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Re: Docket No. AO-14-A73, et al; DA-03-10
USDA - Federal Milk Marketing Order Hearing
Held June 20, through June 23, 2005

Post hearing brief of the Milk Industry Foundation

This post-hearing brief is submitted on behalf of the Milk Industry Foundation (MIF) and its member companies. MIF is a trade association representing processors, manufacturers, marketers and distributors of fluid milk and related products. MIF has over 100 member companies that process and market about 85% of the fluid milk and fluid milk products consumed nationwide. Most of the milk bought and handled by MIF members is purchased under the Federal milk marketing orders promulgated pursuant to the Agricultural Marketing Agreement Act of 1937.

This hearing was called to consider whether any changes should be made to the fluid milk definition in all Federal milk marketing orders in the U.S. Based upon the record evidence, MIF submits that USDA should not make any changes in the fluid milk product definition as included in proposals 1, 2, 3, 4 and 7. In particular, USDA should:

1. make no change regarding the current exclusion from the fluid milk product definition for any products containing less than 6.5% nonfat solids by weight, and
2. continue to exclude all whey and whey products in determining the nonfat solids content of products.

From the time of the first petition to USDA requesting a hearing to consider changes to the fluid milk product definition MIF has taken the position that such a hearing was not necessary ("On September 19, 2003, MIF submitted comments to USDA indicating its opposition to holding a hearing based on the lack of data and analysis necessary to justify any change in the regulation. USDA extended the deadline for interested parties to submit comments to January 30, 2004. This time, the National Milk Producers Federation joined with MIF to file joint comments to USDA requesting that no hearing be held, citing the lack of information about the market for beverage products containing milk and other dairy-derived ingredients. Again USDA extended the deadline for submitting comments, this time to September 30, 2004, and again National Milk Producers Federation joined with MIF to request that USDA not hold a hearing, noting that "initiating the formal rule-making process required to amend Federal Orders without further data and analysis may compromise the effectiveness of the resulting decision." Yonkers transcript pages 879-80).

None of the evidence presented at the hearing changes the correctness of MIF's longstanding position. No factual empirical evidence was presented suggesting that products in today's marketplace which do not meet the current fluid milk product definition are in any way causing disorderly marketing conditions at this time ("MIF's philosophy toward proposed amendments to the federal order system can be simply stated. MIF believes that the proponents of such amendments carry the burden of coming forth with solid data and analysis demonstrating both the need for a change and that the proposed amendment will address that need. Anecdotal evidence or broad suppositions do not suffice. Yonkers Transcript pages pages 880-1).

MIF's position was in fact supported by testimony of the proponents of proposal 7, who noted that adoption of this proposal would not change the classification of any existing products in today's marketplace ("Proposal 7 would accomplish this without reclassifying any existing products and following established principles of form and use." Cryan transcript page 151).

In testimony on behalf of MIF, Yonkers noted past instances where USDA rejected proposed changes to Federal order regulations due to the absence of demonstrable proof that actual marketplace conditions existed to justify the requested changes ("USDA has itself adopted this approach to federal order amendments. A good example is the proposed rule issued in Milk in the Texas and Southwest Plains Marketing Areas, Docket Nos: AO-231-A56 and AO-210-A48 and DA-88-110, published June 16, 1988 (53 FR 22499), addressing (and rejecting) a proposal to amend a federal order with respect to the "producer handler" exemption. Although the proponents asserted that the exemption created a significant unfair advantage, USDA noted that "The existence of large producer-handler operations merely *implies* that the conditions for disorderly and disruptive marketing conditions *may* exist." MIF similarly notes that the mere existence of beverages that contain milk and other dairy-derived ingredients does not prove that those products either compete with beverages that meet the existing fluid milk product definition, nor that such competition has a negative impact on the market for fluid milk products or producer revenue under existing Federal Order regulations.

In the producer-handler decision, USDA went on to note that mere "concern over the *potential* of a large handler who may have the ability to become a producer-handler does not provide sufficient basis for a regulatory change." Applying this lesson here, it seems clear that the proponents of any change to the fluid milk product definition must demonstrate using actual data and analysis that products not meeting the current fluid milk product definition are having an impact on the market, not merely that they have the potential to do so. Without such data and analysis, there cannot be a sufficient basis to justify a regulatory change.

USDA in the producer-handler decision made another apt observation, pointing out that "not sufficient time has elapsed between the time that Pure Milk acquired producer-handler status and when the hearing was held" to evaluate the economic impact. MIF has similarly and consistently maintained that the market for beverages containing milk and dairy-derived ingredients is in its infancy, noting in a January 30, 2004 letter to USDA that "At such time that study and experience provide a more conclusive basis for redefinition of Class I products, the dairy industry can ask the Department to address the issue."

USDA's decision in the producer-handler decision to which I have referred is only one example of the approach to decision-making that should also be applied here. For example, in its 1998 decision rejecting proposals to establish a floor price, USDA concluded that "The data contained in the record of the public hearing in this proceeding provide no basis to expect that an adequate supply of milk for fluid use will not be available nationwide. Therefore, the record does not support adopting the proposal, which would encourage more milk." Again, USDA placed the burden on the proponents to come forward with hard data and analysis justifying the change, and in its absence, declined to adopt the proposed order amendment. Milk in the New England and Other Marketing Areas, Docket Nos. AO-14-A68, DA-98-01, published June 12, 1998 (63 FR 32147)." Yonkers transcript pages 881-4).

In fact, the proponents in this proceeding themselves noted past classification decisions where USDA concluded that actual problems in the market were necessary to justify changes in classification ("In those hearings, USDA specifically cited the growth of skim or reduced-fat milk sales, and the resulting price-based inequities, as a basis for reclassification." Cryan transcript page 160 lines 15-18). Yet the proponents in this hearing cited no market growth data for products which are not currently included in Class I but which would become Class I if proposal 7 were adopted. Moreover, even if some products would be reclassified as a result of adopting proposal 7, the evidence supporting the need for such an amendment to current Federal order regulation is simply lacking. The type of information necessary to establish an economic justification for adopting such a change were outlined during the hearing by Yonkers ("Let me be more specific as to the data and analysis that I or any other dairy economist would need to see before determining whether an economic change in the fluid milk product definition were needed.

1. <u>A quantification of the market share held by beverages which do not fall under the current fluid milk product definition but would be included under any proposed change.</u> Speculative conjecture of the hypothetical potential for such products to gain significant market share in the future is not sufficient. There has been no quantitative market data demonstrating that beverage products not meeting the current fluid milk product definition have a significant market share. Without such information, there can be no analysis of the competitive impact such products are having on the market for beverages which meet the existing fluid milk product definition.
2. <u>An analysis of the cross price elasticity of demand between beverages which meet the existing fluid milk product definition and beverages which would meet any of the proposed changes to the fluid milk product definition.</u> This is the necessary economic test to determine whether two such product types are truly in competition with each other as substitutes in the marketplace. Such competition is a prerequisite to reaching

any conclusion regarding whether other products are being placed at an unfair competitive disadvantage, or whether disorderly marketing conditions exist. Merely looking at how the two products are packaged or where in the retail store they are sold is not sufficient to demonstrate the products compete in the marketplace. I believe that data necessary to perform this analysis could have been obtained and analyzed by the proponents, at least with respect to some of the products that would be re-classified as fluid milk products under the proposed amendments. And even if the fact that no empirical evidence of such cross price elasticities has been presented at this hearing were due to the lack of the data necessary to conduct such an analysis, this would simply demonstrate that the market share of those beverages is just too small today to warrant regulatory attention.

3. An analysis of the own-price elasticity of demand for those beverages. The most obvious economic test to determine the impact of a regulatory change, which would change the cost of ingredients use in beverages with milk and dairy-derived ingredients, is to study how economic agents react to such a change. The first inquiry would address empirical evidence of the impact of consumer response to the increased cost of the product--in economist's terms, own price elasticity of retail demand. That inquiry would be necessary to assess the impact of the regulatory change on the pool--specifically, would the positive impact on pool revenues resulting from a higher minimum price for raw milk be more than offset by the decline in sales of the product resulting from the higher price for the product. Yonkers transcript pages 884-87.)

During this hearing, proponents of proposal 7 provided testimony to clarify that this proposal was designed to include all milk proteins in a beverage product when determining whether that product met the proposed exclusion for products with less than 2.25% milk protein. They noted that while whey proteins would count toward determining whether a product has less than 2.25% milk protein, there would be no Class I price adjustment for those whey proteins. Proponents first argue that that whey protein used in fluid milk products should not be priced at Class I because "whey has already been priced within the Class III formula, and establishing an up-charge procedure for whey is problematic." (Cryan transcript page 177). However, this ignores the fact that all dry milk products, include those listed in Cryan's testimony on pages 167-168 cited above, have already been priced at the time of manufacture. Moreover, this testimony never provides any explanation about why establishing an up-charge for whey would be a problem. If this is a problem for any whey protein product, how can it not be a problem for any milk protein product? This inconsistency and lack of explanation provide further justification for USDA to reject changing the existing fluid milk product exclusion from one with a nonfat solids threshold to one with a protein threshold.

Finally, this proponent states "NMPF does not believe that, at the current time, the innovative use of whey in beverages results in beverages that compete with existing fluid milk products." If the use of whey in beverages does results in products which do not compete with existing fluid milk products, there is no reason to include whey and whey-derived proteins in determining whether or not a product is excluded from the fluid milk product definition.

The proponents presented no evidence that countered the concern that proposal 7 would have a negative impact on producer pool revenue in Federal milk marketing orders. Several witnesses noted that adopting this proposal could reduce the incentive for beverage manufacturers to use dairy proteins in new formulated products in the future. Yonkers noted the importance for such an analysis before a decision to adopt proposal 7 could be made ("One would also need to assess the higher regulated price on the ingredient formulation of the product. This requires empirical analysis of the input substitution between dairy and non-dairy ingredients in those beverages. Once again, the issue is whether the positive impact on pool revenues resulting from a higher minimum price for raw milk would be more than offset by the decline in use of dairy ingredients in the product because of the higher price for the dairy ingredients. Without such an analysis, there can be no credible testimony regarding the impact on producer revenue at federal order minimum class price from the proposed regulatory change." Yonkers transcript pages 887-8.).

One witness, Dr. Mark Stephenson from Cornell University, testifying neither in favor nor opposition to any proposal, noted that his research led him to conclude that a change in the fluid milk product definition exclusion for products with less than 6.5% nonfat solids to a 2.25% protein threshold would have a significant negative impact on producer revenue ("When new product manufacturers substitute nondairy ingredients for milk rather aggressively in response to reclassification, there are significant negative impacts of the reclassification on dairy producer revenues. This negative effect is about $3.2 billion over the nine years that we simulated. This represents about minus 1.8 percent of producer revenues or about a negative 22 cents per hundredweight of milk sold. This negative effect arises because the demand for milk components increases much less as demand for the new product grows over time." Stephenson transcript page 578 lines 2-14).

In addition, numerous witnesses testified to the fiercely competitively market for protein ingredients which can and are used in beverages. During cross examination by Mr. Farrell, one proponent noted that non-dairy proteins do compete with dairy proteins in product formulation (Hollon transcript page 112). A witness from General Mills noted that product formulators in that company focus on delivering the characteristics desired by consumers in a product with the least cost ingredients ("We have experts at product formulation that rely on their creativity and wisdom and experience with dairy products to make us the products that consumers are expecting to taste once they have told us that a concept of the mind that we have presented to them is something they want to buy. They will then use milk and whatever ratio of ingredients to try to deliver upon that expected or anticipated expectation of what the product will taste like." Waldron transcript page 830.). This was echoed by the witness from Leprino ("Product developers consider many factors when selecting ingredients to be incorporated in product formulations. These factors include the functionality, the contribution of each ingredient to the end product characteristics, and cost, among other things. In many cases, several alternative ingredients can be used to provide the desired nutritional or functional profile. Whey and whey products compete with several non-dairy ingredients in product formulas. Under the proposals that would adopt a protein compositional standard, the competitive position of high protein whey fractions, such as whey protein concentrates and isolates, would be most highly impacted . Proteins are generally added to foods or beverages for their contribution to the nutritional profile of the finished product or to enhance the structure and mouth feel. The most commonly referenced competitive ingredients tend to be soy-based, whether they are soy protein concentrates or soy protein isolates. These are the most likely substitutes for whey proteins in applications where they are being used for their protein contribution. However, many other ingredients such as wheat protein isolates and vital wheat gluten /isolates can also be substituted to achieve the desired protein contribution. Several different ingredients can be substituted for whey proteins that are being used to provide structure and mouth feel. An expanding family of hydrocolloids can substitute for whey protein to achieve desired structure and mouth feel. These products can be used individually or in combination with starches and gums. Product developers are very skillful in combining these proteins in developing products. The competitive issues facing the whey complex are becoming more acute over time as improvements are made in alternative ingredients. Soy historically has been criticized for its beanie flavor and its use in beverages has been limited to highly flavored products that were capable of masking the flavor. However, with 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. Archer Daniels Midland, Dupont, Solae, and Central Soya are just a few of these companies." Taylor transcript pages 979-81.). Ms. Ledman, witness for the Yogurt Manufacturers' Association, also noted this ("In terms of new product development, I have witnessed a venture capitalist walk away from a new dairy beverage start-up company due to the complexity and lack of long-term forward pricing for milk. In the competitive, ever changing world of beverages, product developers do not need to use dairy ingredients to manufacture a nutritious beverage. In particular, the soy industry is very aggressive in finding new market opportunities for soy protein. In some cases, soy and milk proteins are being used together in applications that were once considered dairy only." Ledman transcript pages 517-8.).

To summarize, USDA should reject proposals 1, 2, 3, and 4 as no proponents testified in favor of these proposals at the hearing. USDA should reject proposal 7, and keep the current fluid milk product exclusion for any products containing less than 6.5% nonfat solids by weight **and** not expand the exclusion to include a dairy protein threshold, since the proponents failed completely to demonstrate any existing marketplace problem this would correct, nor did they present any evidence of the economic impact of such a regulatory change on the dairy industry, especially dairy producer revenue in the pool. Finally, USDA should expand the current fluid milk product definition exclusion for whey to include all whey-derived protein products.