. However, absent a showing that the change advocated would

¹⁹ Interestingly, the hearing notice states that the current proposed amendments are not intended to have a retroactive effect.

advance a statutory purpose, that rationale is insufficient. Simply put, there has been no such showing.

Respectfully Submitted,

_____, 2005

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