

4. CLASSIFICATION OF MILK AND RELATED ISSUES

The Federal milk order system should continue to contain uniform classification provisions, but with some modification. The proposed modifications are consistent with the Agricultural Marketing Agreement Act of 1937, which requires that milk must be classified "in accordance with the form in which or the purpose for which it is used."

The uniform provisions contained in this final decision provide for 4 classes of use. They are similar to the uniform classification provisions contained in the proposed rule, but with some modifications. In particular, cream cheese has been moved from Class II to Class III, and the proposed fluid milk product exclusion for products packaged in "all-metal, hermetically-sealed containers" has been changed back to the present standard: "formulas especially prepared for infant feeding or dietary use (meal replacement) that are packaged in hermetically-sealed containers."

In addition to these changes, the proposed shrinkage provisions have been revised to more closely resemble the provisions that are now in the orders, and the provision for milk that is dumped or used for animal feed has been added back to the orders, but has been moved from Class III to a new paragraph, § 1000.40(e), which specifies other uses of milk that are to be priced at the "lowest class price for the month," be it I, II, III, or IV. Milk that is lost in an accident, flood, or fire (i.e., § 1000.40(c)(3) in the proposed rule published on January 30, 1998, at 63 FR 4972) has been combined with milk that is dumped or used for animal feed in the new paragraph (e). Finally, the classification for inventory of fluid milk products and fluid cream products in bulk form has been moved from Class III to Class IV.

Changes in the proposed rule that have been carried forward to this final decision include the reclassification of eggnog from Class II to Class I, the formation of a new Class IV which includes milk used to produce butter and any milk product in dried form, and elimination of the term filled milk from the orders.

In addition to changes in the class uses of milk, this final decision modifies the definitions of fluid milk and commercial food processing establishment. Also, this decision contains modified administrative rules related to the classification of milk. These include rules for classifying skim milk and butterfat that is transferred or diverted between plants, general rules pertaining to the classification of producer milk (including the determination of shrinkage and overage), rules describing how to allocate a handler's receipts of skim milk and butterfat to the handler's utilization of such receipts, and provisions concerning the market administrator's reports and announcements concerning

classification. The classification and classification-related provisions have been restructured, in part, to standardize and simplify the regulatory program.

Further details concerning these changes are explained in the following discussion.

4a. Fluid Milk Product (§ 1000.15).

The new orders contain a modified fluid milk product definition in § 1000.15. The changes to the fluid milk product definition include eliminating the term filled milk, including eggnog in the list of specified fluid milk products, and revising the word buttermilk to read cultured buttermilk. The revised fluid milk product definition reads "any milk products in fluid or frozen form containing less than 9 percent butterfat and more than 6.5% nonfat milk solids that are intended to be used as beverages. Such products include, but are not limited to, milk, skim milk, lowfat milk, milk drinks, eggnog, and cultured buttermilk, including any such beverage products that are flavored, cultured, modified with added nonfat milk solids, sterilized, concentrated (to not more than 50% total milk solids), or reconstituted."

The term "buttermilk," as used in the fluid milk product definition, is changed to read "cultured buttermilk." The revised term clearly distinguishes the "beverage" buttermilk product from the buttermilk byproduct which is produced from a continuous churning operation.

The fluid milk product definition also is modified to exclude "filled milk" and to include eggnog in its list of products. Although it is apparent that eggnog is a beverage milk product and clearly meets many of the criteria for being considered a fluid milk product, it is not now included in the list of products identified as fluid milk products. The addition of eggnog to the list of fluid milk products results in a change of the product's classification from a Class II product to a Class I product. The elimination of the term "filled milk" from the fluid milk product definition is discussed later.

In the proposed rule, certain changes were proposed for section 15(b)(1) of the fluid milk product definition. Currently, this section exempts from the fluid milk product definition "formulas especially prepared for infant feeding or dietary use that are packaged in hermetically-sealed containers." As contained in the proposed rule, this exemption would have applied to "formulas especially prepared for infant feeding or meal replacement"--without regard to the type of container--and "any products packaged in all-metal, hermetically-sealed containers." These changes were not widely supported and have been dropped because they could result in reclassifying certain fluid milk products from Class I to Class II. The language in this final

decision is identical to Section 15(b)(1) of the present orders.

4b. Fluid Cream Product (§ 1000.16).

No change has been made to the fluid cream product definition. The current definition is uniform under all the orders and should be used in the newly merged orders. There were no comments supporting a change in this provision.

4c. Filled Milk.

The definition of filled milk has been eliminated from all milk orders and the term has been removed from the fluid milk product definition and other provisions within the orders. Filled milk is a product that contains a combination of nonmilk fat or oil with skim milk (whether fresh, cultured, reconstituted, or modified by the addition of nonfat milk solids). Filled milk was first produced and marketed in the 1960s. In 1968, the orders were amended to provide a definition of filled milk. Currently, there is little or no filled milk being produced under Federal orders. The term filled milk is used 18 times in each of the milk orders. It serves little purpose today except to complicate and lengthen the regulatory language. For this reason, any reference to filled milk has been removed from all orders.

The form of filled milk and purpose for which it is used are the same as the form and purpose for which whole milk is used. Filled milk is marketed by handlers in the same types of packages and in the same trade channels as whole milk, and is mainly intended to be used as a beverage substitute for milk. Whether made from vegetable fat and fresh or reconstituted skim milk, or any combination thereof, the resulting product resembles whole milk in appearance. Therefore, any filled milk produced and marketed in the future will be classified as a Class I product under the revised fluid milk product definition.

No letters were received commenting on this change.

4d. Commercial Food Processing Establishment (§ 1000.19).

The definition of commercial food processing establishment (CFPE) has been revised by removing the filled milk reference, for the reasons previously discussed, and by removing the word "bulk" from the definition. The removal of the word "bulk" will allow a CFPE to receive fluid milk products and fluid cream products for Class II use in certain sized packages as well as in bulk.

Presently, the CFPE definition prohibits the receipt of fluid milk products for Class II use in relatively small pre-measured packages that might reduce the CFPE's production costs. While packaged fluid milk products should be permitted to be transferred to a CFPE in any size, only those products that are shipped in larger-than-consumer-sized packages (i.e., larger than one gallon)

should be eligible for a Class II classification. If milk is received in gallon containers or smaller, the milk should be priced as Class I milk since there is no way of guaranteeing that such products will not be sold for fluid use. Permitting milk in any sized container to be sold to a CFPE for Class II use if the container had a special label, such as "for commercial food processing use only," was considered, but such a provision would be impractical and it would be prohibitively expensive for a handler to prepare specially labeled products for small accounts. The current restriction barring a CFPE from having any disposition of fluid milk products other than those in consumer-sized packages (one gallon or less) should be retained under the new orders.

These two restrictions are based upon practical considerations. The integrity of the classified pricing system would be much more difficult to maintain if the market administrator were forced to audit every CFPE on a regular basis. By prohibiting the sale of fluid milk products in consumer-sized packages to a CFPE for anything but Class I use, there would be less need to regularly audit CFPE's to be sure that such products are not being sold to the public. Similarly, since packaged fluid milk products in containers larger than one gallon are rarely, if ever, found in retail outlets, it is unlikely that such products will be sold for fluid use. By restricting fluid milk product disposition by CFPE's to packaged products not larger than one gallon in size, there is reasonable assurance that milk priced as Class II will not be disposed of as fluid milk sold by the glass from a bulk dispenser.

There were no comment letters that addressed these recommendations in response to the proposed rule.

4e. Classes of utilization (§ 1000.40).

Historically, the fluid or beverage uses of milk have been classified in the highest-priced class (Class I), and soft or spoonable products, those from which some of the moisture has been removed, have been classified in the intermediate class of milk (Class II). The final decision issued on February 5, 1993 (58 FR 12634) provided 3 uniform classes of milk for all orders. Classes I and II continued the traditional classification of milk, while the lowest-priced class (Class III) contained the hard, storable products. In a final decision that became effective December 1993, a fourth class -- Class III-A (actually a sub-section of Class III) -- was established for most orders for milk used to produce nonfat dry milk.

This final decision continues to provide a Class I classification for milk used for fluid and beverage use, with certain exceptions for formulas especially prepared for infant feeding or dietary use in hermetically-sealed containers and

products with less than 6.5 percent nonfat milk solids. Soft or spoonable products, most soft cheeses, and milk that is used in the manufacture of other food products or sweetened condensed milk will continue to be classified as Class II. Class III will continue to apply to milk used in hard cheeses, cream cheese, and other spreadable cheese, but will no longer apply to butter. Finally, the new Class IV applies to all skim milk and butterfat used to produce butter or any milk product in dried form. Class IV will also apply to bulk milk that is in inventory at the end of the month.

A new paragraph (e) has been added to § 1000.40 that classifies other uses of milk that are priced at the "lowest-priced class" for the month.

Under the pricing formulas proposed for the new orders, it is not certain whether the Class III price or the Class IV price will be the lowest class price for the month. In view of this price uncertainty, a new paragraph has been added to § 1000.40 to guarantee that milk that is lost in an accident, dumped, or used for livestock feed is accounted for at the month's lowest class price.

Comments filed regarding the number of classes of utilization for the proposed merged orders varied from supporters of one class, which would eliminate all manufacturing classes, to supporters of 5 classes of milk. Comments concerning the addition of an export class were also received. However, a large majority of the comments on this issue supported 4 classes of utilization as proposed.

4f. Class I Milk.

In this final decision, Class I milk includes all skim milk and butterfat contained in milk products that are intended to be consumed in fluid form as beverages, with certain exceptions. These exceptions include plain or sweetened evaporated or condensed milk, milk that is used in formulas especially prepared for infant feeding or meal replacement if such products are packaged in hermetically-sealed containers, and any product that contains by weight less than 6.5 percent nonfat milk solids.

Under this final decision, eggnog will join lowfat eggnog as a Class I product. Class I products are generally classified on the basis of their fluid form and intended use. Eggnog, a highly seasonal product, is clearly intended to be consumed as a beverage. Since this product is manufactured, packaged and distributed to the consumer as a drinkable beverage, it should be classified as a Class I product. Comments received regarding the reclassification of eggnog were generally in support of its reclassification into Class I, although a few handlers submitted comments opposing this change, arguing that it would increase the

cost of eggnog and, therefore, reduce consumer demand for this product.

Class I Used-to-Produce. In order to simplify the accountability for milk products classified as Class I that may contain nonmilk ingredients and/or previously processed and priced skim milk and butterfat, the proposed rule recommended adding a "used-to-produce" category to Class I. The proposed rule stated that the used-to-produce accountability method would preclude the need to develop and maintain nonstandard conversion factors and non-milk credits (i.e., salt, flavoring, stabilizers) for milk product accountability and would improve the accuracy of handler reporting and minimize audit corrections without sacrificing any statistical information, pricing considerations, or classification criteria.

Several comment letters were received arguing that the proposed Class I used-to-produce category would not simplify the accounting system but instead would complicate it. No comments were received endorsing this proposal.

Our analysis of the proposed Class I used-to-produce category generally supports those who argued against it. If there were no need to follow a pool distributing plant's route disposition to its ultimate source to determine under which order the plant would be regulated, it would be possible to simplify accounting by adopting a Class I used-to-produce category. However, with the pooling standards adopted in this final decision, the proposed used-to-produce category would simply require dual accounting with no offsetting benefit. Accordingly, the Class I used-to-produce proposal has been dropped from this final decision.

4g. Class II, III, and IV Milk.

The classification of milk used in Class II, III, and IV uses and products is essentially the same as contained in the proposed rule with a few exceptions.

First, cream cheese is moved from Class II to Class III, where it has been for many years.

Second, fluid milk products and bulk fluid cream products in inventory at the end of the month have been moved from Class III to Class IV.

Third, the skim milk equivalent of nonfat solids used to modify a fluid milk product that has not been accounted for in Class I has been moved from Class III to Class IV.

Fourth, the proposed Class II classification for any fluid product in an "all-metal, hermetically-sealed container" is changed to what is now in the orders: i.e., "formulas especially prepared for infant feeding or dietary use (meal replacement) that are packaged in hermetically-sealed containers".

Finally, the surplus classification for milk that is dumped

or used for animal feed is added back to the orders, but, as described earlier, it has been placed in a new paragraph (e) of § 1000.40 which prices milk in the lowest-priced class for the month. For the same reasons cited previously, milk which is lost in a fire, flood, or accident also has been moved from Class III to the "other uses" class.

Under the proposed rule, the classification of cream cheese would have been changed from Class III to Class II. The rationale for this change was that the milk used in Class II products is used to process or manufacture products for which handlers know a consumer demand exists and that such products are neither as perishable as fluid products nor perform a balancing function for the market, as do butter, powder, and the hard cheeses.

This proposal was not well received by a large majority of the handlers and producer organizations that commented on it. The International Dairy Foods Association argued that the pricing of milk used for cream cheese under California's state order is below the Federal order Class II or III price and moving cream cheese from Class III to Class II would create a huge competitive disadvantage for milk used in cream cheese under Federal milk orders. The National Milk Producers Federation, Dairy Farmers of America, and numerous individual handlers repeated essentially the same argument.

Some comments addressed the classification of cottage cheese and ricotta cheese, in addition to cream cheese. A national manufacturer of cheese argued that milk used in cottage cheese and ricotta cheese should be reclassified from Class II to Class III. The handler stated that due to falling demand for cottage cheese, it should be placed with other cheeses in Class III. Another cottage cheese manufacturer made the same suggestion. Several comment letters also pointed out that ricotta cheese was priced under California's Class 4-b, giving California processors an advantage over processors making ricotta from milk priced under Federal milk orders. While these comments may have some merit, we believe that more information is needed before these changes can be considered.

Ending inventory of fluid milk products and fluid cream products in bulk form should be moved to Class IV. Since the Class IV price is expected to be the lowest class price in the long run, it is logical to classify ending inventory in Class IV. Also, paragraph (c)(4) of § 1000.40, should be moved from Class III to Class IV. This paragraph prices the skim milk equivalent of nonfat milk solids used to modify a fluid milk product. With the inclusion of a Class IV classification for all products in dried form, the nonfat milk solids used to modify a fluid milk product should be priced as Class IV, together with other dried products, rather than Class III.

Products lost by a handler in a fire, flood, or vehicular accident and products that are dumped or used for animal feed have been moved from Class III to a new paragraph (§ 1000.40(e)) which would price skim milk and butterfat in such uses at the lowest class price for the month. Under the pricing formulas proposed for the new orders, the Class III price or Class IV price is likely to be the lowest class price for the month, but it is possible under some orders that the Class I or II price could be the lowest class price for the month if component values were increasing rapidly. In view of this price uncertainty, a new paragraph has been added to § 1000.40 to guarantee that milk that is lost in an accident, dumped, or used for livestock feed is accounted for at the month's lowest class price.

As previously noted, formulas especially prepared for infant feeding or dietary use (meal replacement) that are packaged in hermetically-sealed containers should continue to be classified as Class II products. Although the proposed rule suggested a modification of this exemption, there was insufficient support to move forward with this suggestion. Accordingly, no change was made from the language that is now in the orders.

The treatment of buttermilk should remain unchanged from the proposed rule. No comments were received in opposition to the proposed distinction between buttermilk for drinking purposes and buttermilk for baking purposes. As set forth in the proposed rule, drinking buttermilk would have to be labeled as "cultured buttermilk" while buttermilk for baking must contain food starch in excess of 2% of the total solids in the product and the product must be labeled to indicate the food starch content.

The proposal to account for all Class II products on a used-to-produce basis was unopposed. Accordingly, this accounting method, which now applies to all Class II products, except for some fluid cream products, is extended to the remaining Class II products that are currently accounted for on a disposition basis.

As noted above, a large majority of the comment letters supported the 4 classes of utilization as set forth in the proposed rule, including the separate Class IV for butter and milk products in dried form. Therefore, no change has been made to Class IV in this final decision except for the addition of the items already discussed.

Several commenters reiterated requests made prior to the proposed rule to reclassify bulk sweetened condensed milk from Class II to Class IV. The commenters explained that sweetened condensed milk is primarily used in commercial food processing establishments and in the confections industry and that it is interchangeable with powdered milk products and sugar in ingredient markets for processed foods and candy. They argued that manufacturers of sweetened condensed milk are currently at a

competitive disadvantage with manufacturers of nonfat dry milk and urged that the 2 products be classified identically. According to one commenter, the Galloway Company, the current system of classification places sweetened condensed milk at a significant disadvantage and has virtually destroyed the market for sweetened condensed milk.

Hershey Foods Corporation filed a comment letter objecting to the difference in classification for fresh milk used to make chocolate compared to fresh milk used to make powder that is used to make chocolate. Specifically, Hershey argued that the Class II classification for fresh milk used to make chocolate, compared to the Class IV classification for milk used to make powder that is subsequently used in chocolate violates the Act because such milk starts out in the same form and is used for the same purpose.

Hershey explained that whole milk, sugar, cocoa butter, and chocolate liquor are used to make "chocolate crumb," which is further processed to make chocolate. According to Hershey, the chocolate crumb has a moisture content of only 1 percent, which means that if a manufacturer receives fresh whole milk, it must remove 99 percent of the water from it in order for the milk to perform its function in the chocolate. An alternative to starting with whole milk and drying it is to purchase whole milk powder and mix it with the sugar, cocoa butter, and chocolate liquor to make the chocolate crumb.

Hershey argues that maintaining the current disparate classifications for fresh milk used to make chocolate and fresh milk that is first dried and then used to make chocolate, in combination with the proposed 70-cent Class II differential, will pressure manufacturers to change their manufacturing processes and formulas, reduce the use of fresh milk and increase the use of milk powders, reduce milk solids in product formulas, replace milk solids with lower cost alternatives, and might even influence the location of chocolate manufacturing plants. Hershey also notes that the State of California does not discriminate between manufacturers of chocolate, but instead prices all milk used to manufacture chocolate in the same class whether the chocolate manufacturer begins its process with fluid milk, sweetened condensed milk, evaporated milk, nonfat dry milk, or whole milk powder.

Galloway and Hershey conclude that there is no justification for pricing milk used to make sweetened condensed milk or chocolate crumb in a higher class than milk used to produce powdered milk. However, Galloway states, if sweetened condensed milk is kept in a class higher than powder, the differential for that class should be no more than 30 cents per hundredweight.

Bulk sweetened condensed milk/skim milk is used as an intermediate product in ice cream, candy, and other manufactured

products. However, these manufactured products can also be made from powdered milk. When powder prices are low relative to the Class II price, there is an economic incentive for powder to be substituted for bulk sweetened condensed milk. As a result, there must be an economic relationship between the Class II price and the cost of using alternative dry or concentrated products to make Class II products. Under current pricing provisions, the Class II price can be excessive relative to using nonfat dry milk since the Class II price is a measure of the value of milk in cheese (the Class III price) plus a differential.

Conceptually, we do not believe that the value of milk used in demand-driven products like chocolate and sweetened condensed milk that is used in food products is the same as milk that is sometimes made into powder for lack of any other use. The major point of the ability to substitute among forms of milk, sweetened condensed milk, and nonfat dry milk in certain uses is that there is a fixed relationship between the Class II and Class IV price. The appropriate price relationship is discussed in the Class II pricing section of this decision.

In the proposed rule, no allowance was provided for dumped milk or milk used for animal feed, and a Class III classification was recommended for milk lost in a fire, flood, or accident. Many handlers and the National Milk Producers Federation objected to the removal of the Class III classification for milk that is dumped or used as animal feed.

On the basis of the comments filed on this issue, a surplus use has been established for milk that is dumped or used as animal feed. The price applicable to such use will be the lowest class price for the month.

4h. Shrinkage and Overage.

Shrinkage is experienced by handlers in milk processing operations and in the receipt of farm bulk tank milk at receiving stations and processing plants. Milk is unavoidably lost as it remains in pipe lines, adheres to tanker walls and/or other plant equipment, and is washed away in the cleaning operations. In addition, unexpected losses, including spillage or leaking packages, also contribute to shrinkage.

In the proposed rule, we proposed a pro rata assignment of shrinkage based on a handler's utilization. In other words, each handler's shrinkage would have been classified according to the handler's use of milk that was not lost in transit or processing. We believed that the adoption of such a provision would have simplified both order language and accounting procedures, and we thought that it would be acceptable to handlers because, although in some cases it increased their costs slightly, the change applied equally to everyone.

There were very few comment letters that supported the proposal and an overwhelming number of comments urging us to keep the current provision. Many of the opponents were high Class I utilization handlers who complained that the proposed change would reclassify their shrinkage from Class III to Class I, increasing their costs for this lost milk.

It was not only handlers that disliked the proposed shrinkage provision. Several producer organizations, including Dairy Farmers of America and the National Milk Producers Federation, also voiced their opposition to the proposal. Most of the comment letters urged us to retain the key features of the present shrinkage provision, but there were comments suggesting a simpler provision.

Based on the comments received, this final decision retains, in large part, the present method of calculating shrinkage allowances and pricing shrinkage, but with certain modifications. Just as in the current provisions, there are specified allowances for shrinkage. The major difference is that shrinkage is not automatically assigned to a specified class, as it is now, but rather is assigned to the "lowest-priced class." This change was made to conform with the new 4-class pricing system and, more importantly, to recognize that there is no fixed relationship between class prices because of the different formulas used to compute them. For example, because the formulas for Class III and IV prices are not directly related, it cannot be known in advance which class price will be lowest. Since the relationship between class prices will vary from one month to the next, under the provision adopted here shrinkage may be priced in Class III one month and in Class IV the next. It is necessary to price shrinkage in the lowest-priced class to avoid the situation where a cheese plant, for example, would have to pay more for its shrinkage than it would for milk used in cheese. Such would be the case if shrinkage was always priced in Class IV and the Class IV price exceeded the Class III price. Pricing shrinkage in the lowest-priced class prevents this problem.

As noted, the current shrinkage allowances has been retained in the revised provision. Thus, a pool plant operator would receive a lowest-priced class shrinkage allowance based on 2 percent of the total quantity of milk physically received at the plant directly from producers' farms on the basis of farm weights and tests, plus 1.5 percent of bulk milk received on a basis other than farm weights and tests, and minus 1.5 percent of the quantity of bulk milk transferred to other plants, excluding concentrated milk transferred to another plant for an agreed-upon use other than Class I. A cooperative association handler that delivers milk to pool plants on a basis other than farm weights and tests would receive a shrinkage allowance of .5 percent of the total

quantity of milk picked up at producers' farms. Shrinkage in excess of these allowances will be assigned in series starting with Class I to the extent of available utilization.

The shrinkage provision adopted for the new orders contains language to accommodate shrinkage associated with "concentrated milk." Prior to the 1993 classification decision, condensed milk, which is made for use in ice cream and other manufactured products, was not a fluid milk product. Hence, it was not addressed by the shrinkage provision. This changed after the decision, however, when condensed milk became a fluid milk product. In making this change to the fluid milk product definition, certain conforming changes that should have been made in the shrinkage provisions were overlooked. The current proceeding involving all Federal orders has been the first opportunity to rectify this oversight. During the interim period, the unique problem associated with condensed milk has been handled administratively. Thus, the new language added to the shrinkage provision does not represent a change from the way the rules have been administered but merely codifies them.

Some plants receive milk from producers, condense (i.e., concentrate) the milk into a product that contains not more than 50 percent total milk solids, and then transfer this product on an agreed-upon basis to another plant for use in some product other than a fluid milk product (e.g., ice cream). In this case, the first plant should retain the full 2 percent shrinkage allowance because it incurs processing shrinkage in the course of concentrating--i.e., most likely condensing--the milk. The plant purchasing this concentrated (i.e., condensed) milk should get no shrinkage allowance on this milk since the designated use of this milk is for non-fluid use. Accordingly, the value of any shrinkage incurred in further processing this concentrated milk would not be much less than its use value.

As noted elsewhere in this decision, a recent development in milk processing is the use of on-farm filtering equipment (e.g., reverse osmosis or ultra-filtration) to concentrate milk before it is shipped to a plant for use in a variety of milk products. Although this milk falls under the same broad "concentrated milk" category as condensed milk, it is actually a very different product which can conceivably be used for fluid use as well as in a manufactured product such as cheese or ice cream. Thus, language is needed in the shrinkage provision to differentiate this type of concentrated milk from condensed milk. We have accommodated these 2 types of concentrated milk by allowing the shipping and receiving handlers to agree on the use of this milk. Accordingly, if a handler receives concentrated milk from another plant by agreement for use in Class II, III, or IV, the receiving handler will get no shrinkage on this milk. If no such agreement

is specified, however, the receiving handler will get the 1.5 percent shrinkage allowance, just as would be the case for unconcentrated milk that was received from another plant.

For example, milk may be concentrated at a plant by using reverse osmosis or ultra-filtration techniques and then be transferred to a 2nd plant for use in a fluid milk product. In such case, the milk will not be transferred by agreement for other than Class I use, but instead will be allocated to use at the 2nd plant receiving this concentrated milk. In this instance, it is appropriate to treat this milk just like unconcentrated milk that is received at a plant and then transferred to a 2nd plant. Thus, the first plant will initially get a 2 percent shrinkage allowance for the milk received from producers, but will be required to subtract 1.5 percent from the 2 percent when the milk, even though concentrated, is transferred to the 2nd plant. The 2nd plant will get a shrinkage allowance based on 1.5 percent of the reconstituted volume of the concentrated milk. In other words, for accounting purposes the water that was initially removed from the milk will be added back to the concentrated milk before computing the 1.5 percent shrinkage allowance for the 2nd plant.

In the example above, the concentrated milk will likely be from a farm plant which concentrates its milk before shipping it using either reverse osmosis (RO) or ultra-filtration (UF). As explained in the uniform provision discussion in this final decision, milk from a single farm with RO or UF equipment will be treated as producer milk of the first pool plant receiving this milk. However, when the milk of 2 or more producers is commingled on a farm with RO or UF equipment, that farm will be treated as a plant and the dairy farmer owning or leasing the farm will be the responsible handler for all of the milk processed that month.

The shrinkage provision in this final decision differs from the current shrinkage provisions in one other respect. At the present time, when a manufacturing facility that has absolutely no Class I utilization has "excess shrinkage" (i.e., shrinkage that exceeds its 2 percent shrinkage allowance) the excess shrinkage is assigned to Class I even though the plant has no Class I utilization. Thus, the milk that is "lost" by the plant is actually priced higher than the milk that is "used" by the plant.

Under the proposed provision, such excess shrinkage would be assigned to whatever utilization the plant has, starting with Class I. In the case of a cheese plant that has no utilization other than Class III, the excess shrinkage would be assigned to Class III.

After shrinkage is assigned pursuant to § 1000.43(b) of the proposed orders, it will be added to a handler's reported utilization to arrive at the "gross utilization in each class." The gross utilization in each class will then be carried over to

§ 1000.44, where it will be used to allocate the handler's receipts to its gross utilization of such receipts.

Overage occurs when the reported utilization of producer milk exceeds the reported quantity of producer milk received. Overage, as well as shrinkage, can occur for a number of reasons but is usually the result of record-keeping and measurement errors.

As set forth in the proposed rule, overage would have been classified by being prorated to a handler's reported utilization. It then would have been subtracted from the handler's reported utilization to arrive at the gross utilization in each class which would have been used to allocate a handler's receipts in § 1000.44.

No comments were received specifically focusing on the proposed treatment of overage, undoubtedly because the proration of overage does not have the same financial impact as the proration of shrinkage. Nevertheless, in conjunction with the change in the treatment of shrinkage, the treatment of overage also should remain the same as it is now in the orders. Accordingly, in this final decision, overage is classified in § 1000.44(a)(11) by subtracting the excess pounds of skim milk and butterfat from each class, beginning with Class IV. This treatment is identical to the way overage is classified under the present orders in Section 44(a)(14), except for the fact that now--since there is no Class IV--the allocation begins with Class III.

4i. Classification of Transfers and Diversions (§ 1000.42).

Certain changes have been made to the classification of transfers and diversions section of the orders to simplify and clarify order language. The changes discussed in this final decision are virtually identical to those contained in the proposed rule, except for minor corrections and conforming changes necessitated by other changes in order provisions. There were very few comments pertaining to this section of the proposed rule. Those that were received supported the changes proposed.

At the present time, in many orders if any milk that is diverted from one order to another for requested Class II or III use is assigned to Class I, the dairy farmer who shipped that milk is defined as a producer under the order receiving the milk with respect to that portion of the milk assigned to Class I. In other orders under similar conditions, the dairy farmer becomes a producer on the receiving order for all of the milk diverted even though only a portion of the milk was classified as Class I. When this type of adjustment is necessary, the diverting handler is informed by the market administrator's office that there is not enough Class II or III use remaining in the receiving plant to absorb all of the milk diverted. In such case, the diverting

handler may pick which load or loads of diverted milk will become producer milk under the receiving order.

Since the orders are not precisely clear on how inter-order diverted milk should be handled, some modification is needed in the order language. Under most orders, and as provided in this final decision, milk may be diverted from one order to another for a requested use other than Class I. However, if there is not enough Class II, III, or IV utilization in the receiving plant to be assigned to the diverted milk, some milk may have to be assigned to Class I. When this happens, the practical administrative problems involve determining which milk of which dairy farmers and which loads of milk will be shifted as producer milk from one order to another.

Market administrators should be given some flexibility to handle these administrative problems on a market-by-market and case-by-case basis. As a practical matter, most milk diverted between orders is diverted by cooperative associations that reblend proceeds to their members. In most cases, it makes little difference to a cooperative association whether a dairy farmer is a producer on one order or another order; any differences in blend prices between the orders will be washed out in the reblending process. In the case of milk of nonmember producers that is diverted between orders, however, differences could arise in a producer's net proceeds for the month depending upon how much milk was pooled in each order. Therefore, these situations should be handled in such a way as to be least disruptive to individual dairy farmers.

A market administrator does not know until handlers' reports have been received that some portion of milk reported as diverted to another order cannot be absorbed by the amount of non-Class I utilization in the receiving order's plant. In such case, the diverting handler should be given the option of designating the entire load of diverted milk as producer milk at the plant physically receiving the milk. Alternatively, if the diverting handler wishes, it may designate which dairy farmers on the diverted load of milk will be designated as producers under the order physically receiving the milk. As a last resort, the market administrator will prorate the portion of diverted milk among all the dairy farmers whose milk was received from the diverting handler on the last day of the month, then the second-to-last day, and continuing in that fashion until the diverted milk that is in excess of Class II, III, and IV use has been assigned as producer milk under the receiving order.

A conforming change that should be made in each order relates to milk that is transferred or diverted for Class II or III use. Presently, milk may be transferred or diverted on a requested Class II or III basis. However, with 4 classes of utilization in

the new orders, milk could be diverted for requested Class IV use also. Rather than specifying "Class II, III, or IV," however, the orders should simply state "other than Class I" to accommodate a system of more than 3 classes. This language is simpler, shorter, and accomplishes the same end.

To simplify and clarify the classification of transfers and diversions of bulk fluid milk products and bulk fluid cream products from a pool plant to a nonpool plant, which are classified by assigning the nonpool plant's utilization to its receipts, the phrase, "excluding the milk equivalent of both nonfat milk solids and concentrated milk used in the plant during the month," has been added in § 1000.42(d)(2)(i). This language will help to clarify the steps to be followed in verifying the utilization of bulk fluid milk and cream at the nonpool plant. It has been added to ensure administrative consistency and does not represent a change in the application of this provision.

In § 1000.42(d)(2)(vi), the allocation process for bulk fluid milk transferred from pool plants to nonpool plants is modified such that any remaining unassigned receipts of bulk fluid products be assigned, pro rata among such plants, to the extent possible first to any remaining Class I utilization and then to all other utilization, in sequence beginning with the lowest class at the nonpool plant. This change returns the order language to the assignment sequence that was adopted in the Uniform Classification Decision of 1974. Receipts from pool plants should not be given preference by assigning such milk to the available Class II use before assigning receipts from dairy farmers who constitute the regular source of milk for such nonpool plant. Generally, milk transferred or diverted from pool plants to nonpool plants is surplus milk and would be used in storable manufactured products, such as nonfat dry milk and butter. By assigning transferred or diverted milk to a nonpool plant's Class II utilization first, the pool plant operator is forced to account for this milk at the Class II price, even though the nonfat dry milk or other surplus product that was made with the milk is of a lesser value. This process will prevent the assignment of receipts at a higher utilization than the actual utilization.

Receipts of bulk fluid cream products at nonpool plants from pool plants and plants regulated under other Federal orders, similarly, will be assigned to the lowest class utilization first. Generally, a plant operator will use its regular source of supply in the highest valued uses before using alternative supplies. Thus, if a nonpool plant receives cream from a pool plant or a plant regulated under another Federal order, it is likely that the regulated plants were trying to dispose of their excess cream. The nonpool plant receiving the cream will most likely use it for manufacturing purposes; therefore, it should be assigned to the

lowest class first. The priority given to regular source supplies is recognized and the provision modified to reflect this.

4j. General classification rules (§ 1000.43).

For classification purposes, the milk of a cooperative bulk tank handler--i.e., a "9(c) handler"--that is delivered to a pool plant will be treated as "producer milk" of the pool plant operator. This change will shorten and simplify the allocation section.

The computation and classification of shrinkage and overage have been added to this section. This will eliminate Section 41, the section previously used for this purpose. Also, the last paragraph of Section 43 has been removed because milk for Class IV use now would be classified in Section 44 of the orders.

No comments were received pertaining to this section.

4k. Classification of producer milk (§ 1000.44).

A handler may receive milk from a producer, a cooperative association acting as a handler on bulk tank milk, by transfer from another pool plant, or from "other sources" such as nonpool plants, partially regulated plants, and plants that are regulated under other orders. Because of this diversity in sources of receipt, it is necessary in a milk order to go through an allocation sequence to determine which source of milk gets priority to a particular class of utilization and to determine how producer milk was used. In some orders, this allocation sequence is done on a system-wide basis; in others, it is done for each plant receiving producer milk.

Section 44 is one of the most complicated and difficult-to-understand sections in a milk order. Consequently, an attempt has been made to simplify and shorten it. Part of this task was made easier by proposed changes to other sections (e.g., elimination of filled milk, elimination of individual handler pools, and modification of the treatment of inter-order transfers and diversions).

All orders are not now uniform in the classification of producer milk. For example, some orders (e.g., Chicago Regional) provide for system allocation while others allocate receipts on a plant-by-plant basis for a multiple plant handler.

Under the consolidated orders, milk will be allocated on a plant-by-plant basis, as modified to reflect other changes proposed herein. The system allocation method that is found in some orders is based upon a set of marketing conditions concerning the locations of handlers' plants and the market's available milk supply in relation to those plants. These provisions were intended to stop abuses that occurred when milk was transferred from one market to another. Rather than permit an inter-order

transfer to be assigned at a handler's high Class I utilization plant, while the handler's producer milk was assigned to lower use value at another of its plants, the system allocation provisions assigned the transfers on the basis of the handler's utilization at all plants combined. The objective was to prevent more distant other order milk from being assigned to Class I use at the expense of producers who were located nearer to the city markets and who represented the normal source of supply for the markets' fluid milk needs.

The 11 new orders do not fit within the parameters of the classical model where a major consumption area is surrounded by production areas. The marketing areas proposed for the consolidated orders span several states and have a number of major population centers. They also have pockets of milk production that, in a number of cases, are in higher-priced areas than some of the fluid milk plants within the marketing area. This milk may not be economically available to a fluid milk plant several hundred miles away. In fact, it may be that a plant near the periphery of a multi-state market may find its closest and cheapest source of supply from outside the market rather than from within the marketing area. Accordingly, the system allocation rules are not supported by current marketing conditions. Therefore, all orders have been modified to allocate milk only on a plant-by-plant basis rather than on a system basis.

Another change that has been made in the allocation section concerns the "98/2" rule. At the present time, only 98 percent of the packaged fluid milk products transferred between orders is allocated to Class I; the remaining 2 percent is allocated to Class III. This provision, originating from the June 19, 1964, "compensatory payment" decision, was adopted to provide an allowance for "route returns." According to that decision, "it is reasonable to expect some route returns will be associated with inter-market transfers just as there are in connection with milk locally processed in the receiving market...a small allowance of 2 percent for such returns, which must fall into surplus use, should be included to avoid such over-assignment in Class I." (29 FR 9120).

This final decision classifies route returns based upon the use of such returns. If route returns are used for animal feed, an "other use" classification is provided and such milk is priced at the lowest class price for the month. If route returns are used to make another product, such as cottage cheese for example, the milk would be reclassified as Class II. This classification not only applies to packaged products made from producer milk, but also includes packaged products that were received from other plants, distributed on routes, and then returned to the last plant of receipt.

A handler transferring packaged fluid milk products to another handler's plant may incur some lost product en route to the buying handler's plant. In such case, the transferring handler may report such product as route returns and account for the milk used in such product at the lowest class price.

In view of the reclassification for route returns for either handler involved in an inter-order transfer who reports such returns, subject to market administrator verification, it is not necessary to classify interorder transfers of fluid milk products at 98 percent Class I and 2 percent Class III because this rule overcompensates handlers for route returns and unfairly reduces income to producers. For these reasons, the "98/2" rule has been eliminated.

In addition to the changes discussed above, Section 44 has been shortened and simplified by removing unnecessary references that serve to confuse the language rather than make it easier to understand. Where possible, simpler language has been used to replace lengthy section references.

No comments were received supporting or opposing these recommendations.

4l. Conforming changes to other sections (§§ ----.14, ----.41, and ----.60).

Paragraph (b) of the other source milk definition has been removed to reflect the fact that all packaged fluid cream products now would be accounted for on a used-to-produce basis. Also, as previously noted, the simpler and shorter treatment for shrinkage shortens the existing shrinkage provision to the point where it is no longer necessary to keep a separate section for it. Therefore, a separate section for shrinkage is eliminated and the revised contents of that section are now incorporated as a new paragraph (b) in § 1000.43. Finally, conforming changes have been made to § ----.60 (Handler's value of milk for computing the uniform price) to reflect the elimination of filled milk from the order, and to reflect changes in references due to other modifications such as the changes in the treatment of shrinkage and overage.

4m. Organic milk.

During the development stage of the order reform process, a proposal was received from Horizon Foods to exempt organic milk from pricing and pooling under Federal milk orders.

In 1990, Congress passed, and the President signed into law, the Organic Food Production Act of 1990 (7 U.S.C. 6501 et seq.), establishing the first Federal standards for organic food products. A proposed rule was issued on December 5, 1997, and published in the **Federal Register** on December 16, 1997 (62 FR 65849), to implement the National Organic Program.

Organic dairy products can now be found in many, if not most, major grocery chains in metropolitan areas. The retail price of organic dairy products is well above non-organic products. In addition to carrying organic milk, many supermarkets now also carry organic yogurt, sour cream, butter, and other organic dairy products. All of these products are priced well above their non-organic counterparts.

Processors of organic milk have asked for exemption from Federal regulation. In a May 20, 1997, letter to the Department, Horizon Foods argued that (1) organic milk is a different commodity; (2) the market for organic dairy products is a niche market; and (3) Federal order regulation of organic milk is contrary to the intent of the Organic Foods Production Act because it does not "facilitate interstate commerce in fresh and processed food that is organically produced." Horizon's proposed solution was to exempt organic milk from the producer milk definition if the milk is produced on a certified organic farm and if the broker pays the producer at least 110% of the month's Class I price for such milk.

The proposal to exempt organic milk from Federal order pricing is denied for several reasons. First, contrary to the assertions of Horizon Foods that all organic milk is priced at 110% of the Class I price, regardless of how the milk is used, there is evidence that some organic milk has been pooled and priced as non-organic milk under some orders, including the Chicago Regional and Southern Michigan orders, for example. Second, although the retail price of organic milk is well above non-organic milk, we believe that organic milk competes with the regulated market and, therefore, also must be fully regulated. Third, if Congress wished to exempt organic milk from Federal milk order regulation, they could have done so either in the Organic Foods Production Act or in the 1996 Federal Agricultural Improvement and Reform Act; but they did not. Fourth, there is no indication that all processors of organic milk price their receipts the same way as Horizon Foods. Even if they did, however, the one class/one price system currently used by Horizon could be a temporary phenomenon due to the rapidly expanding market for organic products. The day may come when the organic market becomes saturated and milk in excess of fluid needs must be disposed of at competitive prices. If and when this happens, it is likely that some form of classified pricing will be implemented. Finally, the Act provides for classifying and pricing milk on the basis of its form and use. As a result, different costs that may be associated with producing organic milk or other types of milk are not relevant. For these reasons, it would be inappropriate at this time to exempt organic milk from pooling or to provide any other type of special treatment for it

under the guise of Federal order reform.

No comments were filed concerning this issue with the exception of Horizon Foods, which continued to support its proposal.

4n. Allocation of Location Adjustment Credits

A provision that is now common to most orders has not been carried forward to the consolidated orders. This provision, which allocates location adjustment credits that are applied to transfers of bulk fluid milk products between pool plants, is commonly found in Section 52 of most current orders (See, for example, §§ 1001.53(h), 1007.52(b), 1030.52(c), or 1079.52(d)).

Under most orders, intra market shipments of milk between handlers are assigned to Class I use, unless both handlers agree on a lower classification. Milk that is assigned to Class I use is priced at the receiving plant subject to a location adjustment credit that may apply if it is demonstrated that such milk is actually needed for Class I use. If the credit is applied, the milk is priced at the transferring plant. This assignment of location adjustment credits is intended to prevent the use of pool proceeds to pay the hauling cost for the transfer of bulk milk between pool plants when the intended use of the milk is for other than Class I use.

To carry out this concept, the provision typically assigns a pool distributing plant's Class I use first to its milk receipts directly from producers, then to bulk milk received from a cooperative bulk tank handler, then to milk received by diversion from another pool plant, and then to packaged fluid milk products received from other pool plants. The remaining Class I use in the distributing plant is then assigned to bulk milk received by transfer from other pool plants. In some orders, this remaining Class I use is assigned pro rata to all of the pool plants from which bulk milk was obtained. In other orders, the remaining Class I milk is first assigned to pool plants with the same Class I price and then, in sequence, to pool plants with progressively lower Class I prices.

This final decision is based on the premise that Class I milk does not have the same value at every location. For this reason, Class I differentials have been established for each order with location adjustments that result in establishing a unified Class I price structure that applies to every county and city in the contiguous 48 states. Given this approach, it is no longer appropriate to classify a bulk movement of milk as Class I milk in one section of the order and then in another section of the order depart from the principle of pricing such Class I milk at the plant where it was physically received.

In actual practice, a distributing plant does not receive a

fixed amount of milk each day of the week. Some days are heavy bottling days when more milk is needed for Class I use. On such days, a distributing plant may not be able to obtain enough local milk to meet its Class I needs and may have to import plant milk from more distant locations. At the end of the month, however, when the allocation of location adjustment credits takes place, it may appear that there was more than enough local milk to meet the distributing plant's fluid needs, even though this was not the case when recapped on a daily basis. Nevertheless, the allocation provision allocates location adjustment credits based on monthly volumes of milk, not daily volumes, so the supply plant could be in a position where it receives no Class I location adjustment credit even though the milk was indeed shipped for Class I use.

Some of the new orders have transportation credit provisions that provide for hauling credits on bulk milk received by transfer from a plant regulated under another Federal order and assigned to Class I use at the receiving plant. To arrive at the classification of such milk, the milk is assigned to the lower of the receiving plant's or the receiving market's Class I utilization. When milk is purchased in this manner, the transportation cost of the milk assigned to Class I is absorbed, for the most part, by the transportation credit that is provided

for the handler purchasing the milk without regard to whether milk could have been purchased from a closer source of supply.

Finally, the current application of the provision in question can result in a situation where there is more incentive to receive bulk milk transferred from a plant regulated under another Federal order than from a plant regulated under the same order, whether or not any other transportation credits are involved. Should this occur, it can result in a transfer of Class I sales to the transferring plant's Federal order market.

For all of the reasons cited above, the allocation of location adjustment credits has been removed from the orders. Several comment letters were received supporting this change; none were received in opposition to it.