

**BEFORE AGRICULTURAL MARKETING SERVICE
UNITED STATES DEPARTMENT OF AGRICULTURE**

July 17, 2006

In the Matter Of:

MILK IN THE NORTHEAST AND OTHER
MARKETING AREAS; RECOMMENDED
DECISION AND OPPORTUNITY TO FILE
WRITTEN EXCEPTIONS ON PROPOSED
AMENDMENTS TO MARKETING
AGREEMENTS AND ORDERS

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: Docket No. AO-14-A73 *et al.*;
: DA-03-10
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WRITTEN EXCEPTIONS OF FONTERRA (USA), INC.

Introduction

These written exceptions are submitted by Fonterra (USA), Inc., Camp Hill, 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. 19,012 (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. Fonterra and numerous other parties participated in the hearing and/or submitted post-hearing briefs expressing concerns regarding certain of the proposals, 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.

In a Federal Register notice dated May 17, 2006, the Agency announced its recommendations for changes to the fluid milk product definition based on the hearing record and requested that interested parties submit written comments or exceptions on or before July 17, 2006. *See Milk in the Northeast and Other Marketing Areas, Recommended Decision and Opportunity to File Written Exceptions on Proposed Amendments to Marketing Agreements and Orders*, 71 Fed. Reg. 28,590 (Proposed Rule, May 17, 2006). Fonterra's written exceptions to the Agency's recommendations follow.

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. §1000.15 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; ...

The rule as proposed to be amended would read as follows:

§ 1000.15 Fluid milk product.

(a) Fluid milk products shall include any milk products in fluid or frozen form 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 *or reduced* nonfat solids, *milk proteins, or lactose*; 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) Fluid milk products shall not include:

(1) Plain or sweetened evaporated milk/skim milk, sweetened condensed milk/skim milk, *yogurt containing beverages containing 20 percent or more yogurt by weight, Kefir*, formulas especially prepared for infant feeding or dietary use (meal replacement) *sold to the healthcare industry*, and whey;

(2) Milk products containing more than 9 percent butterfat;

(3) Milk products containing *less than 2.25 percent true milk protein and less than 6.5 percent nonfat milk solids, by weight, unless their form and intended use is comparable to the products contained in paragraph (a)(1) of this section;...*¹

Most significantly, the rule would adopt a 2.25 percent true protein criterion to determine whether a product meets the definition of fluid milk. However, unlike any of the proposals at

¹ With respect to the proposed amended definition, text in italics indicates substantive additions.

issue in the hearing,² the proposed rule would retain the 6.5 percent nonfat milk solids criterion, thus establishing either/or criteria for inclusion in the definition of fluid milk — if a beverage contains either 2.25 percent or more protein, or 6.5 percent or more nonfat milk solids, it would be considered fluid milk. Moreover, the proposed rule emphasizes repeatedly that these criteria are not absolute determinates of whether a product meets the fluid milk definition, but rather "the Department's primary criteria will be the form and intended use of the product as required by the

² Fonterra addressed only certain of the proposed amendments to this definition in its post-hearing brief. *See* Fonterra Post-Hearing Brief at 1-4. In particular, Fonterra noted that two proposals offered and/or supported by DFA and the National Milk Producers Federation ("NMPPF"), 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. Fonterra did not take a position on proposals 8-11.

Proposal No. 2 (Dairy Farmers of America, Inc.): This proposal sought 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. 1, also 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. 7 (National Milk Producers Federation): This proposal sought 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.

Fonterra found two additional proposals that would adopt a protein standard but with certain specific exclusions to be problematic, namely:

Proposal No. 3 (O-AT-KA Milk Products Cooperative, Inc.): This proposal sought to amend the definition by adding a true protein standard. In determining the true-protein content and milk equivalent of a product, the proposal sought 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.

Proposal No. 4 (Select Milk Producers Inc. and Continental Dairy Products, Inc.): This proposal sought 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 Nos. 5 and 6 (offered by H.P. Hood, LLC ("Hood")): Proposal 5 sought to 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 have amended 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. 13012, 13013-14. While Fonterra did not take a position as to Proposal No. 5, Fonterra opposed any amendment, such as the one embodied in Proposal No. 6, that differentiated between dried and liquid forms of dairy ingredients. 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. 23 below.

Agriculture Marketing Agreement Act." 71 Fed. Reg. 28,599.

Summary

This rulemaking arises from various proposals to amend the definition of a Class I fluid milk product to remove the nonfat milk solids standard and incorporate a protein standard. *See* 70 Fed. Reg. at 19,012 (describing proposals). Proponents of such changes are obligated to provide substantial evidence justifying the change, and proponents here were given more than sufficient opportunity to explain their position and offer authoritative support for the proposed revision. After four days and more than 1,200 pages of hearing testimony, their burden was not met.

Testimony by the proponents is largely conclusory, speculative and anecdotal. The principal reason given for adopting the revised standard is the purported need to "update" the fluid milk definition to take into account new technologies that are being used to make products with dairy ingredients. Producers contend that these products were not contemplated during the drafting of the current fluid milk definition, and as a result the present definition permits their classification as Class II products, rather than Class I, thus depriving milk producers of revenue. The record evidence, however, does not demonstrate that the revision would remedy disruption in the market or that any other statutory purpose would be served.

The Agency's proposal to adopt a 2.25 percent true protein threshold for exemption from fluid milk classification is not supported by the evidence of record. In fact, the record shows that the proposed definition will significantly complicate the current fluid milk standard without any tangible benefit to milk producers. Indeed, the Agency's proposed amendment may actually harm dairy producers by increasing prices for milk protein ingredients and encouraging processors to substitute lower cost non-dairy protein products.

Since those who support the change to a protein standard have the burden of establishing the need for the requested change, the proponents' claim that they are unaware of a single product that such a revision would impact is mystifying. *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.").³ If their requested amendment has, by their own admission, no impact, how can they argue they have met their burden of showing a need for it? The Agency itself made no findings with respect to affected products, one way or the other. *See* 71 Fed. Reg. 28,601 ("Although the record lacks specified data concerning the possible changes in classification of current products as a result of adoption of this decision, the need for the continued use of the form and intended use criteria specified in the AMAA is clear.").⁴ In fact, for very little or no benefit, and perhaps to the long term detriment of milk producers, the proposed amendment would convolute a clear-cut regulation that has been uniformly applied since 1974. At the same time, the proposed amendment 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.

The only attempt to provide an analysis of consumer purchasing practices and possible confusion between Class I products and products that could be subjected to reclassification was a consumer survey and retail sales analysis regarding a single product, H.P. Hood's Carb Countdown[®]. *See* Hearing Exhibits 14e, 14f, 34. However, rather than supporting the

³ 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.").

⁴ We note that the Agency never explains how the adoption of the 2.25 percent true protein standard advances "the need for the continued use of the form and intended use criteria."

proponent's position, these analyses mitigate against the proposed revision. *See* Post-Hearing Brief: Proposed Findings of Fact and Conclusions on Behalf of H.P. Hood at 21 (for example, the data shows that the product is a niche product with low market penetration and a minute market share, that low-carb dieters tend to consume less milk (if any) than the general population, product is marketed as a "dairy beverage" and not as "milk" and has a higher retail price). The proponents did not even attempt to show how this definitional change, applied universally, would impact other products made with dairy proteins.

While dismissing as unsubstantiated the many cautions and objections offered by those opposing the protein standard, the Agency relies on the conclusory and speculative testimony of the proponents of the protein standard as the basis for its own recommendations and proposed rule. The Agency, while proposing to adopt a protein standard, also recommends keeping the nonfat milk solids standard already part of the definition. No explanation is offered by the Agency for its proposed adoption of this "either/or" option that was not contained in any of the proposals discussed during the hearing.⁵ Ignoring the obligation of those offering the revised fluid milk definition to establish the need for the policy change, the Agency embraced, warts and all, the proponent's case for the protein standard. The arguments of the opponents of the standard (who do not share the proponent's burden) were noted, but summarily dismissed.

Change for the sake of change is not advisable, nor is it permitted. The Agency contends that amendments to the milk marketing orders do not require that a current problem exist (71 Fed. Reg. 28,603), although in the past, the Agency has rejected changes where there was no evidence of market disorder. Regardless, the Agency must establish that its proposed

⁵ One can surmise that the Agency's rationale for using both standards is its also unexplained assertion that "the 2.25 percent true protein criteria is comparable to 6.5 percent nonfat milk solids." 71 Fed. Reg. at 28,600. There is no substantive explanation as to how or why inclusion of both standards would be beneficial or meaningful.

amendments would effectuate the statutory purpose of marketing orders, namely to provide for an orderly exchange of commodities to protect the interests of consumers and the purchasing powers of farmers. Furthermore, the Agency must supply adequate data and a reasoned analysis to support the proposed revision to the definition. The Agency's proposed changes to the fluid milk product definition and the findings and conclusions on which the proposed revisions are based fall well short of what the law requires. If anything, the record establishes the need for further analysis so that any proposed revisions do not thwart the use of dairy ingredients by food processors, thereby harming the producers the amendment seeks to protect.

Finally, the proposed revision of the fluid milk definition would be an unjustified end run around the impropriety of the Agency's recent change in the treatment of milk derivatives in the calculation of the nonfat milk solids content of a beverage. The Agency'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 proposed amendments improperly incorporate, without sufficient basis or meaningful analysis, this policy shift.

Any Action is Premature

As noted by Fonterra in its Post-Hearing Brief, revision of the definition, if warranted at all, is premature.⁶ 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

⁶ In the absence of the Agency's response in its recommendations to most of the arguments presented by opponents to the protein threshold, Fonterra reiterates them here and elsewhere in these comments where relevant.

888 (R. Yonkers—Milk Industry Foundation).⁷ For example:

- 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 University⁸); Tr. at 103 (R. Cryan) ("I think at this point in time it would be close to revenue neutral"));
- 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. Tipton⁹) ("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 beverages that are not milk will discourage development of new products in the first instance..."); *see also* Tr. at 1077 (E. Tipton)¹⁰);
- 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

⁷ "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."

⁸ "[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."

⁹ Mr. Tipton offered testimony on behalf of Bravo! Foods International Corp., Lifeway Foods, Inc., Pepsico, Starbucks Corporation and Unilever.

¹⁰ "[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 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."

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.")); and

- 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)).

Answers to all of these questions are essential 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.

No Current Disruption in the Market Exists

The Agency's discussion of the proposed rule gives very little consideration to arguments that without evidence of disorder or disruption in the market, adequate justification for a change in the definition has not been established. While the Agency notes that "record evidence reveals criticism that the current fluid milk definition has not changed to reflect [] technological advances, including fractionation of milk "(71 Fed. Reg. 28,600), the Agency does not suggest that there are any current problems in the market. Rather, the Agency purports to be undertaking this rulemaking for the purpose of "[a]nticipating problems and amending regulations to address anticipated changes in marketing conditions". 71 Fed. Reg. 28,603. In the Agency's view, such actions may be valid "to assure continued orderly marketing conditions and equity among producers and handlers" and to "address the future needs of a rapidly changing industry brought about by new technology." *Id.* Even were that the case, the Agency offers no appropriate justification or support for how the proposed rule will promote orderly marketing conditions or producer-handler equity.

The statute providing for commodity 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.

* * * *

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.¹¹

¹¹ The Agency states disingenuously that "[p]roducers may benefit from products being determined as meeting the fluid milk product definition if the dairy ingredients in these products are priced as Class I and not because of the adoption of a 2.25 percent true protein criteria." 71 Fed. Reg. at 28,600. *See also* Tr. at 178 (R. Cryan). ("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.").

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. 27,179; 27,182; 27,184 (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 either how the market is currently suffering or how the proposed amendment could alleviate or prevent any theoretical future disruption or disorder.

Not only is there no evidence of current disruption in the marketplace that will be remedied by the proposed rule, the Agency points to no studies or analysis— by the government or by the private sector—that demonstrate the prospective need for a rule change, or any support at all for the propositions that : 1) there are products on the market that will meet the new definition of Class I fluid milk that are not meeting it now; 2) that those products are in form and intended use true substitutes of fluid milk; 3) that inclusion of these products through amendment of the rule will increase rather than decrease producer revenue; 4) that the proposed rule provides an equitable or sensible way of addressing the "criticisms" that the current definition of fluid

milk does not address technological innovation in the dairy industry; or 5) that specific future market disruptions will likely emanate from the current fluid milk definition. The proposed rule appears to be a change for the sake of change that has not been shown to help dairy producers, but could certainly discourage the use of dairy products by processors.

The proposed revisions to the fluid milk definition are not reasoned or supported by industry data. In proposing the amendments, the Agency essentially ignored the arguments made by opponents to such changes in the hearing process, while adopting the conclusory assertions of certain producers. Rulemaking through such practices is not permissible. *See Motor Vehicle Mfrs Ass'n v. State Farm Mutual Ins. Co.*, 463 U.S. 19, 43 (1983) (an agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between facts found and the choice made"; an agency may not entirely fail to consider one important aspect of the problem or offer an explanation for its decision that runs counter to the evidence before the agency). For example, the Agency never substantively addressed testimony that the proposed rule would cause substitution or decreased use of dairy ingredients. *See p. 26 below.*

Reliance on conclusory and speculative opinions and predictions is not sufficient basis for the Agency's recommendations. *See Lehigh Valley Farmers v. Block*, 829 F.2d 409 (3rd Cir. 1987) (Where testimony of proponents of amendment to milk marketing order consisted of general and speculative opinions (notwithstanding 4,000 pages of testimony and over 60 exhibits), decision of Secretary to implement amendment was not permitted). For example, the Agency Findings and Conclusions noted that:

[s]everal witnesses at the hearing addressed specific composition criteria that should be used for determining if a product meets the fluid milk definition. Proponents of the 2.25 percent true protein criteria explained that with the technology to

separate the lactose from the protein in milk, protein should also be used in determining if a product should be a fluid milk product because protein is the highest valued nonfat milk solid and because lactose is the component most often not used in the formulation of many manufactured dairy-based beverages.

See 71 Fed. Reg. 28,600. Even if these recited statements are true, the Agency provides no explanation of how they are relevant to a conclusion that the use of a protein standard is necessary to remedy (even prospectively) market disruption. The Agency does not offer any specific citation to the record, explanation, or support for this premise, although the Agency is relying on these statements for justification of the proposed rule.

After meandering through summaries of testimony, without citing specific facts or data, the Agency boldly states as its General Findings:

- (a) The tentative marketing agreements and the orders, as hereby proposed to be amended, and all of the terms and conditions thereof, *will tend to effectuate the declared policy of the Act*;
- (b) The parity prices of milk as determined pursuant to section 2 of the Act are not reasonable in view of the price of feeds, available supplies of feeds, and other economic conditions which affect market supply and demand for milk in the marketing areas, and *the minimum prices specified in the tentative marketing agreements and the orders, as hereby proposed to be amended, are such prices as will reflect the aforesaid factors, ensure a sufficient quantity of pure and wholesome milk, and be in the public interest*; and
- (c) The tentative marketing agreements and the orders, as hereby proposed to be amended, will regulate the handling of milk in the same manner as, and will be applicable only to persons in the respective classes of industrial and commercial activity specified in, marketing agreements upon which a hearing has been held.

71 Fed. Reg. 28,603 (emphasis added). After a review of the Agency's recommendations, as well as the record evidence, there is no adequate support for the Agency's General Findings or for the adoption of the proposed rule.

The Findings In Support of the Proposed Rule Do Not Address Past Agency Practices

The proposed addition of a protein minimum to the fluid milk definition is really an

attempt to justify, *post hoc*, an unsupportable change in practice by AMS, when in 2004 it abandoned its long-standing position that products such as casein, sodium caseinate, lactose, whey solids, whey protein concentrate and milk protein concentrate, were milk derivatives, and consequently not includable as a non fat milk solid in the calculation to determine whether a beverage was a milk product. That action by AMS was challenged by H.P. Hood and overturned. *See In re: HP Hood, Inc., et al*, 2004 Docket No. AMA-M-4-2 (Oct. 26, 2005).¹²

Ostensibly this rulemaking was commenced to address proposals by various dairy producers to revise the fluid milk definition to take new technology into account and protect threatened producer revenues. *See* 70 Fed. Reg. 19,012. The burden falls on the party urging a change of existing practice to justify the requested policy change. *See, e.g. Commonwealth of Puerto Rico v. Federal Maritime Commission*, 468 F.2d 872, 879-81 (D.C. Cir. 1972) ("ultimately the rule requiring the proponents of an order to sustain the burden of its justification rests on the policy of requiring a person seeking a change from the *status quo* to take on the burden of justifying the change"); *see also Lehigh Valley Farmers*, 829 F.2d at 413 ("when an agency changes its mind, it must supply adequate data and a reasoned analysis to support the change."); *Motor Vehicle Mfrs Ass'n v. State Farm*, 463 U.S. at 42 ("an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required where an agency does not act in the first instance."). Here, proponents of the various proposals to incorporate a protein standard in the fluid milk definition did not meet their burden. They did not evaluate what the likely results of the revision would be or analyze its impact on dairy product innovation and the substitution of nondairy for dairy proteins. Now, in the context of the October 2005 reversal of Agency procedures in *In re: HP Hood, Inc., et al*,

¹² See Note 14 below.

the Agency is looking to use this rulemaking as a salve to heal its self-inflicted wounds.

Regardless of why this rulemaking is still underway, the record does not support the proposed revisions to the Class I definition.

Adopting the proposed rule would unfairly allow the Agency to abandon without basis long-term agency practice and 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). Even so, the USDA should not engage in a *post hoc* justification for interpretations that were procedurally flawed.

Since 1974, the fluid milk definition has 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 standard 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 percent nonfat milk solids and its interpretation of how this percentage was to be ascertained unchanged. 58 Fed. Reg. 12,678. A 1993 Memorandum issued to Market Administrators implementing a final decision for all 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 updates to Classification and Policy Issues. Memorandum from W.H. Blanchard, Director, Dairy Division, USDA to All Market Administrators, USDA, (January 31, 1994). 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 [*sic*], 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.*¹³

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

¹³ As noted in the post-hearing briefs of H.P. Hood and General Mills, Inc. (among others), over time, a number of economic standards and competitive factors have been employed by the Agency to ascertain the value, comparative value, and classification of milk in particular uses. For Class I uses, these factors have included product elasticity, Grade A requirements, storability, shelf life, competition with or substitution for Class I products, distribution area, serving sizes, packaging, impact on producer revenues, among considerations. *See* General Mills, Inc. Post-Hearing Brief at 2; Post-Hearing Brief: Proposed Findings of Fact and Conclusion on Behalf of H.P. Hood, at 4-5 citing 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); Tr. 435-36 (C. Alexander); Tr. 510-12 (E. Olsen); Tr. 661-62 (J. Box). Apparently the Agency is content to ignore most of these factors in this rulemaking.

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.

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 percent exception and the test for calculating this percentage unchanged. 64 Fed. Reg. 47,898.¹⁴

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

¹⁴ 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 as confirmed by an administrative law judge in *In Re: HP Hood Inc. et al.*, 2004 Docket No. AMA-M-4-2 (Oct. 26, 2005). The ALJ determined that the Agency improperly classified Carb Countdown® and that a formal rulemaking process would be required for the Agency to change its classification standards. 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.

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). 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 rulemaking 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. Nowhere has the Agency addressed its past interpretations and explained why or how they are inadequate, or why or how the proposed rule will affect dairy producers. *See* 71 Fed. Reg. 20,602 ("the record of this proceedings lacks the data to conclude that exempting certain milk-based products, or reclassifying current products from one class to another, will harm producer revenue. Any negative impact may be offset by other products that may be determined to meet the fluid milk product definition as a result of adoption of its recommended changes."). 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. Simply asserting that conditions have changed does not support a change in agency position. *See Lehigh*

Valley Farmers, 829 F.2d at 413.¹⁵

The Proposed Rule Is Inequitable in the Way It Would Treat Different Dairy Ingredients and Products

Between casein, sodium caseinate, calcium caseinate and whey, and MPC

The proposed rule retains the distinction in the proposals between protein which is "counted" for purposes of determining the status of the beverage, and protein which is subject to an upcharge. In the case of the proposed rule, casein, sodium caseinate, calcium caseinate, and whey would all be counted when determining if a product meets the fluid milk definition, but unlike skim milk and MPC, would not be subject to an upcharge. Thus the net effect of the rule is to place a new upcharge on MPC used in a beverage if the total milk protein in the beverage is 2.25 percent or higher or the total milk solids is 6.5 percent or higher. The simple fact is that under this rule one could make a beverage with sodium caseinate and whey that is a fluid milk by definition but not subject to any upcharge, while a virtually identical product made with the addition of MPC would be subject to an upcharge.

The Agency's findings purportedly justifying an upcharge on MPC, and not on casein, calcium and sodium caseinates and whey, are mere conclusions without support. The Agency strains to draw lines of distinction between these products and in doing so undercuts its "form and intended use" principles. All of these dairy ingredients serve the same purpose -- they all provide processors with means of adding protein to products.

¹⁵ In *Lehigh Valley Farmers*, the Secretary of Agriculture had previously declined to amend the Federal order "because the action would not perceptibly improve the condition of the producers." The Court found that in the absence of substantial evidence in support of the proposed change, the Secretary's change in position could not be sustained. See *Lehigh Valley Farmers v. Block*, 829 F.2d at 413.

The Agency likens MPC to non fat dry milk, thus warranting an "upcharge," since both are "the end result of a manufacturing process (the removal of water and lactose) to convert milk solids into a storable, easily transportable, and versatile product for use in the dairy and food industry." 71 Fed. Reg. 28,601.

MPCs can be used as a substitute in drinkable beverage products for the protein and some of the butterfat traditionally supplied by fresh milk, ultrafiltered skim milk, nonfat dried milk, or whole milk powder.

Id. The Agency attempts to distinguish casein, calcium and sodium caseinates and whey from MPC (although acknowledging that they are all milk-derived) by concluding that "these products can not readily be substituted for a listed fluid milk product as can nonfat dry milk and MPC."

*Id.*¹⁶ Not only does the Agency fail to support this conclusion with any record citation, it contradicts itself. The Agency's treatment of whey in the proposed rule is inconsistent with its affirmation of classifying products by use. Thus, the Agency's fundamental finding that "it is reasonable and appropriate that milk used in identical or nearly identical products should therefore be placed in the same class of use" (71 Fed. Reg. at 28,599) combined with its assertion that "[a] dairy-based beverage could be made from microfiltered whey proteins, butter, lactose and water that would have equivalent butterfat, true protein, and nonfat solids as milk" (71 Fed. Reg. 28,600) should lead to the conclusion that the whey in such a beverage be placed in the same class as fluid milk. The Agency's proposed rule holds that the primary means of

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.

classification should be based on use, and yet treats products with the same ultimate use very differently. If whey is used in "identical or nearly identical products" as MPC, they must be treated the same.

The fact of the matter is that all of these dairy ingredients can be and are used as a protein source in beverage products. MPC is whey protein and casein protein. USITC *Conditions of Competition for Milk Protein Products in the U.S. Market*; Inv. No. 332-453, USITC Pub. 3692 (May 2004) at 1-9. The whey protein in whey protein concentrate ("WPC") is indistinguishable from the whey protein in MPC, except that in WPC the added whey is not subject to an upcharge, while in MPC it is.¹⁷

Between Imported and Domestic Products

Not only is the treatment of whey protein in the proposed rule illogical, it is discriminatory. In essence, the proposed rule would count whey protein in calculating milk protein levels for purposes of classification of a product as Class I, but would not subject whey protein to the Class I up-charge. *See* 71 Fed. Reg. at 28,601. 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 to the same up-charge as MPCs. As noted above, this disparate treatment of whey protein and MPC defies logic -- indeed the record is devoid of any reasonable explanation for the difference.

The differential treatment of whey protein from what could arguably be domestic

¹⁷ The proposed rule inadequately attempts to address the confusion at the hearing regarding what exactly constitutes whey by defining whey as including "whey, dry whey and whey protein concentrates" with differing methods of calculating fluid equivalency depending on whether or not the relationship between the protein and nonfat milk solids in the whey product has been altered. 71 Fed. Reg. at 28,601. *See also* Fonterra Post-Hearing Brief at 14-17; Tr. at 174-175, 268-277 (R. Cryan); Tr. at 1167, 1176 (E. Hollon).

sources, *i.e.* cheesemaking, vis-à-vis whey protein from imported sources, *i.e.* milk protein concentrate, could be subject to a national treatment argument under the GATT as violative of the United States' WTO obligations.

This *defacto* discrimination against the whey protein in imported MPC 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).

In fact, the proposed rule appears to be nothing more than the result of an effort to "gerrymander" which protein products are subject to up-charges—excluding whey proteins that are typically domestic byproducts of cheese making, while including MPC, which is typically imported. *See, e.g.*, Tr. at 179-80 (R. Cryan) ("producer revenue would be reduced....based on the substantial difference between the Class I and Class II prices and based on the significant share of milk proteins in these products that have been imported."); 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."¹⁸); H.P. Hood Post-hearing Brief at 11 ("USDA data reveals higher costs for imported milk proteins than for protein in producer milk; a hidden tariff in the form of Class I upcharge would tend to reduce imported milk protein use").

¹⁸ While the Agency proposal would not apply an upcharge to caseinates, the point made remains valid as to MPC.

Between Drinkable Yogurt and Other Dairy Beverages

"Fluid milk products are drinkable and are intended to be used as beverages." 71 Fed. Reg. 28,599.¹⁹ Nonetheless, the Agency's proposed amended fluid milk definition would exclude yogurt beverages, since they are not typically consumed with a meal or as a milk substitute. 71 Fed. Reg. 28,601; *see also* 71 Fed. Reg. 25,591 ("The proposed amendments also would not consider beverages containing 20 percent or more yogurt as an ingredient in the finished product or Kefir as meeting the fluid milk product definition.").

Fonterra agrees that drinkable yogurts should not be subject to Class I pricing, however, Fonterra objects to the need for yet a further exception in the Agency's construction of its proposed rule. While the proposed rule provides that in beverages containing less than 20 percent yogurt, *i.e.* those which would be considered a fluid milk product, the yogurt content would not be subject to an upcharge, while an upcharge would presumably apply to any milk, skim milk, nonfat dried milk or MPC incorporated in the beverage. *See* 71 Fed. Reg. 28,602.

Between Meal Replacements and Meal Replacements Sold to the Healthcare Industry

The proposed rule would also exempt from the fluid milk definition formulas especially prepared for infant feeding or dietary use (meal replacement), regardless of packaging. In an effort to resolve apparent discrepancies in the treatment of meal replacements based on how they are packaged (hermetically sealed or not), the Agency has created another unnecessarily complicating product distinction. Oddly, the meal replacement products must be sold to the

¹⁹ The Agency, while basing much on its interpretation of the term "beverage," never fully defines it. The Agency merely states: "Federal milk orders provide a definition of a fluid milk product to identify the types of products that are intended to be consumed as beverages and to specify that the skim milk and butterfat in these types of milk products should be classified as Class I and priced accordingly." 71 Fed. Reg. 28,599. Webster's Dictionary defines "beverage" as "a liquid for drinking, usu. excluding water."

healthcare industry for them to be excluded from the definition of fluid milk. *See* 71 Fed. Reg. at 28,602. On its face this distinction appears untenable, as the same product could be classified as a fluid milk or not a fluid milk, depending on its channel of distribution, without regard to the product's form and intended use. If the Agency has determined that meal replacements are not to be included in Class I, then no further caveats should be necessary – all of such products should be similarly classified.

The Findings in Support of the Rule Do Not Address the Increase in Product Substitution or Decrease in Technological Innovation that Would Occur as a Result of the Proposed Rule

The Agency's Findings and Conclusions summarize the arguments made by opponents that the adoption of a protein standard would encourage substitution of nondairy for dairy protein. Specifically, the Agency noted that:

[e]ven though the record and post hearing briefs contain considerable discussion concerning the possible substitution of nondairy ingredients in fluid milk products, no data was presented at the hearing to indicate at what price level or degree such substitution would take place. Testimony at the hearing speculate that handlers may use nondairy ingredients in the event that the fluid milk product definition were broadened, for example, by adoption of the 2.25 percent true protein criteria as an option to the current 6.5 percent non fat milk solids criteria. Additionally, most handlers who are making new dairy-based beverages were of the opinion that broadening the fluid milk product definition would hinder innovation and new product development.

See 71 Fed. Reg. at 28,602. Thus, the Agency does not deny that substitution would take place, that use of dairy ingredients would decline, and that new product innovation using dairy ingredients would be hindered. The Agency simply fails to address these well-founded and supported assertions.

Clearly there is record evidence that the increased costs created by the proposed revision 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).²⁰ 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).²¹ 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).

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)²²; 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 amendments cite technological developments as the basis for a revision, technological developments are enabling the greater

²⁰ "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."

²¹ "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."

²² "[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."

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. Dean Food's "Silk" brand of soy milk is the best selling flavored milk drink in the United States.²³ 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).^{24 25}

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>	<i>35,230</i>	<i>50,234</i>	<i>9.3%</i>
<i>WHEY</i>	<i>21,350</i>	<i>32,903</i>	<i>11.4%</i>
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 innovation will be stifled by milk protein costs increase. *See, e.g.*, Tr. at 974 (S. Taylor) ("I

²³ G. Zachary, *Why the Soy Milk King Still Reigns - By Selling Out to the Nation's Largest Dairy Distributor, White Wave President Steve Demos Turned Silk Into a Beverage for the Masses*, Business 2.0, April 2004, available at http://money.cnn.com/magazines/business2/business2_archive/2004/04/01/366226/index.htm.

²⁴ "[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."

²⁵ *See* Physicians Committee for Responsible Medicine, *Study Finds Soy Milk is a Hit with School Children*, April 2006, available at <http://www.perm.org/newsletter/apr06/soymilk.html>; D. Toops, *Health Claims Buoy Soy Milk Sales*, Wellness Foods Magazine, 2004, available at <http://www.foodprocessing.can/articles/2004/167.html>.

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 6.²⁶ 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.

The proposed rule is clearly a disincentive to innovation as it favors "old" technology over "new" technology. The analysis in the proposed rule does not seem to fully contemplate the notion that not only does this discrimination work against MPC, but it also discourages the use of whey in any product in which the use of that whey will push the protein level above 2.25 percent, thereby creating an upcharge.²⁷ Even though the upcharge would not apply to the whey, it

²⁶ "[T]he impact of reclassification (moving products from class II to class I pricing) is likely to be small—less than ±0.1% of discounted revenues (±\$0.01/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/cwt). One way to interpret these results is that there is little upside potential from reclassification, but significantly important downside potential."

²⁷ *See, e.g.*, Tr. at 752-53 (R. Waldron); Tr. at 979-981 (S. Taylor). Without reasoned analysis the Agency simply concludes that "opposition to the inclusion of whey as a determinate of whether or not a product meets the fluid milk product definition because it may cause processors to use alternative protein sources in manufactured beverages and reduce producer revenue is rendered moot." 71 Fed. Reg. 28,601.

creates an additional cost to the manufacturer for the skim milk, SMP or MPC that he uses. Thus a manufacturer would be motivated to formulate a beverage product using, for example, MPC and soy protein rather than MPC and whey protein, to avoid incurring the upcharge on MPC. Again, the economic implications of the rule are not fully analyzed.

Conclusion

The proposed amendments to the Class I definition reduces an established bright-line rule that can be understood and anticipated by the industry to an unreasoned administrative muddle. Even in the face of its newly proposed remedy for alleged producer concerns, the Agency recognizes that it still may not have gotten it "right" by stating:

The 2.25 percent true protein criteria should, in most cases, be sufficient to distinguish if a product is a Class I or Class II use of milk. Nevertheless, products that may more closely resemble the listed fluid milk products in form and intended use but contain less than 2.25 percent true protein, may be determined by the Department to meet the fluid milk product definition because the products are competing with fluid milk.

71 Fed. Reg. at 28,600. If the Agency is correct in this interpretation then it is also true that if a product does not meet the 6.5 percent nonfat solids standard, but resembles fluid milk products in form or use, the Agency could similarly make the determination that it should be Class I, thus rendering the addition of the protein standard superfluous. Since it is unclear if any products will be subject to classification changes as a result of implementation of the proposed rule, this would present a more streamlined and less disruptive alternative to the adoption of the protein standard. *See Fairmont Foods Company v. Hardin*, 442 F.2d 762, 772 (D.C. Cir. 1971) ("use of a requirement that is more burdensome and less refined than an available alternative requires very careful scrutiny" since "a sweeping rather than a more refined administrative remedy may...represent an improvident use of administrative discretion.").

Adoption of the proposed rule would be, at the least, premature. 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 rule 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.

The Agency's justifications for the proposed rule lack reasoned analysis. The Agency emphasizes form and intended use as the primary criteria for classification, but then abandons that premise when it comes to whey. If whey and MPC are used in virtually identical products they should be treated identically.

The adoption of a protein standard for the Class I classification of beverages is not supported by the evidence of record. 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. In fact, the proposed amendment attempts to "lock in" old technology without establishing that the change would advance any statutory purpose. Until the Agency can demonstrate that a definitional revision is warranted, cobbling together a proposal without a full appreciation of its potential effects helps no one.

Respectfully Submitted,

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