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UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

In re: Milk in California	[AO] Docket No. 15-0071

REPLY BRIEF

SUBMITTED BY

DAIRY INSTITUTE OF CALIFORNIA

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I. INTRODUCTION

This Reply Brief is submitted on behalf of the Dairy Institute of California ("the Dairy Institute"), a trade association representing proprietary fluid milk, ice cream, yogurt, and cheese processors. This matter comes before the United States Secretary of Agriculture upon the request of three dairy farmer-owned Cooperatives: Dairy Farmers of America ("DFA"), Land O'Lakes, Inc. ("LOL"), and California Dairies Inc. ("CDI") (collectively, "the Cooperatives") to promulgate a Federal Milk Marketing Order ("FMMO") for California.

From the Opening Briefs, it is abundantly clear that the Cooperatives utterly failed to carry any burden of proof or of going forward, as required. *See* Part III, Dairy Institute's Opening Brief, pp. 8–10. The Cooperatives and their allies cannot justify any California FMMO, let alone the Cooperative Order, based upon USDA's own long-established standards. Moreover, if somehow a California FMMO is to be promulgated then it must be based upon current, not decades old economic data[1] affecting the California milk market and must recognize basic and long-standing principles of FMMOs, such as tangible performance-based pooling standards. Further, minimum classified prices and price formulas, if any, must be fully and completely justified. Proposal 1 should be rejected.

We applaud the Administrative Law Judge's decision to allow for reply briefs in this unique proceeding impacting 20% of the nation's milk supply. Remarkably, despite the Dairy Institute's opposition and arguments set forth before the hearing commenced (April 9, 2015 and May 27, 2015), in the Dairy Institute's Opening Statement (Friday, September 25, 2015, Tr. 775-788) and throughout the Hearing, the Cooperatives in their Opening Brief gave short shift, at best, to the leading legal arguments raised by the Dairy Institute (e.g., applying USDA standards, the definition and lack of disorderly marketing, the legal underpinning of the Quota Provision (7

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[1] The Class I price surface stems from a model run in 1995, based on even older transportation cost data; the structure of classified pricing dates back at least to 1999 when FMMO Reform was completed; the make allowances were partially updated in 2008 using 2006 data. As Dr. Stephenson's study demonstrates, a great deal has changed in the dairy industry since these USDA recognized developments that date back 10 – 20 plus years. The fact that location values have changed significantly in that time period is especially important when analyzing the California market for a California FMMO. 7 U.S.C. §§608c(11) and 608c(18).

U.S.C. §7253(a)(2) as reauthorized in the 2014 Farm Bill), the level of any classified price based upon current economic conditions, the need for performance-based pooling standards, and the justification for and level of Class I Differentials). In a very real way, USDA is left with a Cooperative Opening Brief rich in emotional assertions yet so devoid of legal analysis that USDA cannot promulgate any FMMO, let alone Proposal 1.

USDA must conclude that no California FMMO is warranted or justified by the Record evidence. If an FMMO is justified, Proposal 1 must be rejected. Any California FMMO must be based on current economic conditions underlying the California milk market and any Order provisions must recognize long-standing USDA policy (e.g., voluntary pooling of non-Class I milk).

II. THE COOPERATIVES FAILED TO PROVE THE NECESSARY ELEMENTS OF THE PROPOSED COOPERATIVE FMMO

Considering the blatant failure to address critical issues in their Opening Brief, the Cooperatives fail to provide sufficient evidence and arguments to support the implementation of a California FMMO. As demonstrated further below, the key provisions of the Cooperative Order have no foundation in law or fact.[2]

A. The Cooperatives' Expansive View of the Quota Provision Contradicts 80 Years of History.

As discussed at length in our Opening Brief, USDA cannot propose any California FMMO on a blank slate. Instead, USDA must analyze the Record evidence not only in light of its own established policies and interpretations, but also that of myriad courts, including the United States Supreme Court, with respect to the meaning and limits of the Agricultural Marketing Agreement Act ("AMAA"). The Cooperatives' Opening Brief suggests an entirely different approach to interpreting the AMAA, devoid of any tether to USDA's historical and often cited interpretations employed when establishing order regulations. As the U.S. Supreme Court noted almost contemporaneously, but after adoption of the AMAA, the amount of weight

[2] Although technically unnecessary under the Rules of Practice, the Dairy Institute expressly preserves all objections and motions raised at the Hearing. 7 C.F.R. §900.8(c)(2) (2015).

given to administrative interpretation of an act depends, *inter alia*, on "its consistency with earlier and later pronouncements." *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944) (finding as not controlling Labor Administrator's overtime definition under the Fair Labor Standards Act). Moreover, of course, the AMAA has been repeatedly interpreted, defined, and refined, and USDA actions found lawful or unlawful by many reviewing federal courts. There is no blank slate, but rather a full and powerful established set of agency and court legal interpretations that cannot simply be scrubbed away as if the tide has rolled in and out.

Adoption of the Cooperative Order requires abandonment by USDA of 80 years of USDA and court interpretation of the AMAA, the enabling act for FMMOs: principally, but not exclusively: (1) that the purpose of the AMAA is to bring forth an adequate supply of milk for fluid use (Dairy Institute Opening Brief, pp. 38-41); (2) that a central purpose of FMMOs is to avoid destructive competition for the more lucrative Class I (fluid milk) market by providing all dairy farmers with the opportunity to share in the value of the Class I sales (Dairy Institute Opening Brief, pp. 41-52); (3) that pooling standards that are performance-based are the only reasonable way to achieve the goals of the AMAA by permitting sharing in the Class I market based upon a reasonable association with the market (Dairy Institute Opening Brief, pp. 60-78); (4) minimum regulated prices shall be uniform as to all dairy farmers (Dairy Institute Opening Brief, pp. 12-37 and 134-136); and (5) minimum regulated prices for manufactured milk products must be set so as to permit the market to clear (Dairy Institute Opening Brief, pp. 79-123).

Clearing away the clutter, the Cooperative Order rejects each of the foregoing long-established AMAA interpretations by USDA and the courts and rests solely and squarely on the head of a pin – "The Quota Provision."[3] As importantly, and recognizing that courts will consider the agency's "consistent" pronouncements, the Cooperatives' arguments undermine the

[3] We diagram the grammar of the Quota Provision, codified at 7 U.S.C. §7253(a)(2), in Part III below to show that this pin cannot justify abandonment of USDA's long-standing requirements for performance-based pooling standards.

legal underpinnings of the existing FMMO system especially the rationale for regulation of Class I milk along with the *quid quo pro* for such regulation - performance-based pooling standards. If the Cooperatives were correct (and they are not), then performance-based pooling standards are both unnecessary and thus not justified in the existing FMMOs. And if they are not justified then they cannot exist in the FMMO system. However, both USDA in the post-FMMO Reform series of "Pooling Decisions" (*see* Dairy Institute Opening Brief pp. 61 - 69) and the courts have found otherwise. *See, e.g., Alto Dairy v. Veneman*, 336 F.3d 560, 562-563 (7th Cir. 2003). Adopting the Cooperative logic (and ironically contradicting DFA's position at other FMMO hearings regarding performance-based pooling standards) inevitably leads to the conclusion that the existing FMMOs unlawfully impose performance-based pooling standards. We reject that premise.

The Cooperatives' argument regarding the AMAA is untenable because they contradict 80 years of USDA interpretation and case law. Their arguments rest on an assertion that the single sentence of the Quota Provision is more specific than the existing, extensive language found in the AMAA.[4] No objective observer can reach that conclusion in light of the history, complexity, length, and innumerable agency and court discussions and review of the AMAA. Moreover, given Congress' past proven ability to specifically, and at length, amend the AMAA (*see* Dairy Institute Opening Brief, pp. 10-33), the Cooperatives' specificity argument is untenable. As noted in the Dairy Institute's Opening Brief, merely saying it is more specific doesn't make it so. *See,* Dairy Institute Opening Brief, p. 31. As to disorderly marketing, the Cooperatives essentially argue that the standard is unnecessary or meaningless. *See* Cooperative Opening Brief, pp. 28-36. In the face of USDA's repeatedly articulating the "disorderly marketing" standard and applying it in a six-part test for decades (Dairy Institute Opening Brief

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[4] We note a critical contradiction by the Cooperatives in their Brief in which they now assert that the Quota Provision and the AMAA's requirements for uniform pricing can be harmonized. (Cooperative Opening Brief, p. 46). This is in direct contrast to the unequivocal argument by Counsel for the Cooperatives in the last days of the Hearing: "I would like to emphasize here this morning, there's no reconciliation of quota and the uniformity provisions of 608c(5)(B) of the AMAA. They are not reconcilable. We can be here until Doomsday, and you can not reconcile those things." (Mr. Beshore arguing before Judge Clifton, Tr. 7012:11 – 7013:1). As with everything else in this proceeding, the Cooperatives make expedient, inaccurate or inconsistent, arguments.

pp. 38-53), the Cooperatives' assertion brings forth the famous Gilda Radner line on Saturday Night Live "Never Mind!" To accept the Cooperatives' proposition, USDA must concede, as it cannot, that it never really meant any of those things it said in multiple rulemaking proceedings adopting FMMOs for Alabama, Georgia, the Carolinas, Tampa Bay and Idaho. Dairy Institute Opening Brief, pp. 42 – 46.

In summary, the Cooperatives are arguing for unprecedented regulation of Class III milk simply because California's Class I utilization no longer enhances producer prices to the level that the Cooperatives desire. The proof of this is on page 1 of their Opening Brief when they claim that they seek an FMMO "in order to enhance California producer income." On page 28 they further argue that one of the essential purposes of the AMAA is enhancement of producer income. This may have been true so long as parity prices were a relevant consideration in the early days of FMMO regulation, but the Secretary has consistently and *expressly* found that parity prices are unreasonable since at least the mid-1960s and thus enhancement of prices is not since then a relevant consideration. *Milk in Tampa Bay Marketing Area*, 30 Fed. Reg. 13143, 13144 (October 15, 1965).

USDA's official position can also be found in a September 17, 2012 letter from Dana Coale, Deputy Administrator Dairy Programs to Ms. Dori Klein (a dairy producer who petitioned for a FMMO hearing seeking emergency price relief). In that letter Ms. Coale for USDA states (consistent with the Dairy Institute's position here): "First, the Federal Milk Marketing Order (FMMO) program is not designed to be a price or income support program since it is not authorized to establish minimum prices above the relative market value of the products of milk." Ex. 112, at 51–53.[5] As with so much else in this proceeding, the Cooperatives wish away established policy and procedure in order to achieve their ends. But USDA cannot ignore its own policy pronouncements in these areas.

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[5] This document may also be found at: https://www.ams.usda.gov/sites/default/files/media/Preliminary%20Impact%20Analysis%20-%20Final.pdf.

Nothing the Cooperatives have argued overcomes the legal impairments they face in demanding a California FMMO that looks nothing like any other FMMO and would instead deliberately negate the legal rationale for standard provisions of the existing FMMOs. USDA cannot lawfully abandon that 80-year policy here and should not do so without understanding that doing so means that it would no longer have a consistent justification for the provisions in the existing FMMOs.

B. The Cooperatives Provide No Basis for Prices

1. The Cooperatives Fail to Provide Any Evidence Supporting Class I Differentials.

The Cooperatives' reliance in any fashion on FMMO Reform for Class I prices is not just misplaced, it is critically and fatally flawed. In the FMMO Reform process, USDA expressly and specifically stated that its data and economic analysis for Class I price surface ***excluded*** consideration of raw milk flows to California Class I plants.

> The preliminary reports, the proposed rule, and this final decision concerning order consolidation were prepared using data gathered about receipts and distribution of fluid milk products by all known distributing plants located in the 47 contiguous states, ***not including the State of California***.

64 Fed. Reg. 16026, 16044, c.2 (emphasis supplied) (April 2, 1999). USDA has never made the determination of what the price should be in California based on *any* economic conditions within California, let alone current market conditions.

This argument is overwhelming and conclusive – no party, including the Dairy Institute, provided support for any Class I price differential level. The Dairy Institute's Proposal 2 which contains existing FMMO price surface is not evidence of the *need* to use those price levels and the Dairy Institute does not support those provisions. At best, if permissible at all, the price levels shown in Dr. Stephenson's study from 2006 (not current economic data for the California market) would support only a lower Class I price surface than that found either in Proposal 1 or Proposal 2.

2. Failure to Update FMMO Pricing Leads to Overvalued Whey

The value of whey must also reflect the limitations on processing whey from different cheese products or using different processing methods. Even facilities that have whey processing are hamstrung in recovering whey costs due to the fact that whey from different facilities (even if the same type of whey) can have different taste and other properties, so will have to be adjusted to be harmonized within a single batch. *See* Tr. 4749:16 – 4750:24 (testimony of Mr. Hofferber). Additionally, purchases of whey from other facilities will require two additional rounds of pasteurization (upon pickup and delivery), further reducing the market value of the product. *Id.*

3. Legal Requirements for Milk Price Regulation and Price Control.

a. The U.S. Constitution and the Administrative Procedure Act require regular updates to product price formulas.

The price regulation that USDA has adopted under the AMAA must not only be consistent with the AMAA, but also pass muster under the United States Constitution. USDA's price regulation must also not be arbitrary and capricious. This is not just a matter of rational economic policy as identified by USDA in setting prices that are market clearing with a return on investment, but also settled law with respect to price controls and ratemaking generally.[6] The Cooperative Order's proposed adoption of a California FMMO using decades old economic data that manifestly is out-of-date and deprives California businesses of any rate of return would be, by its very nature, arbitrary and capricious.

The Cooperative Order assumes away the necessity for USDA to perform a 2015 California-specific economic and market analysis for the setting of classified prices. The requirements of the AMAA for market-specific, current economic conditions prevent this result. 7 U.S.C. §§608c(11) and 608c(18). Moreover, USDA, in FMMO Reform pronounced the policy that Class III and IV milk prices must "not exceed a level that would require handlers to pay more for milk than needed to clear the market ***and make a profit***." 64 Fed. Reg. at 16094-16095.

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[6] The Dairy Institute in this Reply Brief clarifies that its Opening Brief argument characterized as "ratemaking" is analogous to the legal requirements for returns of investment under milk price regulation and other forms of price control. The Dairy Institute adopts Hilmar Cheese's analysis of regulated prices from both Hilmar's Opening and Reply Briefs.

USDA cannot reasonably achieve this goal using economic data known to be decades old, outdated, and contradicted by Dr. Stephenson's unchallenged analysis and by more current, audited CDFA manufacturing studies.

As importantly, USDA needs to use current economic data to establish price formulas here because price formulas represent a proxy value of milk, rather than the value of milk itself. In contrast to product price formulas, the Minnesota-Wisconsin price was a direct valuation of unregulated milk that adjusted automatically every month for demand and supply conditions for Grade B milk purchased for manufacturing in the Upper Midwest. Order formulations for manufacturing areas like Idaho occurred when the M-W price series established the Class III price.[7] The M-W, The Basic Formula Price ("BFP") incorporated product price formulas, but only as an updater to the Grade B milk price series. Over relatively short periods of time, the BFP remained a direct milk price valuation that adjusted automatically to represent the most current market conditions possible.

End product price formulas by their nature only indirectly represent, as a proxy, the value of the milk itself. While the product prices within the price formulas adjust regularly, the price formulas themselves (unlike the M-W or the BFP) do not adjust on any regular basis, but instead require USDA oversight, formal rulemaking, and amendments to the FMMOs. The static end product price formulas thus risk (and indeed have) sclerosis. By definition, use of antiquated economic data (especially in the face of Dr. Stephenson's uncontroverted testimony regarding 2014 economic conditions) does not substitute for and cannot establish prices that will clear the market and assure Class III and IV manufacturers in California a profit.

Also the issue of whey value was not overly important in FMMO Reform as whey prices were low and contributed little to Class III prices. And there was no whey factor in California at the time, as it was added in 2003 by California. Ex. 79, at 21 (Testimony of Dr. Schiek), Tr. 3613:8–14. Thus, it is not surprising that USDA found high correlation in prices between FMMO

[7] Idaho regulation terminated when the Western Order was voted out by DFA. Ex. 66 (DFA Press Release).

Class III and California Class 4b. 64 Fed. Reg. at 16101, c.1. From 2003-2007, CDFA used an end-product whey formula similar to the one used in Class III. CDFA expressly abandoned that formula for a fixed whey factor and later a sliding scale because changing marketing conditions and the inappropriateness of the price level generated by the Class III-like price level demonstrated that the formula was not workable for California. Ex. 79, at 23–24 (Testimony of Dr. Schiek), Tr. 3620:17–24. CDFA's well-documented decisions are agency admissions that the Class III price did not correlate well with the market value of milk used to make cheese in California. USDA must not ignore these critical market and regulatory realities. USDA, having undertaken to adopt end-product pricing formulas, must adjust those formulas to reflect current market structure and conditions on a regular and sustained basis. And it must use only current economic conditions for California in adopting any California FMMO. As discussed in more detail below, the failure to do so is arbitrary and capricious and unlawful.[8]

Federal regulation of energy prices, while based upon a different regulatory scheme, bears some striking similarities to FMMO price control. The legal analysis underpinning price control under the Administrative Procedure Act ("APA") and the United States Constitution are applicable to the Federal Energy Regulatory Commission's ("FERC") regulation of utility prices. Under FERC's cost of service pricing, utility rates are established via a hearing by reference to actual costs, revenues and units of service over a defined recent historic period. When these utility rates get out of date and are thus believed to be too high or too low, the utility or FERC (or the utility's customers if FERC concurs) can cause the reevaluation of such rates via a new hearing. In that hearing, the utility's costs, revenues and units of services are reevaluated to establish new rates which reflect more current economic circumstances.

Alternatively, future utility rates can be established under a formula. FERC has held that the formula itself is the rate. *Virginia Electric and Power Co.*, 123 FERC ¶ 61,098 (2008). A

[8] It may well be, for separate consideration, that the existing FMMOs static and largely outdated price formulas may be unlawful, and USDA is clearly late to cure this problem; however, at a minimum, as to any California FMMO, USDA must use only current economic data. USDA could mitigate this critical problem by immediately noticing, holding and concluding (before adopting a California FMMO) a hearing for Class III and Class IV formulas generally.

formula obviates the need for a periodic hearing to maintain the reasonableness of the rates because the formula updates these rates on a regular basis (usually annually). Under a formula rate, the utility annually provides to the FERC updated inputs for the formula which inputs must reflect its current costs, revenues and units of service. The formula then automatically produces the new rates. Once FERC approves the inputs, the new rates take effect automatically. In this way, FERC's rates are current at least based upon new annual data.

The price control formula used for component milk pricing is similarly a rate as determined by the Ninth Circuit Court of Appeals,[9] but some of its inputs are based upon static fixed numbers within the formulas and others are updated. This formula price control establishes the lawful regulated minimum price to be paid by handlers to dairy farmers for the milk the handlers use to produce manufactured milk products. USDA is exercising price control/ratemaking authority when it establishes and enforces minimum component milk pricing rates via this formula rate. USDA's exercise of such authority is unlawful if it is arbitrary or capricious or fails to reflect the exercise of reasoned decision making, per the APA. The failure to use or update prices with current economic conditions on a consistent basis violates this requirement.

The make allowance (and the whey factors) in component milk control pricing are static numbers that have not been updated in a number of years and thus cannot reflect current costs, revenues or units of service. In fact, more current manufacturing costs surveyed by CDFA and introduced at the hearing clearly show that costs have increased. Ex. 123, at 4-14 (Exhibits to Testimony of Dr. Schiek). In contrast, the product prices within the same component milk pricing allows for monthly updating of another input. Updating *all* inputs to component milk pricing, including the make allowances and whey factors, is therefore required to insure that USDA component milk prices remain lawful under the APA. And of course, when adopting any

[9] USDA price regulation or price control also results in the establishment of "rates" or minimum prices. The Ninth Circuit Court of Appeals (which includes California) has expressly found that USDA's classified price system establishes "Filed Rates" subject to the filed rate doctrine. *Carlin v. DairyAmerica*, 705 F.3d 856, 873 (9th Cir. 2013) (holding that the filed rate doctrine applies to FMMO pricing generally and that USDA's Class III and Class IV prices are "rates" for purpose of ratemaking analysis).

California FMMO, USDA must start by using only current economic data and not data from FMMO Reform as partially updated based upon data that is at least 10 years old.

Consistent with this approach to legal price control through evenhanded evaluation of current economic conditions, FERC price control/ratemaking regulation of Alaskan crude oil streams is deliberately designed to maintain up to date pricing factors. The Quality Bank is administered by the Trans Alaska Pipeline System (TAPS) under FERC regulation to address the effects of comingling of crude oil streams of different values on the pipeline. The Quality Bank is an accounting arrangement approved by FERC that makes monetary adjustments between shippers utilizing TAPS in an attempt to place each in the same economic position it would enjoy if it received the same petroleum at Valdez, Alaska (the end of the pipeline) that it delivered to TAPS on the Alaska North Slope (the start of the pipeline). To accomplish this, the Quality Bank charges shippers of relatively low-quality petroleum who benefit from commingling and distributes the proceeds to shippers of higher quality petroleum whose product is degraded by commingling. *Exxon Company, U.S.A. v. Federal Energy Regulatory Commission*, 182 F.3d 30, 34 (D.C. Cir. 1999).

The Quality Bank uses a distillation valuation model to calculate the value of each shipper's crude oil by first determining the relative proportion of end-use products refined from that producer's oil, and then valuing those products based upon published, publicly available and current spot market prices. At refineries, the Alaska North Slope crude oil is distilled into nine different cuts, six of which can be sold into the spot market at published prices, and three others that must be further processed before they can be sold into the spot market at published prices. For the three cuts that require further processing, the Quality Bank uses the spot market prices, but deducts the ***current*** costs of such processing to ensure that all nine cuts are valued on a level playing field, i.e., the Quality Bank essentially backs into what the market value of those three cuts was prior to the additional processing. This treatment is required by the U.S. Court of Appeals for the D.C. Circuit in *OXY USA, Inc. v. FERC,* 64 F.3d 679, 694 (D.C. Cir. 1995):

> We are conscious of the difficult and necessarily imprecise task FERC faces when it must split petroleum streams into component parts and then place a value on each of them. We agree with the Commission that there is no "perfect way" to value the different quality oils shipped on TAPS, especially in the case of products without a readily ascertainable market price; and we will not hold the Commission to an impossibly high standard. But if the agency chooses to value some cuts of petroleum at the prices they command in the market without the benefit of processing, as it appears to have done, it must attempt, to the extent possible, to value all cuts at the price they would command without processing. It cannot, consistent with the requirement of reasoned decisionmaking, value some cuts precisely and others haphazardly.

Importantly, the D.C. Circuit and FERC have recognized that this Quality Bank mechanism is a rate under price control and FERC has recognized that the costs of additional processing for the three cuts that cannot be sold after simple distillation must be kept ***up to date*** to ensure those cuts are properly valued in relation to the other cuts. *See, e.g., OXY*, 64 F.3d 679. As approved by FERC and the D.C. Circuit, the Quality Bank does so by indexing those costs for inflation annually based on what is known as the Nelson Farrar index which measures changes in refinery operating costs. *See, e.g.,* Exxon Co. v. FERC, 182 F.3d 30 (D.C. Cir. 1999); *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,039 (2009); *Trans Alaska Pipeline System*, 113 FERC ¶ 61062 at P 18(2005).

FERC could have chosen other ways to update and maintain currency of the indexed costs; the important point is that to meet Constitutional and APA requirements, the costs are adjusted at least annually. USDA cannot adopt a California FMMO based upon anything other than current costs, and USDA needs to adjust the existing FMMOs in order to achieve current prices as soon as possible. The APA and the United States Constitution demand that the FMMOs price formulas be and remain current.

b. Regulated prices established by end-product pricing formulas effectively result in regulation of plant margins

Regulated minimum prices that are set by end-product pricing formulas effectively establish the margins that can be attained by the commodity cheese plants of the type represented in the formula. Ex. 122, at 4–5 (Testimony of Dr. Schiek). If we consider the case of a commodity cheddar cheese plant, the regulated minimum prices established by USDA define the margin that can be attained by a plant with the same costs and yields that are included as factors in the pricing formula. The plant might be able to improve its efficiency (by lowering costs or increasing yields) as a means of increasing its margin, but such changes have technical limits and can often be made only through additional capital (or labor) investment. Plants that are already operating near or at the efficient production frontier can do little to improve their margin through efficiency gains.

The ability of a plant to improve its margin by increasing its output price is likewise limited. Dairy commodity plants compete in a national and international marketplace with products that are sold according to established specifications. Dairy Institute Opening Brief, pp. 100-102. As such, the demand curve that these plants face for their product is highly elastic and downward sloping. Ex. 146, at 38 (Exhibits to Testimony of Dr. Schiek). A small increase in the plant's output price relative to its competitors will lead to a large reduction in its sales as buyers shift their business to other suppliers. A downward sloping, highly elastic demand curve would also be faced by other dairy commodity makers, not just those that make the representative product in the formula (*i.e.*, by mozzarella and jack cheese makers, not just cheddar makers). All would likely lose sales if they attempted to adjust their margins by increasing their product price.

In the case of the plant making the representative product, there is another factor limiting its ability to adjust its margin by increasing its output price. If, for example, a commodity cheddar cheese plant were able to increase its output price, that new, higher price would influence what other cheddar plants charge for their product, likely leading to an overall increase in the market price for the commodity. This price-follower behavior, which is a characteristic of less than perfectly competitive markets, would drive the market price for the reference product higher. Transmission of the plant's price increase through the market would eventually raise the regulated milk price because the end product formula used to set the milk price would be employing the new, higher cheddar cheese price. The circularity in the cheese price and the regulated milk price determination limits the ability of a cheddar plant to increase its margin by adjusting its output price.

The situation faced by cheese plants operating under regulated minimum prices that are set using end product pricing formulas is thus highly analogous to that faced by regulated utilities when output prices are controlled by regulatory agencies. Margins earned by the utilities are limited in those cases by what the utility is allowed to charge its consumers. The utility has limited ability to influence its costs. In the case of milk, the margins of plants are limited by the minimum prices that the state requires plants to pay for the milk they use. The plants have limited ability to influence their achievable output price.

Plant margins must be adequate for the plant operator to cover its cost and make a profit. If it cannot, it will have no incentive to purchase dairy farmers' milk. Under the case that a price cannot be found at which dairy farmers and plant operators are both financially viable over the long run, then the industry will contract. In such a case, the most natural place for the contraction to begin is in the producer sector where the dairy supply chain begins. That way, as the milk production declines, the market will determine which plants will be able to secure the available milk supply based on their ability to generate enough product revenue in order pay the necessary milk price. The plants that survive will be those that are able to pay the most for milk. USDA does not have sufficient information to anticipate or circumvent the market's determination of which plants should be the ones that survive and which ones should be forced out by a rising competitive milk price. For this reason, USDA should use caution and set regulated minimum prices so as to maintain adequate plant margins and allow market-based premiums to work to allocate milk among the different plants.

c. California cheese manufacturers cannot afford to pay higher regulated minimum prices.

FMMO Reform minimum regulated prices may well have been market clearing in 2000 for the markets subject to FMMO regulation, especially as such prices are not actually mandatory as to Class II, III and IV in the existing FMMOs. However, California was not part of

FMMO Reform as discussed above and the Cooperative Order would make the pricing mandatory as to California. Moreover, as demonstrated in Dr. Stephenson's study and testimony (Ex. 133), in the intervening years, the substantial industry changes with explosive growth of milk supplies in the western United States require a fresh examination of what the market clearing price is for a California FMMO. USDA cannot simply attach California to the existing FMMO system like an appendage without considering the present current market structure and conditions described in detail by the Dairy Institute in the hearing.

The Cooperatives fail to rebut the Dairy Institute's point that California cheese manufacturers cannot afford to pay a higher regulated minimum price for Class III milk. The Dairy Institute's witnesses presented clear, consistent, and supported testimony that an increase in minimum prices would result in scaled-back production or plant closures. Dairy Institute Opening Brief, pp. 96-103. The Cooperatives' evidence, including the six factors listed by Mr. Christ as supporting the Cooperatives' contention, fails to show otherwise. Cooperative Opening Brief, pp. 82–83. The fact that other manufacturers in different markets can pay a regulated, but never mandatory, higher price or support premiums (as argued by Christ and Hollon cited in the Cooperative Opening Brief, pages 82 and 84, respectively) has no relevance to the price that can be paid in California, a fact clearly proven by Dr. Stephenson and his unrebutted study. Ex. 133.[10] Any alleged advantages held by the economies of scale of these plants or affordability of milk procurement (for which no hard evidence exists beyond Mr. Christ's assertions) are outweighed by the increased costs of labor, water, and other regulatory business expenses, along with the significant cost of getting that product to a population center.

The Cooperatives bizarrely also point to the strong export demands as a buoy to Class III manufacturers, but then ignore that their proposed prices would, in fact, cause a *decline* in exports from California. Dairy Institute Opening Brief, p. 101. The Cooperatives provide no

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[10] The Cooperative Order's mandatory pooling clearly means that California processors would always have to pay the Class III price while their competitors can and do escape that requirement when price inversions encourage that result. USDA cannot ignore this economic fact without being arbitrary and capricious. Moreover, this problem raises significant Equal Protection issues. *See*, Dairy Institute Opening Brief, pp. 78-79.

basis beyond this hollow argument to support their assertion that California cheese producers can afford the Cooperatives' proposed increase in prices. Indeed the fact that the Cooperatives now seek to exempt smaller plants processing less than 300,000 pounds of milk for manufacturing classes is its own evidence that the prices sought by the Cooperatives are too high.

Finally, the Cooperatives confuse and conflate market conditions with a regulatory contrivance. Quota is not an economic or market condition; it is a creature of California statute and regulation that has no relationship to economic or market conditions. Quota does not and cannot change the value of milk (in fact it is merely a redistribution of that milk's value). Dr. Stephenson's examination of markets does evaluate market conditions and demonstrates that the relative value of milk in the United States has changed over time based upon location (e.g., milk used to produce cheese in California is less than in the Upper Midwest and that spread is growing). Thus, since FMMO Reform, the location value of milk has become more, not less, important. USDA cannot ignore this market condition.

d. Differences between California and Upper Midwest mailbox prices are irrelevant.

Comparisons of mailbox prices among different regions or states are problematic because of variations in regional dairy industry structures. These differences in market structure are often as or more important than differences in the regulatory prices at explaining differences in Mailbox prices. Some of the important structural factors are outlined below:

1. Comparisons between California and the Upper Midwest suffer in part because of the difference in location value noted in testimony by Dr. Stephenson (Ex. 133, at 6-7). The Upper Midwest is much closer to the bulk of the domestic U.S. population (Testimony of Dr. Schiek, Ex. 79, at 27), and the domestic market is still where the bulk of cheese produced in the country is sold.
2. Plants in the Midwest are generally smaller and produce specialty cheese products, whereas plants in California are larger and produce commodity-style products (Testimony of Mr. Dryer, Ex. 91, at15-16). These differences can result

in higher plant margins in the Upper Midwest that can accommodate higher producer pay prices that are above the minimum price.

3. Differences in milk utilizations differences can confound comparisons as well. While the Upper Midwest and California both share lower Class I utilizations, California has considerably more Class IV usage than the Upper Midwest. Comparisons between California and the Pacific Northwest suffer because the Pacific Northwest has a considerably higher Class I utilization percentage than California.

4. The structure of plant ownership also can play a role in mailbox price differences. Cooperative plants might be required by their producer-owners to pay out the profits and depreciation charges to producers through the milk price because there is no immediate necessity for those items to be retained by the plant as they are not cash costs. For investor-owned (proprietary) plants, these charges must be retained for the business and not paid to producers or the plant operation will not be sustainable. Of the western FMMOs, only the Southwest order has a cheese industry that is dominated by proprietary owned, commodity- type, large plants, as is the case in California.

In the end, differences in mailbox prices are of little policy relevance. They ultimately will reflect what the market determines is necessary to achieve a balance between supply and demand in the region and may be reflective of all of the above factors, as well as the differences in the farm-level cost of production that were noted in the testimony of Greg Dryer (Ex. 91, at 7-15). Mailbox prices are descriptors of regional differences, not indicators of policy in need of redress.

4. Response to Northwest Dairy Association Brief

The Brief filed by Northwest Dairy Association ("NDA") supports both adoption of an FMMO for California, without citing any Record evidence, and the current Class III/IV prices in the existing FMMOs. The principal reason for NDA's positions is "price alignment." However, price alignment is not an economic condition that affects the California milk market. USDA must consider the economic conditions in California in adopting any FMMO for California. 7 U.S.C. §§608c(11) and 608c(18). Price alignment cannot be paramount, especially when such price alignment fails to consider changes in the dairy industry generally and in California specifically since the 1990s and 2007 when the economic data used to generate the current price formulas was reviewed. Unadjusted prices adopted for a new FMMO for California without evaluating current economic conditions in California cannot be the basis for adopting prices for a California FMMO. *See* Dairy Institute Opening Brief, pp. 96-103. Moreover, USDA in FMMO Reform expressly concluded that price alignment is *less* important than establishing prices that reflect supply and demand (at the time): "[t]he more important criteria of reflecting supply and demand are also met by the revised formulas." 64 Fed. Reg. at 16098, c.1.

Indeed critically everyone, including USDA, knew before FMMO Reform's Proposed Rule was issued in 1998 that California was unlikely to join the FMMO system:

> Over 150 comments were received that addressed the issue of a Federal milk order for California, with approximately 120 of them being a form letter advocating a California Federal milk order. These comments, and number of additional individual comments, came primarily from commenters outside California who expressed a need for California and Federal order prices for milk used in manufactured products to be in closer alignment to eliminate California manufacturers' perceived competitive advantage in product prices.
>
> Interest in a Federal milk order has been expressed by some California producers, but for the most part California commenters expressed a desire to have a chance to study and comment on this final decision before deciding whether to pursue a proposal for a California Federal order.

64 Fed. Reg. at 16044, c.3.

The deafening silence that followed this announcement on April 2, 1999, means that California interests never really had the genuine opportunity to debate FMMO issues until

USDA's 2015 hearing.[11] Adopting a California FMMO using data and arguments for which California interests did not actually participate because they knew that there would be no California FMMO resulting from FMMO Reform deprives California interests of their rights under 7 C.F.R. Part 900 to have the issues aired at a formal rulemaking proceeding and deprives the Dairy Institute and its members of critical due process rights under the United States Constitution. The Record evidence (and the dearth of evidence especially submitted by the Cooperatives with respect to the need for and level of Class I Differentials and current California market structure and conditions) is all that USDA can go on in examining the need for and terms of any potential California FMMO.

Finally, and most critically, NDA leaves out the fact that the Cooperative Order it supports would require mandatory pooling of Class III and Class IV milk for California, but not impact the FMMO rules applicable to NDA. The Cooperative Order's mandatory pooling is of course different from the rules that apply to NDA in that NDA can pool or not eligible milk as it chooses. Thus regulated price alignment between the Pacific Northwest FMMO and California (whether by CDFA or USDA) is a chimera. Perhaps NDA's support for Proposal 1 is founded on its recognition that mandatory pooling of Class III (and Class IV) milk will hamstring their competitors in California, thereby giving them an advantage in the marketplace. Unlike the non-existent evidence allegedly supporting using 1990s economic data for California FMMO in 2015, there is ample Record evidence that NDA has regularly chosen to not pool eligible milk when the economics of price provided it with that economic incentive. 71 Fed. Reg. 54136, 54140 (Sept. 13, 2006), *as cited in* Ex. 98, at 19 (Testimony of Mr. De Jong) and Ex. 100, at 1–7 (Statistics of FMMO 124). Thus, NDA cannot genuinely argue that the Cooperative Order would result in regulatory price alignment because only one FMMO (California) would actually be subject to inescapable, full regulated prices. Indeed, unlike the Dairy Institute's Proposal 2,

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[11] In fact, USDA's Regulatory Impact Analysis that accompanied USDA's Final Decision also stated that "[t]hese analyses assume that Class I differentials in California would remain unchanged." Found at, https://www.ams.usda.gov/sites/default/files/media/FOR%20Regulatory%20Impact%20Analysis.pdf, p. 12.

which includes real restrictions on the ability of a handler to pool or not unlimited volumes of eligible milk (Proposal 2, 7 C.F.R. §1051.13(f)), NDA faces no real re-pooling restrictions under the Pacific Northwest Order. 7 C.F.R. §1124.13.[12] NDA also neglects to discuss the fact that milk manufactured into cheese in Idaho is wholly unregulated. Given all of this, it is particularly important that USDA consider the impacts on California of that unregulated cheese production.

As discussed in the Dairy Institute's Opening Brief, pp. 60–78, this unequal and unjustified treatment would violate a number of tenets of the AMAA and also deprive California interests of Equal Protection rights under the United States Constitution.

5. FMMO Prices Must be Based on Law and Hard Data

The Cooperatives have failed to provide any legal analysis or hard data supporting their proposed mandated minimum prices. Instead, the Cooperatives chose to make an emotional appeal to the USDA based on anecdotal testimony from farmers. Cooperative Opening Brief, pp. 9 – 16, 56–57. The Dairy Institute certainly sympathizes with the challenges faced by the dairy farmers, as its members face similar challenges with drought, increased employment costs, and the continued competition for "stomach space." All parties involved, from farmers to small and large manufacturers to the PDs, have personal stories, family enterprises, and cherished businesses they are trying to protect. A promulgation hearing, though, is not a mechanism to evaluate sympathies – it considers the facts and data entered into evidence and the demonstrated market effects of various proposals. The FMMO system is not intended to, nor equipped to, respond to emotion-based appeals for price subsidies that are not supported by the market.

USDA policy-decisions must only be founded upon verifiable, fact-driven data and analysis. The Cooperatives' extensive dedication to the experiences of farmers (found on pages 9–16 – 56–57 of their brief) provides no support for the California FMMO because the link between fact-driven data and analysis is wholly missing. The Cooperatives assert that unanimity of producers (a "fact" contradicted by the testimony of a Hilmar producer (Testimony of James

[12] This is also true of the Southwest Order upon which additional significant volumes of cheese are produced in competition with California.

Ahlem, Tr. 4995-5011) and Pacific Gold Producers (Testimony of Leonard Vandenburg, Tr. 5440-5451)) is an element of proof of the need for a California FMMO. Proponents mistake so-called unanimity for facts. Assuming, as the rhetoric does, that California farmers will do better under a California FMMO than under the CDFA Order is a circular argument not based on facts, evidence, or logic. And it is rebutted because what the Cooperatives want is not economically justified. The Cooperatives failed to provide any such evidence supporting increased prices, as demonstrated above and in the Dairy Institute's Opening Brief. An FMMO system cannot be established on emotional rhetoric because the market will not support such misaligned prices. *See* Dairy Institute Opening Brief, pp. 81–83, 102–103; *see, also,* Dr. Stephenson's conclusion "that the markets will win." Tr. 6024: 13–22. Basing a California FMMO on prices driven by sympathy certainly will end up harming the entire industry, including farmers, when manufacturing capacity tightens, exports decline, and domestic customers refuse to accept increases in prices.

C. The Cooperative Order's "Call Provision" is Not an Adequate Performance-Based Pooling Standard.

The Dairy Institute joins in Dean Food's Reply Brief arguments especially as to the inadequacy of a so-called call provision operating in lieu of traditional performance-based pooling standards as found in Proposal 2. 7 C.F.R. §§1051.7 and 13. Again, as with so much else in this proceeding, the Cooperatives seek to avoid USDA's stated policies regarding performance-based pooling standards. In 1990, USDA evaluated the call provision from then Order 2, which operated by itself without minimum shipping requirements, as now proposed by the Cooperatives for California. USDA determined that the solitary call provision was neither "equitable nor orderly." *Milk in the New England, New York-New Jersey and Middle Atlantic Marketing Areas*, 55 Fed. Reg. 50934, 50953, c.3 (December 11, 1980). Instead, USDA concluded that in addition to any call provision: "[a]doption of minimal shipping requirements and the resulting relationships expected to form between suppliers and fluid processors should result in more orderly marketing conditions." *Id.*, c.1.

USDA was right in 1990 in concluding that a call provision without performance-based pooling standards like those found in Proposal 2 is not equitable or orderly. The Dairy Institute urges USDA, if any California FMMO is recommended, to adopt the provisions found in Proposal 2. 7 C.F.R. §§1051.7 and 13. In so doing, USDA would maintain its consistent, long-standing policy that real performance-based pooling standards are the only viable method for meeting the declared policies of the AMAA – to bring forth an adequate supply of milk for fluid use and equitably determine which dairy farmers may share in the higher valued proceeds of the Class I market.

D. To "Recognize" Quota, USDA must Only Ensure the $0.195 per pound solids nonfat Premium is Paid.

"Quota" is itself a financial instrument which entitles the holder to an extra $0.195 per pound of nonfat solids on their milk production covered by quota. Ex. 145, at 3 (Testimony of Dr. Schiek). As shown by the Dairy Institute, the meaning of "recognize quota value" in 7 U.S.C. §7253(a)(2) is limited to this $0.195 payment. Dairy Institute Opening Brief, at Section VIII. The Cooperatives' interpretation of this phrase is incorrect for a number of reasons: first, it fails to specify how the "value" of quota is lost in a system where payments of $0.195 per pound of nonfat solids can still be made to quota-holding farmers; second, it fails to take into account the negative impact on non-quota holding farmers; third, it wrongly values quota as an asset for lending institutions beyond the income stream; and fourth, it would require USDA to determine the actual purchase and sale price of quota (something grossly exaggerated by applying the current sale price of approximately $525).

First, in claiming that the Dairy Institute's Proposal will "destroy" quota, (Cooperative Opening Brief, p. 144), the Cooperatives overlook the actual definition of quota – the $0.195 payment. Even if there are no non-quota holders in the quota pool, this value can still be recognized. Quota-holders will still be able to receive their $0.195 payment and a resulting overbase price. Quota can still be bought and sold under this scenario. The only difference will be that the overbase price will be lower than it would have been had non-quota holders been in the pool. Such a scenario provides for the "recognition" of quota because it allows for the monthly payment of quota. The only variation between this result and one where nonquota holders have to participate in the pool is the overbase price, and the Quota Provision is silent as to this value.

Second, the Cooperatives' valuation of quota ignores the source of the monies for quota payments – all California farmers to the extent they do not own quota. Quota does not generate any new or additional funds - the monies paid to quota holders come from the paychecks of farmers who do not own quota (as confirmed by the Cooperatives' own expert). Tr. 2344:7 – 2345:10 (Testimony of Mr. Hatamiya); *see also* Tr. 3196:25 – 3197:20 (Testimony of Ms. AcMoody). In fact, quota has no impact on the gross domestic product contribution from the sale of milk to California because it is merely a redistribution of funds. Tr. 2352:4 – 2353:13 (Testimony of Mr. Hatamiya).

However, the Cooperatives still maintain that the existence of quota has other benefits to the farmers of California. But Mr. Hatamiya (who provided the valuation of quota relied upon by the Cooperatives) focused only on the positive side of quota and the benefits it provides when doing his calculations, without taking into account the corresponding decrease in funds available to all other farmers because of the quota program. Tr. 2345:24 (Testimony of Mr. Hatamiya). The fact that Mr. Hatamiya was only asked "to look at the value and look at the benefits that that value brought," without consideration for the entire system exposes the Cooperatives' attempts to exaggerate the "value" of quota. *Id.*; *see also* 2349:23–25 (Testimony of Mr. Hatamiya) ("In this instance, I was looking primarily focused [sic] at the benefit of quota holders.").

If one adopts the Cooperatives' proposal for determining the value of quota, then USDA must also calculate the negative impact of the program on farmers without quota. In his analysis of quota value, Mr. Hatamiya provided a framework upon which one can also calculate the loss to farmers who would otherwise receive a higher blend price if they were not required to participate in the quota pool. Mr. English walked through this hypothetical calculation with Mr. Hatamiya (who declined to perform such "negative side" calculations himself), and, following through on that calculation, the evidence shows that non-quota farmers in Tulare County lost approximately $86,434.71 in income in January 2015 in the form of lower overbase prices due to quota payments. Tr. 2393:10 – 2395:4.[13]

The calculation works as follows:

417,068.87 x 14.8% = 2,818,032.91

(Quota SNF in Tulare) x (Percent of total milk production covered by quota in Tulare) = (Total SNF pounds in Tulare)

2,818,032.91 – 417,068.87 = 2,400,964.04

(Total SNF pounds) – (Quota SNF pounds) = (Non-quota SNF pounds in Tulare)

2,400,964.04 x $0.036 = $86,434.71

(Non-quota SNF pounds in Tulare) x (Difference between overbase and true blend per pound) = (Lost value at blend in Tulare)

Thus, farmers in Tulare County who did not own quota lost a total of $86,434.71 in income for the month of January 2015 due to having to support the quota payments. Such a loss undoubtedly has a negative counter-effect to much of the claims made by Mr. Hatamiya. Thus, even if USDA were to adopt Mr. Hatamiya's definition of "quota value" (and it should not), it would still need to go beyond his limited evaluation of only the benefits of quota and take into account how this lost income impacts the thousands of farmers who produce milk not covered by quota.

Third, the Cooperatives' claims that financial institutions place a value on quota ownership beyond the asset stream are incorrect. Cooperative Opening Brief, p. 142. Loans based on quota "are expected to be paid back with the incremental return generated by holding this asset," Tr. 3192:19–21 (Testimony of Ms. AcMoody), not by some abstract value in the

[13] The data for the total quota ownership and total SNF pounds in Tulare is found on page 12 of Exhibit 54 (Testimony of Mr. Hatamiya). The value of the difference between overbase and true blend comes from the estimates in Exhibit 191, adjusted from hundredweight to per pound (Hypothetical Quota Payout Schedule). This calculation is approximate because the $0.036 below was from 2013 and milk production levels were different for 2015. However, the Dairy Institute urges USDA to calculate the exact monthly differences when running its analysis so as to ensure an even more precise calculation of the loss should it decide to adopt Mr. Hatamiya's valuation theory.

quota itself. Even Mr. Hatamiya explained that quota is the asset stream that the farmer leverages for bank lending. Tr. 2360:5-14 (Testimony of Mr. Hatamiya). As stated above and in the Dairy Institute's Brief, its proposal provides for this "incremental return," meaning the Dairy Institute provides for the source of revenue whereby banks value quota. Additionally, banks cannot seize or take ownership of quota as a collateral asset in regards to loans. Tr. 2372:1-5 (Testimony of Mr. Hatamiya). Thus, to banks, the "value" of the asset is not in the instrument's purchase price, but rather in the ongoing payments that the farmers receive due to ownership.

Fourth, a calculation of "quota value" that goes beyond this distribution of $0.195 per pound to include the purchase and sale price of quota would require USDA to make the nearly impossible evaluation of who actually purchased quota and at what price. Should USDA adopt the Cooperatives' definition of quota value to include the "balance sheet asset" it would need to determine this purchase price. USDA cannot rely upon Mr. Hatamiya's inflated calculation based upon the current $525 per pound average (Exhibit 54, at 6), as much of the quota would not have been purchased at this price (or not purchased at all). Even Mr. Hatamiya admits, "[i]t's virtually impossible to determine what folks pay for [quota] over time, because much of that quota may have been sold again, bought again, sold again, so it's impossible to determine what that value is." Tr. 2367:1 – 7 (Testimony of Mr. Hatamiya). Many dairy farmers were allocated quota at the outset of the program, meaning they had to make no investment in quota. Tr. 2323:18 – 21, 2367:10–19 (Testimony of Mr. Hatamiya). Others purchased it at much lower prices than its current value today. That the Cooperatives' method for calculating the value of quota is wholly unworkable further supports the conclusion that it is not the correct interpretation of the statute.

E. Permissive De-pooling Will Not Create Disorder Within a California Market

The argument that the lack of mandatory pooling (the ability of dairy product manufacturing plants to choose not to pool their milk) under Proposal 2 will create market chaos is unfounded and contradicted by FMMO history that has always provided a choice for pooling or not eligible milk used in manufacturing classes. First, the order provisions under Proposal 2 contain re-pooling restrictions that create economic disincentives for plants that choose not to pool previously pooled milk by introducing uncertainty about the gains from not pooling milk. Limiting access to the pool in future months introduces uncertainty about future gains from not pooling milk, and is therefore a deterrent to sporadic pooling and de-pooling practices.

No other FMMO imposes mandatory pooling on milk used in Class II, III, and IV products. Furthermore, the other FMMOs in the West (Order 124, Order 131, and Order 126) have no restrictions on de-pooling and re-pooling – a handler can choose not to pool one month and bring it all back in the next month – and yet these orders are meeting the objectives of the AMAA. If they weren't, they would have been either terminated by the Secretary, or amended to make re-pooling of de-pooled milk more restrictive. The Cooperatives have provided no actual evidence of the alleged chaotic or disorderly marketing condition that would ensue without mandatory pooling, rather, they have offered only unsubstantiated hypotheticals that provide an inadequate basis for policymaking, especially under the APA.

In fact, the Record evidence shows that significant volumes of milk are de-pooled and re-pooled on Orders 124 and 126 on a regular basis. Ex. 98, at 19 (Testimony of Mr. De Jong); Ex. 100, at 1–7 (Statistics of FMMO 124); Tr. 4424:6 – 4425:14; Ex. 98, at 15 (Testimony of Mr. De Jong); Ex. 101, at 2 n. 3 (MA Report SW April 2015). Very large plants in New Mexico and West Texas engage in these activities, and despite their market concentration, complaints have not been filed with USDA. California on the other hand, has a much richer and diverse mix of uses for milk. There is simply no reason to conclude that continued voluntary pooling of milk for manufactured uses will result in disorderly marketing conditions under Proposal 2, especially as the Dairy Institute has proposed re-pooling restrictions identical to those in the Upper Midwest.

F. The Cooperatives Proposed Exemption from Mandatory Pooling.

In their proposal to increase the exemption for plants processing 300,000 pounds of milk per month, the Cooperatives create yet another inconsistent and incompatible exemption driven by their unique mandatory pooling provisions. This expanded exemption is de-facto acknowledgment that involuntary pooling is overly and inequitably burdensome. The factors justifying such an exemption apply to all manufacturers in California, and creating an exemption for some only demonstrates the need for all non-fluid handlers to be able to pool voluntarily. By imposing involuntary pooling on all California non-fluid handlers when no other FMMO requires such strictures, California non-fluid handlers are placed in an inequitable competitive position with all other handlers across the United States that violates the Equal Protection Clause of the U.S. Constitution.

III. THE QUOTA PROVISION LANGUAGE DOES NOT SUPPORT THE COOPERATIVE ORDER'S MANDATORY POOLING OR THE PRODUCER DISTRIBUTOR'S EXEMPT QUOTA

The Quota Provision is a complex sentence, but it is nonetheless subject to standard English grammar sentence diagramming which conclusively proves that the Quota Provision cannot be used by either the Cooperatives to expand the scope of "order receipts" or by the Producer Distributors ("PDs") to shrink the size of the pool in the form of "order receipts" withheld. "The order" is the subject of the sentence. "Shall have the right" is the verb phrase with "shall" as the verb and "have the right" as the helping verbs. The critical phrase "to reblend and distribute order proceeds" is a prepositional phrase that tells us what USDA may authorize. The phrase "to recognize quota value" is the object of the prepositional phrase and completes (but does not alter) the prepositional phrase. The prepositional phrase tells us what the California FMMO may do, if USDA so chooses exercising its discretion consistent with the unamended AMAA. And the object of the prepositional phrase tells us why USDA may do so.

Thus the permitted, discretionary act is limited to dividing up order receipts. USDA may not abandon all other parts of the AMAA and its 80 years of history by increasing the size of order receipts through mandatory pooling. The reverse is also manifestly true, that USDA cannot exempt milk from participating in the pool because that would reduce order receipts, not reblend and distribute them. The PDs turn the sentence diagram on its head and make the object of the prepositional phrase the prepositional phrase. But Congress did *not* say "[t]he order covering

California shall have the right to recognize quota value." That sentence would have still been discretionary, but it arguably would have been more expansive. Neither the Coops nor the PDs may read out the critical prepositional phrase that simultaneously permits reblending and distributing order proceeds, and limits USDA's actions. Mandatory pooling as demanded by the Cooperatives and exempt quota demanded by the PDs are thus not authorized acts by the Quota Provision.

IV. MOVEMENT AND EXITS OF DAIRY FARMS IS NOT EVIDENCE OF CALIFORNIA MARKET DISORDER

The Cooperatives argue that the "price inequity of the California system versus the FMMO system has been a significant contributor to the distress of the California dairy producers, evidenced by the decrease in the number of dairies and land devoted to dairies in California." Cooperative Opening Brief, p. 6. However, the record contains evidence showing that comparing 2013 to 2014, the percentage reduction in California dairy herds actually ranked 34^{th} among the 50 states, and among the 15 states with 500 or more herds, only three lost a lower percentage of their herds than did California. Ex. 91 pages 13-14. Dr. Schiek's Exhibit 80, Figure 6 shows that California's percentage reduction in dairy farm numbers is less than the reductions in the states of Wisconsin and Idaho, and in the U.S. as a whole for the period 2003 through 2014. Exhibit 80, Table 8 shows those percentages indexed for the same period. Clearly, the reduction in dairy farms is a national trend, and California's trend line is less steep than two major dairy states and the country as a whole.

Successful farmers will move to the optimal milk-producing region. The Cooperatives argument that "multi-generation dairy farmers have been forced to transition to more economically sustainable regions to establish dairy farms or to other, more reliable and economically viable agricultural pursuits such as almonds," (Cooperative Opening Brief, p. 4), represents the market at work. For generations, producers have moved to the regions where they can produce milk in the most efficient manner and farmers should choose to grow products that have the highest demand. California has been the beneficiary of this in the past. The AMAA does not authorize USDA to adopt a California FMMO on this basis.

V. CONCLUSION

Given the fact that the Cooperatives asked for this hearing and had ample opportunity in their Opening Brief to address these many legal issues thoroughly, the Dairy Institute as a matter of due process, respectfully requests the opportunity to file a limited sur-reply as to the principal legal issues if the Cooperatives choose to use the Reply Brief as a mechanism to address critical issues in the first instance.

For all of the foregoing reasons, USDA should decline to promulgate any California FMMO. If any California FMMO is to be promulgated, it must not be based upon Proposal 1, but rather Proposal 2. Finally, USDA must, if it can, justify any and all classified prices based upon the Record evidence in this proceeding, not as a legacy of FMMO reform.

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