In re: Milk in the Northeast Marketing Area, et al.

Docket Nos. AO-14-A73, et al.

Post-Hearing Submission
of
The National Milk Producers Federation

Introduction

The National Milk Producers Federation (NMPF) makes this Post-Hearing Submission in connection with the Federal Order Hearing, held on June 20-23, 2005. NMPF is the voice of America's dairy farmers, representing over three-quarters of America's 67,000 commercial dairy farmers through their memberships in NMPF's 33 member cooperative associations. In this submission, NMPF will briefly restate its position, clarify a number of points raised by staff during the hearing, and respond to proposals made by other parties at the proceeding.

NMPF urges adoption of Proposal 7 as published in the hearing notice. Proposal 7 would strengthen the current standard for Class I products by closing certain potential and unintended loopholes that are the result of changes in food technology and that now threaten to undermine the Federal order definition of "fluid milk product." Proposal 7 would accomplish this by employing the traditional and well-established principles of form and use, but without reclassifying any existing products, except those that have been reformulated specifically to avoid the fluid milk product definition, per the hearing record. Proposal 7 would:

1. **Replace the 6.5% nonfat solids minimum with a 2.25% protein minimum.**
2. **Delete "whey" from the products exempted from the definition (so that whey proteins count toward the 2.25% minimum), but without establishing reconstitution upcharges for whey ingredients used in these products.**

Proposal 7 could be effected by the following changes in the language of the regulations:

Sec. 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~~ **2¼** percent **protein derived from milk** ~~nonfat milk solids, and whey~~; and

(2) The quantity of skim milk equivalent in any modified product specified in paragraph (a) of this section that is greater than an equal volume of an unmodified product of the same nature and butterfat content.

...

Sec. 1000.40 Classes of utilization.

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

(a) Class I milk shall be all skim milk (**including the skim milk-equivalent of protein derived from milk, where the proportions of skim milk solids have been modified)** and butterfat, **except whey and whey solids**:

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

(2) In packaged fluid milk products in inventory at the end of the month; and

(3) In shrinkage assigned pursuant to §1000.43(b).

...

NMPF contends that this language will address the issues involved in this hearing. In this regard, NMPF urges a review of Exhibits 14 through 14f, as well as the testimony and exhibits identified below.

USDA Data

One important point that emerged from the hearing is that the Class II beverages identified in Exhibit 12 are reported on the basis of the milk equivalent used to produce them. This means that on the supply side, those products are produced from a volume of milk equivalent to approximately 0.36% of Class I disposition. However, on the demand side, the total product volume of those sales is about double that. This is because most of those products are excluded from Class I due to their containing less than 70% of the nonfat solids of regular milk; and because many of the most common of these Class II beverages contain considerably less than 70%, as laid out in Exhibit 14B.

Reform of milk accounting:

A second important point that emerged at the hearing was that Proposal 7 will operate to reform the accounting for Class I fluid milk products. Proposal 7 would specifically authorize the use of the accounting methods described by Mr. Wilson in his testimony and in Exhibit 35. In effect, Mr. Wilson's office is applying a protein standard

close to 2.25% in defining fluid milk products, and accounting for the milk equivalent of those products on a protein basis.

NMPF contends that using protein as the basis of accounting for products whose proportions of skim components have been altered is entirely consistent with the intent of Federal order regulation. Because protein is the component with the predominant value in skim milk, it is appropriate to embody this reform in the language of the Federal Order regulations.

Including all dairy protein to qualify

At the hearing, several witnesses objected to milk protein concentrates (MPCs) being considered "dairy ingredients" in fluid milk products. These witnesses apparently misunderstood the nature of the proceedings and believed, incorrectly, that Federal Order language could prevent the use of MPC's in fluid milk products. Their objections are more properly made to the Food and Drug Administration and cannot be addressed in this proceeding.

NMPF does, however, sympathize with the frustration expressed by these witnesses with cheap dairy ingredients taking Class I revenue from fluid milk suppliers in Federal Order markets. However, this legitimate frustration is best addressed by including MPCs as dairy ingredients in Class I accounting methods, and by assessing an appropriate upcharge from Class IV to Class I.

Excluding Whey Protein from Class I Pricing

As testimony at the hearing showed, because whey is a product derived from the cheese-making process, it does not lend itself easily to upcharging. This is because whey's uncertain Class origin makes it difficult to decide the appropriate charge from which it is to be up-charged. Whey can originate as a by-product of Class III cheese production, Class II cottage cheese production, or (by some interpretations) Class IV dry casein production.

In each case, it represents a minor, and essentially indistinguishable part of the value of skim milk used to produce these products. The price of "other solids" in Class III milk is based on whey prices, which are driven primarily by the protein value contained in whey; the "protein" price, which prices all protein in Class III milk, is based on the cheese-yield value of casein. This substantially confuses the basis for upcharging whey to Class I. Similarly, the price of "nonfat solids" in Classes II and IV are based on total skim solids, from which the whey value is hard to separate. This difficulty in defining whey's share of each Class value is the second reason why it is difficult to determine an appropriate upcharge of whey to Class I.

Finally, we believe at this time that whey is sufficiently de-natured to serve as a poor substitute for the bulk of dairy ingredients in a fluid milk product. (If this were to change in the future, another hearing would be in order.)

Defining Whey

While it is true that the proteins in whey are the same as the proteins in some other dairy products, Proposal 7 would only exclude from pricing those whey proteins which have been separated from casein through the cheese-making process. (See Exhibit 14, and Transcript, especially p. 222-223.) NMPF does not intend to exclude proteins obtained in any other way. Therefore, it is important that the final order language contains a whey definition that is as specific as possible.

Both 21 CFR 184.1979 and 7 CFR 58.805 define "whey" as "the fluid obtained by separating the coagulum from milk, cream, or skim milk in cheesemaking." It only makes sense that "dry whey" and any other "whey" product be products derived from the same process. (See also 21 CFR 184.1979a, 1979b, and 1979c.) NMPF contends that identical or nearly identical wording should be explicitly incorporated into amended Federal order language to make the distinction between whey and other dairy proteins as clear as possible, and in order to avoid unintended consequences in the case of changes to the definitions in other parts of the Code of Federal Regulations.

NMPF notes that Food and Drug Administration Memo M-I-92-16, dated December 11, 1992, and cited in NMPF's direct testimony in this proceeding, has been recently reclassified as "inactive" by the agency. This does not change the underlying definition, now embodied in the CFR regulations identified above.

Role of Food and Drug Administration Regulations

NMPF contends that, while FDA definitions and standards can be useful in developing Federal order language, they should not unduly constrain it. An FDA definition, if adequate to the purposes of the Federal order, can give added assurance with respect to the nature and sources of such ingredients as "whey". The labeling of a product, for example, can help verify a product's content. Similarly, USDA auditors could be reasonably sure that only Grade A ingredients from approved and identifiable sources have been used to produce a Grade A product, unless otherwise documented.

NMPF recommends the explicit incorporation of the definition of whey contained in 7 CFR 58.805 (which is essentially identical to that in 21 CFR 184.1979) into the Federal orders. The identity of the Federal order definition of whey with that contained in both the USDA grading provisions and the FDA standards of identity are useful as long as the latter both specify a byproduct of coagulation in the cheesemaking process. However, explicit incorporation will ensure that the current definition, which meets the functional needs of the Federal orders, is maintained even if changes are made to regulations for grading and standards of identity.

Substitution

The issue of "substitution" was discussed frequently in the hearing. Products can be substituted for one another for various reasons, an obvious one being price. It is predictable, for example, that as the price of whole milk rises and the price of skim milk falls, consumers will buy more skim milk and less whole milk.

Another type of substitution is based upon shifting preferences. If a consumer's doctor tells him he needs to cut fat out of his diet, he may shift from whole milk to skim milk. NMPF notes that this type of substitution is not accounted for in the sort of estimated demand elasticity model that Dr. Yonkers proposed in his testimony or that was the focus of his cross-examination of other witnesses. Rather, this kind of substitution can only be identified through the sort of switching studies and consumer surveys that were presented in Exhibits 14F and 34.

Another type of substitution is based upon a change in product selection, such as the availability of an entirely new product that serves as an effective substitute. For example, low-carb milk substitutes now serve some consumers as an effective substitute for milk. NMPF notes that the potential demand for an entirely new product cannot be known or accurately represented before that product exists; so a model such as Dr. Yonkers proposes cannot capture this type of substitution.

In the case of low carb milk substitutes, the availability of a product similar to milk, but with one additional attribute, could induce large volumes of milk to be replaced, with little relation to price, and with little sensitivity to price once new preferences are established. This switching, like the switching in the last two types of substitution, is a change in the structure of demand, so it cannot be effectively captured in an estimated demand elasticity model.

Each of these examples reinforces the point that the type of model suggested by Dr. Yonkers is an inadequate means of assessing the broader issue of "substitution." Such a model assumes that the underlying demand relationships are constant. Newly emerging products, changing preferences, and product innovations all serve to change these relationships. Such changes cannot be measured by an estimated demand elasticity model. Again, NMPF asserts that the only way to assess the degree of substitution is through such studies as presented in Exhibits 14F and 34.

Finally, fluid milk products traditionally include flavored milk, milk of varying fat content, and lactose-reduced drinks, like Lactaid. While it is important to determine the degree of substitution between new products and fluid milk products generally, it is also important to consider the degree to which a new flavored yogurt drink, for example, is a substitute for a flavored milk drink, rather than white milk. The most appropriate subject for consideration of substitution by new low-carb drinks may be Lactaid, rather than, say, whole chocolate milk. The traditional set of fluid milk products are somewhat varied, but they have basic "form and use" in common. New products need not be perfect substitutes for all fluid milk products, but their similarity in "form and use" may reasonably qualify them as fluid milk products.

Flaws in Cornell Analysis

The analysis presented by Dr. Stephenson of Cornell University contained several incorrect assumptions and, as a result, the conclusions of that study were flawed.

For example, the Cornell study appears to assume that a 16.6% increase in raw milk costs translates into the same percentage retail price increase for all dairy beverages.

However, as demonstrated in Exhibit 14B, a 16.6% raw milk increase would translate into a 5.4% increase in the retail price of a gallon of whole milk, but only a 0.4% increase in a the retail price of a pint bottle of Yoo-Hoo and a 2.7% increase in the retail price of a half-gallon carton of Hood Carb Countdown (despite its higher milk protein content).

Dr. Stephenson's analysis also assumes a closed U.S. market for milk proteins and skim milk. Under this assumption, an increase in Class I revenues would induce increased milk production which would, in turn, depress U.S. skim milk prices. In fact, the U.S. is increasingly dependent upon the world market, especially for skim milk prices. As a result, increased revenues associated with Class I differential do not necessarily affect the base manufacturing prices as much as assumed by Dr. Stephenson, if at all. If U.S. prices for manufactured products such as cheese and nonfat dry milk depended on world prices (as they do today), then there would be a much smaller price response to changes in Class I and II use than in Dr. Stephenson's model.

NMPF also notes that most witnesses who discussed impacts on producer revenues did not distinguish among the impacts on total revenues, average prices, and net income. While selling milk at a lower price could, under some circumstances increase total revenue, they might do so at the expense of lower net producer income. For example, if farmers sell their milk at 1% above its cost of production, their net income is modest but positive. If they sell 2% more milk at exactly its cost of production, their total revenue is increased by about 1%, but their net income disappears. The benefits of classified pricing can be best assessed by looking at revenue minus the cost of production, rather than by looking at revenue alone.

Finally, the results of the "Le Carb" and "Swerve" scenarios were difficult to compare with other scenarios due to the much smaller volumes assumed for each product. By assuming volumes for those hypothetical products that were 90% smaller than the volumes for the baseline scenarios, the estimated price and producer revenue of their reclassification were not comparable in magnitude to those scenarios. Dr. Stephenson emphasized in his testimony under cross-examination that the impacts could not simply be multiplied by ten to produce comparable results, because his model is not linear. We are therefore unable to effectively assess the differences between reclassifying the products in these scenarios and his "baseline" scenarios. (See Transcript pp. 584-586.)

It is also worth noting that dairy protein prices at Class III or IV are often 50% higher than those for the most comparable vegetable proteins. Most price-based substitution of these vegetable proteins for dairy proteins has largely taken place before adding the Class I differential. That is, current uses of dairy proteins are those that are least sensitive to the price of vegetable proteins. Dr. Stephenson's scenario of large-scale substitution lacks a substantive basis.

Producer Income

Although the impact of regulatory changes on producer revenue is part of the various regulatory impact analyses undertaken by the Department in connection with Federal milk marketing order amendments, maximization of producer income is not an objective of the program under the provisions of Agricultural Marketing Agreement Act.

Rather, the objective of the Act, as amended, is to provide for orderly marketing; and issues of producer revenue can only bear on this proceeding insofar as they bear on orderly marketing.

No Justification for Exempting Yogurt Beverage:

Several witnesses, testifying on behalf of yogurt makers, claimed that drinkable yogurt is not a beverage because it is not "used" as a beverage. Exhibit 25 demonstrates yogurt is nearly identical with milk in composition and nutrition. Further, the dictionary defines "beverage" as "a drinkable liquid" (Merriam-Webster online, found at www.m-w.com). Drinkable yogurts are, of course, drunk, and as Ms. Ledman testified, for example, are a substitute for the milk that her children normally drink with their cookies. (See Transcript, p. 542)

The Agricultural Marketing Agreement Act provides for "classifying milk in accordance with the form in which or the purpose for which it is used". [7 USC 608c(5)] This is the "form and use" criteria which have long been applied to the classification of fluid milk products. Plain and flavored drinkable yogurts and yogurt drinks are nearly identical to plain and flavored milks in ***form***, including physical composition, nutritional content, and liquidity. Similarly, they are identical in that they are ***used*** as beverages.

Yogurt makers produced beverage products to expand their markets; that is, to expand into the beverage market. By marketing them as a beverage, they are redefining the form and use of yogurt; and as such, they are redefining drinkable yogurt as a fluid milk product.

In this regard, the data collected by the NPD group for General Mills (Exhibit 26, Chart 4) was strangely arranged and potentially misleading. A group of "uses" for fluid milk and yogurt smoothies were listed: cooking aid, additive, base dish, or ingredient. For reasons that are not clear, the most common use of these products -- that of "beverage"-- was apparently not even included as one of the choices. Even faced with this strangely incomplete set of choices, respondents indicated a very substantial overlap in uses for drinkable yogurt and fluid milk: 50% of the reported uses matched up one-for-one.

Other traditional criteria for dairy product classification also identify yogurt and fluid milk as similar products: Yogurt drinks depend upon the same fresh fluid milk supply as other fluid milk products; they cannot be stored without refrigeration; and they are shipped from factory to consumer at the full weight of the milk used to produce them, limiting their geographic market or requiring substantially higher costs.

One witness at the hearing emphasized the degree to which the nutritional composition of Nouriche differs from that of milk. However, Nouriche is substantially fortified and is not representative of most other yogurt drinks. NMPF notes that neither Proposals 8 nor Proposal 9 would distinguish this product from other yogurt drinks.

In short, the record of this proceeding provides no basis for considering yogurt drinks as exempt *per se* from the fluid milk product definition.

Regulatory Burden

Ms. Taylor, from Leprino Foods, raised concerns about the regulatory burden placed on processors who would use milk protein concentrates to formulate fluid milk products. Federal order language currently allows for Class I transfers of nonfat dry milk, for use in reconstitution of fluid milk products. This allows a formulated fluid milk product plant to buy Class I powder at a fixed price each month, and hold it in inventory. As long as such a plant has no other milk receipts or the Class I powder receipts fully account for the milk used to produce Class I fluid milk products, it has no obligation to or from the Federal order pool, except to verify receipts and report its Class I sales. (See 7 CFR 1000.43(d))

The specific inclusion of milk protein concentrates and other dry products in defining and pricing fluid milk products calls for conforming changes to these provisions. In order to minimize the burden of regulation of these ingredients, and consistent with the principle embodied in Section 1000.43(d), conforming language could adopt a more general Class I ingredient use that would allow for milk to be processed into a wider variety of dry Class I ingredients. These could be priced at Class I, stored in dry form, and sold at a later date with no additional obligation to (or from) the Federal order producer pool. Currently, only inventories held by the buyer are spared inventory price adjustments; it would also be reasonable to allow powder makers to hold Class I ingredient inventories without price adjustments. In this way, a dairy ingredient processor could take responsibility for the paperwork and price uncertainty, and allow a beverage formulator to buy the ingredient without further obligation. This would more fully address the concerns raised by Ms. Taylor that the reporting burden of the Federal orders discourages more liberal use of dairy ingredients in alternative beverages. (Because these products would not be subject to inventory price adjustments, a reconstitution credit may not be necessary, since inventory that contributes to seasonal balancing would tend to be made in low price months and used in high price months, providing a more market-based incentive to balance seasonal supply and demand.)

Ms. Taylor also expressed concern about the burden placed on users of whey in soft drinks. As proposed by NMPF, whey proteins would be counted toward the qualification of 2.25% protein, but would not be priced in Class I. As a result, a processor using only whey proteins and no other dairy proteins in a beverage could satisfy Federal order regulation simply by satisfying the Market Administrator that whey is the only dairy ingredient in use, and certifying that on that basis, the volume of Class I sales of fluid milk products can be converted to zero milk equivalent, far below the 150,000 pounds of monthly sales that define exempt plants by volume. (See 7 CFR 1000.8(e)(4)).

Opposition to Proposal 9, as presented

NMPF opposes Proposal 9 as it was presented at hearing. Although, on its terms, Proposal 9 is not inconsistent with Proposal 7, testimony by its proponents indicated that Proposal 9 was conditional on the continued exclusion of milk protein concentrates and whey ingredients from both the definition of a fluid milk product and the pricing of Class I milk. NMPF asserts that the record clearly shows these conditions are inconsistent with orderly marketing, the essential purpose of the Federal Order system.

Opposition to Proposal 5 and "Case-by-Case" Definition

NMPF opposes Proposal 5, which recommends that every product's classification be determined on a case-by-case basis. This proposal would be extremely burdensome on both the government regulators and the industry, would result in inconsistent application and numerous legal challenges, and is highly unlikely to withstand legal scrutiny. Furthermore, such an approach would also be likely to put an undue burden on producers and their representatives if they were forced to initiate case by case Class I nominations, at considerable expense and at the risk of ill will from their customers. A change from a nonfat solids standard to a protein standard is more equitable than a set of subjective criteria based on no real set of principles, but rather on the insistence that "I can't define a fluid milk product, but I know it when I see it."

Opposition to Proposal for Exemption of "New Products"

H.P. Hood's modified proposal to exempt "new products" up to 3 million pounds per month is unworkable. The contemporary market offers finer and finer variations among products, and through a proliferation of similar "new product" formulations, a plant could obtain an almost unlimited exemption for milk beverages through this proposal. The analogy to the producer-handler decision is misleading because a single plant can easily process more than one product. (Producer-handlers in two western orders will be limited to 3 million pounds per plant, not per product.)

There is no basis for this Proposal in the Agricultural Marketing Agreement Act of 1937 and NMPF strongly opposes it.

Economic Impacts

Although one witness at the hearing expressed concern that adoption of Proposal 7 might result in some product being re-classified from Class II to Class I, no evidence was presented to identify what product that might be or why it might be re-classified. NMPF asserts that Proposal 7 will not result in any products being re-classified, and the record is devoid of any evidence to the contrary. The only demonstrable current impact of this proposal would be the reclassification of a limited volume of milk protein concentrates now being used in current Class I fluid milk products.

In this regard, NMPF also notes that the difference in raw milk costs between Class I and Class II is less than the very large swings in the underlying manufacturing milk prices in recent years. (See Federal Milk Order Market Statistics, 2004 Annual Summary, p. 44, *inter alia*; noticed at hearing, Transcript p 187.)

Conclusion

Federal order Class I pricing is intended to compensate producers for the difficulty of supplying fresh fluid milk to the market. In regions where the supply of milk is more limited, there is a higher Class I use percentage and a correspondingly higher compensation for producers

Processing technology has evolved significantly since the advent of the Federal milk marketing order system. Previously, the standardization of butterfat and expanded sales of skim and lowfat milk compelled adjustments of Class I standards and valuations to maintain the integrity of the Federal order system; today, new technology that allows for standardization of lactose and development of low lactose milk substitutes requires similar adjustments.

The Class I definition must include more than just "milk" under the Federal standard of identity, although certainly some limits on the Class I definition are necessary. These limits should be clear physical standards, but should also reflect a reasonable assessment of what type of products simulate, and substitute for, milk and flavored milk. The 6.5% nonfat solids standard made sense when it prevented large sales of milk substitutes from being exempt from Class I pricing. However, because new technology has changed the industry and the traditional 6.5% nonfat solids standard cannot distinguish between valuable protein and valueless lactose in today's market, it must be modified to recognize 2.25% protein content as the true defining test of a fluid milk product.

The history of the fluid milk product definition, as outlined in part in Exhibit 14, demonstrates the need for revisions to give clarity under changing circumstances. USDA has been struggling to continue to apply the traditional principles of "form and use" with outdated regulatory language. The specification of a protein standard will bring principle and language back into harmony and remove all doubt as to the intent of the orders.

NMPF respectfully asserts that the record of the hearing makes an overwhelming case in favor of accepting and adopting Proposal 7.