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May 13, 2016

**VIA UPS (TRACKING: 1Z 965 W53 13 6412 7244)**
**AND E-MAIL TO: oaljhearingclerks@ocio.usda.gov**

Brenda Seegars, Acting Hearing Clerk
U.S. Department of Agriculture
Stop 9203 South Building Room 1031
1400 Independence Ave SW
Washington, DC 20250-9203

**Re: Brief and Proposed Findings of Fact and Conclusions of Law**
**Milk in California; (AO) Docket No. 15-0071**

Dear Ms. Seegars:

Enclosed please find the Reply Brief Filed on Behalf of California Producer-Handlers Association.

Very truly yours,

Nicole Hancock

Nicole C. Hancock

NCH/kra
Enclosures

**DEPARTMENT OF AGRICULTURE**

**AGRICULTURAL MARKETING SERVICE**

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| In the Matter of Milk in California; Notice of Hearing on a Proposal to Establish a Federal Milk Marketing Order | 7 CFR Part 1051<br>Docket No.: AO-15-0071;<br>AMS-DA-14-0095 |

# REPLY BRIEF FILED ON BEHALF OF CALIFORNIA PRODUCER-HANDLERS ASSOCIATION

## I. INTRODUCTION

California Producer-Handlers Association ("CPHA") submits this post-hearing reply brief in support of its Proposal 3 to address issues raised by third parties pertaining to Proposal 3. Of the 13 entities that filed briefs pertaining to the proposals for a California Federal Milk Marketing Order (FMMO), only the Dairy Institute raised any concerns with preserving exempt quota as part of the overall quota system. In particular, the Dairy Institute raised objections on the grounds that it contends the Farm Bill did not justify preserving exempt quota, the CPHA members have some financial advantage, and the CPHA members should be treated as producer-handlers in all other federal orders.

The opposition to preserving exempt quota ignores the overwhelming evidence presented at the hearing: exempt quota is inextricably intertwined with the quota system, and preserving the quota system means exempt quota is preserved along with regular quota; the CPHA members consist of two separate, distinct entities, and only the farm entity receives a financial benefit for exempt quota; all CPHA handler business entities pay Class 1 rates for their raw milk and are

thus on a level playing field; and there are no market disruptions attributed to exempt quota the CPHA members.

## II. DISCUSSION

### A. Farm Bill Directs USDA to Preserve "Quota System"

The Dairy Institute contends that because the Farm Bill stated that "[t]he order covering California shall have the right to reblend and distribute order receipts to recognize quota value" but did not explicitly mention exempt quota, seems to indicate Congress did not have any intent to preserve or value exempt quota, because "Congress knows how to say that and chose not to do so." (Dairy Institute Conclusions of Law at pp. 27-29, 144-46.) The Dairy Institute argues that when the Farm Bill directed the USDA to recognize quota value, it was not talking about exempt quota. (*Id.* at p. 145.)

The testimony unequivocally revealed that exempt quota is as much a part of quota value as is regular quota. Regardless of whether you read any further into the Congressional intent, the plain language of the Farm Bill directing the USDA to recognize quota value pertains to both exempt and regular quota. The Dairy Institute's proffered explanation that Congress chose not to address exempt quota is illogical. If Congress' intent was to dive into the details of what made up quota value, it would have simply valued quota in the Farm Bill and been done with it. Instead, Congress gave the USDA the authority, and in the 2014 Conference Report further clarified its expectations that the USDA would hold a hearing to address the California FMMO. *See* H.R. Rep. No. 113-133, at 385 (2014) ("The Managers intend for the Secretary to conduct a hearing prior to the issuance of an order designating the State of California as a Federal milk marketing order.").

In revealing its intent that the USDA hold a hearing, Congress also clarified that it granted the USDA authority to "recognize the longstanding California quota system, established

under state marketing regulations, in whatever manner is appropriate on the basis of a rulemaking hearing record." *Id.* (emphasis added). Congress expressly referenced the *plurality* of California marketing regulations, not a singular provision pertaining to any one aspect of the quota system. Instead, it specifically contemplated that the hearing that recognized the quota value would include recognizing the "longstanding California quota system." In so directing the USDA to recognize the "quota system," Congress gave the USDA wide breadth to hold a hearing to understand what elements compose the quota system and determine how best to preserve or recognize the system.

In selective parts of its brief, the Dairy Institute even quotes the 2014 Conference Report as legislative history to the Farm Bill, relying on Congress' legislative intent for the position that preserving quota is discretionary, but ignoring the express Congressional intent to grant the USDA with authority to recognize what Congress called the "**quota system**." (Dairy Institute Conclusions of Law at p. 34.) The Dairy Institute later disavows this same quote as superfluous language when it argues exempt quota should not be recognized. (*Id.*; *see also id.* at p. 145.) But the Dairy Institute cannot escape that the Conference Report is part of the legislative history that makes up the direction to the USDA in promulgating a California FMMO, and clearly refers to something broader than just regular quota when it refers to the "quota system." H.R. Rep. No. 113-333, at 385 (2014); *see Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Serv.*, 462 U.S. 810, 832 n.28 (recognizing significance of conference report above and beyond mere statements by Congressional testimony*); see also Disabled in Action of Metro. New York v. Hammons*, 202 F.3d 110, 128-29 (2d Cir. 2000) (supporting analysis by stating "the most reliable portions of the Act's legislative history—the Conference Report, the statements of committee

managers and members both for and against the legislation, the committee reports, and the statement of a sponsor—confirm our textual analysis").

The word "system" is defined as:

> (1) A regularly interacting or interdependent group of items forming a unified whole: as (a)(1): a group of interacting bodies under the influence of related forces, (2) an assemblage of substances that is in or tends to equilibrium ... (f) a form of social, economic, or political organization or practice;
> (2) An organized set of doctrines, ideas, or principles usually intended to explain the arrangement or working of a systematic whole;
> (3) (a) An organized or established procedure; (b) a manner of classifying, symbolizing, or schematizing;
> (4) Harmonious arrangement or pattern....

Merriam-Webster, http://www.merriam-webster.com/dictionary/system (last visited May 11, 2016).[1] Each component of the definition for "system" reveals that it is not a standalone element, but rather a more complex, dynamic, and inter-relational body. With respect to the "quota system," Congress clearly did not intend for only regular quota to be recognized, but instead have all of the interacting and interdependent items that make up the quota system be recognized. By explicitly using the words "quota system," Congress recognized that there are multiple components that make up quota – a group of things that work together that comprise the whole quota system.

Here, the California quota system comprises regular quota and exempt quota, which are interdependent with the operation of a mandatory pooling system as proposed by the Cooperatives in Proposal 1, and as more fully developed by Proposal 3. The evidence at the

[1] Oxford English Dictionary defines "system" as "an organized or connected group of things." http://www.oed.com/system (last visited May 11, 2016).

USDA hearing was uncontroverted on this point: the quota system comprises both regular and exempt quota as was described by numerous witnesses during the hearing.

George Mertens testified that the quota system, from its inception 50 years ago, included both regular and exempt quota. (Tr. Sept. 29, 2015.) He further explained how the exempt quota was negotiated to be an integral part of the quota system, and it has always been a necessary and indispensable part of the quota system. (*Id.*) Mr. Hofferber testified that exempt quota has historically been part of the quota system since its inception in 1967, just as with regular quota. (Tr. 73:8-95:19.) Dr. William Schiek also testified that exempt quota was issued as a form of compensation at the same time that regular quota was issued, when the pooling came into place in California. (Tr. 162:9-19.) And he further testified that exempt quota, like regular quota, has a marketable value (with exempt quota holding an additional value to the CPHA members). (Tr. 162:19-163:18.)

Anthony Gonsalves testified about the historical enactment of the quota system as part of the pooling act in California, and how "[u]nder California's quota system" both regular and exempt quota were created based on Class 1 contracts. (Tr. 39:8-44:8 ("rather than receiving regular quota, these producers were issued exempt quota as part of the quota system" (emphasis added)).) Mr. Gonsalves testified that the 1977 amendment to the Gonsalves Milk Pooling Act "reaffirmed the [state legislature's] commitment to preserve the exempt quota as part of the quota system." (Tr. 49:16-50:1 (emphasis added).) In conclusion, Mr. Gonsalves testified:

> Throughout the legislative history of the Gonsalves Milk Pooling Act, the quota system has had many aspects beyond the regular quota held by any producer. The entirety of the quota system in California included both regular quota and exempt quota.

(Tr. 56:17-22 (emphasis added).)

Richard Shehadey testified that the quota system includes "both types of quota, regular and exempt." (Tr. 164:8-9.) In explaining the historical creation of the quota system, Mr. Shehadey testified that "[l]egislators fashioned the California quota system under the Gonsalves Milk Pooling Act to provide for exempt quota in consideration and recognition of [CPHA's] unique structure in creating its own Class 1 market." He further testified that "[t]he only way by which to 'recognize the long standing California quota system,' is to preserve the value of both regular quota and exempt quota together, as they are both granted at the quota system's inception." (Tr. 196:1-6.)

Frank Otis testified that "for nearly 50 years Foster Dairy has participated in the California quota system, which has, since its inception in 1967, included a class of quota called exempt quota." (Tr. 90:15-21.)

Dr. Eric Erba testified that "[w]e recognize that exempt quota is rooted in the same California statutes as regular quota and was granted by the state or was purchased from other producers, just as regular quota was." (Tr. 60:22-61:1.) Dr. Erba recognized "the interconnection between quota and exempt quota based upon what happened when the Gonsalves Pooling Act was adopted" and on that basis agreed that exempt quota should be recognized along with regular quota. (Tr. 71:10-14.)

This testimony is consistent with how the parties discussed the California State Order System (CSOS) as well. The Dairy Institute refers to the CSOS throughout its briefing – and there is no doubt that its reference to the CSOS includes everything under that regulatory umbrella. Similarly, under the quota system, it likewise includes all of the components under the quota umbrella, including the regular and exempt quota provisions.

Congress intended for the USDA to recognize the quota value, which includes all of the interacting or interdependent items forming a unified whole that make up the "quota system."

## B. No Evidence of Actual Market Disorder

In its brief, The Dairy Institute inconsistently claims on the one hand that there are no disorderly market conditions (when arguing that a California FMMO is unnecessary), and on the other hand claims that there are "market disruptions" pertaining to the exempt quota holders' ability to win Class 1 accounts. (*Compare* Dairy Institute Conclusions of Law at pp. 38-59 *with id.* at pp. 144-47.) In a proverbial attempt to argue out of both sides of its brief, or perhaps draw a distinction between market disruption and market disorder, it suggests regardless that CPHA members have some unfair advantage over other Class 1 handlers.

The Dairy Institute maintains that exempt quota creates disorder (or its lesser cousin, disruption) in the California marketplace and its only example was because two of the CPHA members were able to take a portion of one customer account from Dean Foods though it was an open market bid on the account. Further to this point, Dairy Institute also maintains that the decrease in market share or sales experienced by other Class 1 sellers was not as dramatic for CPHA members, and that this can only be attributed to the exempt quota (according to the Dairy Institute). While the Dairy Institute claims that these conclusions are all attributed to exempt quota benefits for CPHA, the hearing evidence makes clear that these results were achieved without the benefit of any exempt quota.

### 1. Exempt Quota Holders Are on a Level Playing Field with All California Handlers

The Dairy Institute claims that CPHA members are not on a level playing field with other handlers, citing the testimony of Mr. Blaufus from Dean Foods. (Dairy Institute Conclusions of Law at p. 144.)

During the hearing, there was testimony from non-CPHA members who believed that the CPHA exempt quota holdings gave them a price advantage in the cost of their raw milk, and ultimately in the input costs that go into pricing their Class 1 milk sales. However, none of the witnesses who testified about this perceived unlevel playing field had any first-hand knowledge about the CPHA handlers' pricing of raw milk – they merely just "believed" the handlers had a price advantage.

The Dairy Institute cites to a witness for Clover-Stornetta, Mr. Britt, who purports to have lost sales to a CPHA member. The entirety of Mr. Britt's testimony regarding the CPHA exempt quota is as follows:

> As a non-exempt fluid milk processor, Clover must pay into the California pool on a monthly basis for all pounds of product used at the reported class values. This places [it] at a significant disadvantage compared to the exempt producer-handlers that are allowed to not account to the pool on the exempt quota portion (volume) that they bring into their bottling plant from their own operations, since they don't have any pool obligation (or credit) on that volume. The PH, producer-handler, pricing advantage depends on how high the regulated Class 1 price that you have to pay is compared to the quota price on that milk for which the exempt PD does not need to report. That margin plays several roles in the exempt producer-handler's ability to beat regulated handlers in the market ... [discussing how he believes PH use advantage by getting bids].

(Tr. 5520:12-25.) Despite all of Mr. Brit's perceived disadvantages when competing against CPHA members, Mr. Brit testified that he never made any reports to the CDFA with any concerns that he had regarding exempt quota holders or the operation of the pooling act. (5529:15-18.) Mr. Brit never complained to the CDFA or his legislators, or anyone else for that matter, about how the quota system (including exempt quota) operated. (Tr. 5529:19-24.) And perhaps most importantly, Mr. Brit testified that he does not know the difference between an Option 70 producer-handler and an Option 66 producer-handler exemption. (Tr. 5530:26-32.)

But Mr. Brit admitted that Clover-Stornetta pays its own producers a "premium to produce milk to meet these rigorous [NCEC program] standards" and that Clover-Stornetta was a leader in the organic fluid milk industry when it became certified in 1999. (Tr. 5518:24-37.) Clover-Stornetta also took such pride in its product that it increased the standards for the quality of life led by the cows from which it obtained milk, and became certified by the American Humane Association ("AHA") for its animal welfare program. (Tr. 5519:1-30.) Premium pricing to cover its premium raw milk from AHA-certified cow facilities is likely the contributing factor to Clover-Stornetta's increased costs associated with its Class 1 pricing, not what Clover-Stornetta suspected must be attributed to any exempt benefit (especially because all of the CPHA members pay Class 1 for their raw milk).

In short, while Mr. Brit may believe that CPHA members have a financial advantage, there was no example of an account that was lost, no indication of whether Mr. Britt was talking about Option 66 or Option 70 producer-handlers, and every indication that Clover-Stornetta's loss of a bid was more likely attributed to its higher input costs based on business decisions to operate at higher certified standards.

Next, the Dairy Institute cites to the testimony of Mr. Hofferber of Farmdale Creamery, which also believed it was disadvantaged by the CPHA exempt quota holdings. (Dairy Institute Conclusions of Law at p. 153.) But when asked what he meant, Mr. Hofferber stated it was a "hypothetical situation that could occur, where we get a, what I've called it a predatory pricing scheme that could hurt us on a customer-by-customer basis." (Tr. 83:20-84:25.) Mr. Hofferber admitted that his hypothetical cannot come to fruition, as Farmdale Creamery is not a Class 1 supplier. Mr. Hofferber explained his testimony about the hypothetical as a way of saying that if you "just do away with it and nobody has this discussion or argument anymore" then "nobody

will talk about it, [and] our little paranoia goes away." (Tr. 84:18-85:16.) In sum, Mr. Hofferber admitted that he has no real examples of CPHA members using any price advantage, but says there is paranoia that it might happen.

Even after admitting it was just paranoia, the Dairy Institute touts this testimony as "precisely what USDA meant in 2010 when it concluded that 'handlers with own-farm milk could "smooth" the price advantage gained on the volumes of exempt fluid milk products across any additional Class 1 sales.'" (Dairy Institute Conclusions of Law at p. 153.) Such paranoia cannot be the basis for eliminating such a significant valuable asset that Congress directed the USDA to preserve, as the law prohibits such a change on the basis of what may "potentially" occur in the future. *See Milk in the Texas and Southwest Plains Marketing Areas*, 54 Fed. Reg. 27179, 27182 (June 28, 1989) ("Although the marketing of milk by producer-handlers has the potential of creating disorderly marketing conditions, it has not been found necessary to regulate fully this type of operation .... There is no evidence of market disorder as a result of competition between such producer-handlers and fully regulated handlers.").

Admitting that the witnesses "do not have access to the books and records of [CPHA members] to prove their activity" and thus that witnesses just assumed the conclusion based on their own external perceptions, the Dairy Institute recognizes that it had absolutely no proof that the CPHA members have used their exempt quota for any pricing advantage. Indeed, the CDFA has a reporting and investigatory body available if any such complaints were ever raised, and there was not one witness with any knowledge of any complaints that were filed with the CDFA. In nearly 50 years of exempt quota holders existing in California, there was no evidence at the hearing to suggest that any exempt quota holder ever had a price advantage in the markets. But now, with the self-serving benefit of potentially obtaining additional funds in the pool if exempt

quota were eliminated, handlers try to cloud the record with unsubstantiated rumors about what potentially could happen.

The unequivocal testimony from those with first-hand knowledge revealed that none of the four CPHA members have any price advantage from owning their exempt quota shares. Each CPHA member comprises of two separate entities, with two separate ownership structures for each entity. The farm is owned by different people than the handler side of the business, although within the proper lineage requirements to preserve exempt quota. The handler side of operations pays Class 1 prices to the associated farms. The price of CPHA members' raw milk is exactly the same as all of the other handlers' price of raw milk in California. Any financial benefit from owning exempt quota goes to the farm entity, and flows through to that farm ownership alone. When CPHA members bid on Class 1 milk contracts, they have to build in the price of their raw milk at the same rate as any other handler in California. In summary, the playing field is actually level between CPHA members and other Class 1 handlers in California despite misperceptions to the contrary.

**2. Dean Foods Lost 60% of National Account, Where No Producer-Handler Exemptions Exist**

Notwithstanding the above evidence from CPHA members on the separation of their farm and plant, and how the farm alone receives all of the financial benefit of exempt quota, the Dairy Institute cites to Dean Foods' testimony that it lost an account to CPHA members for what Dean Foods perceives must be attributed to the exempt quota. (Dairy Institute Conclusions of Law at pp. 153-55.)

The referenced testimony from Dean Foods was revealed to be merely one national account for Dean Foods. Dean Foods lost a significant portion of that account on a nationwide basis. Other than this one account, Dean Foods could not reference any other account or incident

that it had ever lost to a CPHA member or to any other exempt quota holder. Dean Foods, the largest national food and beverage company in the entire United States, lost one account to two separate family-run operations, and concludes from that single instance that the only plausible explanation must be a financial advantage from the companies' exempt quota holdings. Dean Foods offered no explanation for why it lost such a significant portion of the national accounts outside of California to Class 1 handlers who do not own any quota, or why it had not lost any other accounts other than this one to CPHA members. It is illogical to conclude from this testimony that the only plausible explanation is attributed to CPHA members owning quota.

The volume of sales lost by Dean Foods to Producers Dairy and Foster Farms was far outweighed by the numerous accounts that Dean Foods took from both of those CPHA members. If Dean Foods were truly in such a disadvantaged position to CPHA members, Dean Foods would not have been able to take more sales from CPHA members than it lost to them.

It is a far more likely conclusion that Dean Foods lost its account for quality reasons, and CPHA members were able to gain accounts because of the cost savings attributed to their vertical integration and closely held family operations.

### 3. CPHA Market Share

The Dairy Institute claims that while the Class 1 markets have fallen over the past years, the CPHA members' share of the markets has either remained flat or grown slightly.

As an initial matter, even the Dairy Institute's line of questions on this point undermines the credibility of the calculation, as it admits double-counting CPHA numbers with out-of-state production. (Nov. 11, 2015 Tr. 63:10-64:2 ("[T]here may well be, according to CDFA, if there is, there may be duplication between, of some kind, I don't know, it could be one pound, it could be far more than one pound, that could be ... duplication of the out-of-state Class 1 that is

included in Table AC total producer-handler Class 1 pool utilization. Okay? So there could be some duplicative pounds.").)

Regardless of admitting how its underlying assumptions flaw the calculation, the Dairy Institute poses to the USDA for argument that only one conclusion can be drawn from the CPHA members' ability to maintain a flat market share. (Nov. 11 Tr. 67:11-24 (testifying based on the Dairy Institute's calculations that the CPHA market share increased by 0.84%, which Mr. Shehadey testified was "pretty much flat").) Yet the Dairy Institute was never able to provide any evidence of the growth, and their argument completely ignores the evidence that the CPHA handler side of the business gets no financial advantage from the exempt quota, so there is no possible way for the Class 1 sales to be linked to the CPHA members' sales growth or flat sales. Given that there are only four CPHA members, the Dairy Institute did not attempt to develop the facts to determine if the market share was attributed to one or two or all of these members. Yet now it tries to draw one conclusion, when any number of conclusions can be attributed to the flat sales.

Further to this point, the Dairy Institute ignores the testimony explaining exactly how CPHA members have been able to maintain their sales. Off the top of his head, Mr. Shehadey was able to compile events that had occurred in the Class 1 markets over the years and had a substantial impact on growth and decline of Class 1 sales:

> There's many other factors in the industry that have caused that. And last night when I was thinking about this discussion, I went back and made some notes from my memory. In 1971, Borden left California. They closed five plants in Northern California, sold them to different processors, there was turmoil in the marketplace. 1977, Arden sold to Knudsen. There were three or four plants involved in that that affected Southern California. In 1978, Challenge sold to Foremost. There was about five plants and they were all over California. In 1984, Foremost and Knudsen merged and became a $1.7 billion company. In 1986, Knudsen and

> Foremost went bankrupt. They were both run by investors. They went bankrupt, they closed for a week, I won't use the word how they treated the farmers, but there was a lot of money they owed the farmers and didn't pay it. They sold their plants, north and south, there was big disruption in the market, there were opportunities, and we had customers calling us and coming to us like crazy. And when I say we, I'm talking about all the producer-handlers. Each one of these transitions caused turmoil in the marketplace and it gave us opportunities to gain business. Had nothing to do with price. 1988, Carnation Company, who was owned by Nestle at the time, closed two fluid plants in Los Angeles on Main Street and in Oakland. They just closed them. Everyone was scrambling for business. We happened to be at the right place at the right time in each one of these. All of our producer-handlers. These are opportunities for gaining business without price involved. In 1998, Berkeley Farms sold to Dean Foods. Here we went from the Sabatti family that owned Berkeley Farms to a big corporation out of Texas. A lot of customers in San Francisco didn't like buying from a big corporation. In 1989, Alta Dena sold to Bongrain, which is a French company. In 1999, Bongrain sold it to Deans. Here's more disruption and change in the marketplace. In 2009, Santee Dairy sold to Dean Foods. All of these activities that were designed to, for big corporations to make money or make more money, affected our marketplace, and it had nothing to do with price, the price of milk, it had to do with service, customer service, and having a relationship with the customer. So I just wanted to lay that out, because there's a lot more going in this marketplace than [] some small exemption.
> I also did a calculation on our exemption, and when you, when you go to -- where's my exhibits -- you go to this $1.14 in Exhibit E, if you take the $1.14 and you reduce it to a gallon, that's a hundred pounds. If you reduce it to a gallonage, which you divide it by 11.6, you get 9.8 cents a gallon over this 20-year period, so-called advantage. But if 17.4 percent of our sales are from this exemption, you reduce that 9.8 cents down to 1.7 cents, and that's the money that's going to our farming operation, but it's not a lot of money to work with when you look at all the other factors that have to do with business today.

(Tr. 7068:3-7070:9.) Mr. Shehadey further testified about the rest of the market decline:

> Well, the 14 percent drop just seems a little extreme. I know it's gone down, but just 14 percent seems more than what it -- what it should be. But I don't want to get into a percent here or percent

> there, but we have good relationships with our customers. We have been able to maintain them through this decrease in milk consumption. And we, I think most of the producer-handlers feel the same way, they are family businesses, they have relationships with their customers, and it's more than just, you know, bidding on price. I mean, maybe your large customers are thinking more about price, but we have one large customer that we have had since they had five locations in Northern California, five warehouses in Northern California, and that was in 1985. And they have stayed with us since 1985 to today. We have a good relationship with them. So if other sales are going down, we have not experienced that, as like maybe some other people have.

(Tr. 7094:1-16.)

If exempt quota gave its holders such a financial advantage in the Class 1 markets, California would not have seen the reduction of exempt quota holders from 47 down to the final four remaining exempt quota holders. (Tr. 7084-7085 (testifying that an exempt quota holder sold its quota as recently as 2009).)

#### 4. Hypothetical Scenarios and Potential to Create Disorderly Market Conditions Are Insufficient Justifications to End Exempt Quota

At the hearing, at least two witnesses stated that they were "paranoid" that the exempt quota would allow the exempt quota holders a market advantage, which the Dairy Institute now claims amounts to disorderly market conditions. But the law is clear: the mere "potential" to create disorder in the market is not enough to justify a change to the regulation. *See* 54 Fed. Reg. at 27182 ("Although the marketing of milk by producer-handlers has the potential of creating disorderly marketing conditions, it has not been found necessary to regulate fully this type of operation .... There is no evidence of market disorder as a result of competition between such producer-handlers and fully regulated handlers.").

When it benefits the Dairy Institute, it claims that substantial impacts on the dairy markets, such as the Cooperatives' downsizing, selling, or closing cheese-making operations in

California due to the market conditions, are insufficient evidence of disorderly market conditions—and are, rather, attributed to the natural effect of market conditions. (Dairy Institute Conclusions of Law at p. 56.) The Dairy Institute even is so bold as to state that the "USDA cannot rely on hypotheticals or potential disorderly market condition[s] to justify adoption of an order, especially in light of its long history of requiring real and substantial evidence of actual fluid milk market disorder." (*Id.*) Yet, the Dairy Institute poses that exact argument against exempt quota when it concludes that the only reason CPHA members could have performed better than the averages in dairy markets must be because they are exempt quota holders—even though there was zero evidence that connected the Class 1 sales performance to the CPHA members' exempt quota holdings.

On the contrary, all of the evidence at the hearing conclusively proved that the input prices that make up the cost of the Class 1 production for CPHA members is on a level playing field with all of the other producers of Class 1 products. CPHA members pay their farms a Class 1 price for the milk, just as all of the other processors pay for their raw milk. Because the exempt quota impacts the processing side of the CPHA business, the only true explanation for why CPHA members may have outperformed Dean Foods and other Class 1 processors is the exact reasons articulated by Mr. Shehadey:

Simply put, the suggestion that CPHA members use their exempt quota to secure customer bids is not based in reality or the record in this case. Any sales CPHA has achieved were not attributed to their exempt quota holdings, because that benefit goes entirely to the farm operations. Any sales that CPHA gained is because of their hard work, quality of product, and customer service. Price is always a factor in any competitive arena, and these entities work hard to ensure that they build in efficiencies to their family-run businesses. They offer customers a

high-quality product with impeccable customer service, control their product quality from the farm through to the final product that is sold to their customers. These family businesses have invested in modern technology, controlled cost through operating an efficient distribution system and supply chain. Hard work and dedication toward improving efficiencies on the handler side of our business is what provides the ability to submit competitive bids for customers business; it is not exempt quota and never has been because the benefit goes to the farming operations. (Tr. 6953:9-6954:1.) The hearing record was never provided with evidence to the contrary.

Moreover, when one averages any figures, as the Dairy Institute did in averaging the growth of the Class 1 markets in California, there are always those who fall above the line and those who fall below the line. That is how one arrives at an average. CPHA members' performance aligns with their business models of running highly efficient, customer-service-oriented family-run operations. It is not surprising that the CPHA members, while not growing their market share, were able to maintain their shares on a greater average than larger corporate operations.

### C. Exempt Quota Holders Differ from Federal Order Producer-Handlers

The Dairy Institute argues that Proposal 3 should be rejected for the primary reason that California producer-handlers are different from federal order producer-handlers. (Dairy Institute Conclusions of Law at p. 143.) The Dairy Institute misunderstands the point of Proposal 3. CPHA is not attempting to be considered a "producer-handler" that would hold its milk production from the pool altogether. Instead, CPHA seeks to preserve the exempt quota shares that it owns along with the preservation of the overall quota system. It is the very differences between CPHA members and other federal order producer-handlers that explains why CPHA's exempt quota should not be treated as federal orders have treated producer-handlers' exemptions. They are completely different.

Quota, by its very nature, makes the CSOS, and all of the proposals for a California FMMO, very different from any other federal order system in the United States.

More akin to the federal order producer-handler definition is California's Option 66 producer-distributors, who are fully exempted from the California pool for their entire production and do not participate in the quota system. (Hearing Tr. 6945:14-17.) And Option 66 producer-distributors are more like federal order producer-handlers, who either categorically fall into the definition and have all of their milk excepted from the pool, or categorically fall into the pool. (Hearing Tr. 6992:3-6993:10, 6945:14-17.) In contract, none of the CPHA members are Option 66 producer-distributors, and CPHA's Proposal 3 does not have anything to do with Option 66 producer-distributor definitions.

Further, CPHA does not object to the inclusion in a California FMMO of a producer-handler definition as proposed by the Cooperatives (or Dairy Institute) that allows for exemptions if the total production does not exceed 3,000,000 pounds per month of milk route distribution (as well as the other requirements). While that provision will expand the potential exemption to producer-handlers that do not presently have that exemption allowance, and it will not apply to any CPHA members, CPHA has no objection to the consistent provision with all other federal orders.

Further, CPHA's Proposal 3 is not inconsistent with a producer-handler definition, as it only preserves exempt quota, a clearly defined asset that has been part of the quota system since the inception of the quota system. The Dairy Institute's attempt to group CPHA's exempt quota into the producer-handler definition in other federal orders ignores the Farm Bill's explicit direction regarding quota value and recognizing the quota system in California. There is a marked difference between the limited exempt quota holders, and the unencumbered producer-

handler situation that was addressed at the producer-handler hearings. The differences, as outlined by Dairy Institute, between CPHA and producer-handlers explain how the arguments to limit producer-handlers do not apply to CPHA's exempt quota.

### D. California Producer-Handlers Differ from "Producer-Handlers" in Existing FMMOs

Producer-handlers holding exempt quota under the CSOS are very different from producer-handlers in other federal order systems. (Hearing Tr. 7096:4-6.) This is the case for several reasons.

*First*, CPHA members comprise two separate legal entities: on one side, the farm or dairy operation that invested in and acquired all of the exempt quota, and on the other side, the processing and handling plant that purchases from the farm on an arm's-length basis, just as if it were purchasing from any third-party farm. They are separate businesses, with separate profit and loss statements, separate balance sheets, and separate ownership structures. (Hearing Tr. 6997:11-19.) For example, Mr. Shehadey, Chief Executive Officer of Producers Dairy Foods, Inc., testified on behalf of the CPHA. Producers Dairy dates back to 1932, and it has been owned by the Shehadey family since 1949. (Hearing Tr. 6940:12-25.) Their farm is called Bar 20 Dairy, and the plant is operated under Producers Dairy. These are separate legal entities, and their ownership structure is different (although overlapping with some individuals). Bar 20 is the entity that purchased, owns, and reaps all benefits from its exempt quota. Thus, in 2009, when Bar 20 lost millions of dollars with the economic downturn, members of Mr. Shehadey's family had to cover the losses with their own individual personal financial resources. None of those resources were covered by the plant/handler side of their business because it is a separate legal entity. (Hearing Tr. 6997:11-6999:5.) Likewise, the handler side of their business stands alone and receives no financial benefit from Bar 20's ownership of exempt quota. (*Id.*)

*Second*, under the federal order system, there was no investment requirement to obtain the exemption like there is under the CSOS to obtain and maintain exempt quota. (Hearing Tr. 6984:1-23.) The financial investment to create a Class 1 market to obtain the original designation as an exempt quota holder and the subsequent financial investment of $9 million to purchase new exempt quota certificates were tangible investments made by CSOS Option 70 producer-handlers in order to obtain their exempt quota. Exempt quota is a book value asset held by the producer side of their business. (Hearing Tr. 6984:1-23.)

*Third*, the exempt quota is limited in scope, volume, and duration. The number of producer-handlers who hold exempt quota was set in 1968 with the enactment of the Gonsalves Milk Pooling Act. The volume of exempt quota shares was set by the 1994 amendment to the Act. And exempt quota will sunset when the tables of consanguinity are exceeded, and are currently capped by March 1995 volumes. (Hearing Tr. 6984:1-23.) In contrast, in the federal order producer-handler hearings, the concerns addressed producer-handler exemptions that did not have similar limitations to the CSOS and could be expanded as much or as long as the producer-handlers continued to produce and sell their milk. (Hearing Tr. 6984:1-15.) The CPHA exempt quota holders have a limited amount of exemption, it cannot be expanded, and it will sunset after a period of time.

*Fourth*, there has been no evidence that exempt quota disrupts the milk market. The exempt quota holders have been operating with their exemption rights since 1969, and there is no actual evidence of disorderly market conditions. As Mr. Shehadey testified, "after 50 years of exempt quota being part of the California State order system, to my knowledge, there has never been a finding of disorderly market conditions, and no reports that any CPHA member has improperly priced product below cost because of the exempt quota." (Hearing Tr. 6985:11-21.)

"No Option 70 producer-handler has ever used their exempt quota to win any customer account." (Hearing Tr. 6953:6-8.) All four of the CPHA members pay their producers the full Class 1 milk price– the same that they pay any third party producers for the milk. So the CPHA members compete on a level playing field with all other Class 1 handlers for the sale of their Class 1 milk.

Exempt quota is a value that is held by the farm entity of each CPHA member. (Hearing Tr. 6951:6-21.) The plant side of the business that sells the Class 1 milk does not receive any price advantage. The plants all pay their own farms the Class 1 price, the exact same price that the plant would pay into the pool if it were not exempt. The plant accounts to the pool for the volume of milk, and then gets a deduction in the exact amount that it paid to its farm. That means there is absolutely no financial advantage for the plant for any exempt quota shares held by its farm. There is no price advantage to pass on to customers or to undercut Class 1 competitors.

Dean Foods was the only witness that testified it allegedly lost a customer to a CPHA member, but that testimony was based entirely on speculation as to what it concluded must have been merely a singular reason it could have lost the bid to a CPHA member.

Producers Dairy, the entity Dean Foods presumed to have allegedly won a bid based on a price advantage, testified specifically about the bid that Dean Foods lost. Producers Dairy confirmed that it won the bid on a variety of factors, and none of them were based on any competitive price advantage realized from the exempt quota holder benefit. (*See* Hearing Tr. 6995-6998.) In reality, Producers Dairy, along with the rest of the CPHA members, has lost more bids to Dean Foods than Dean Foods has lost to the entire group of CPHA members. (Hearing Tr. 6996:21-6997:10.) If CPHA members held a competitive advantage because of their exempt quota shares, they would have been able to take a larger market share than what

they have taken from Dean Foods. The simple truth is that the only bid CPHA members have won against Dean Foods was an account that Dean Foods lost on a national basis, and not one that was lost due to exempt quota ownership.

The evidence has been uncontroverted. The farm entity holds all of the financial benefit for the quota exemption treatment. The handler side of the business that processes the raw milk into fluid Class 1 milk incurs the exact same cost for the raw milk as if it were purchasing the milk from a third party, and the handler side of the business receives no financial benefit from its farm owning exempt quota. There are no disorderly market conditions from the existence of quota, regular or exempt.

## III. CONCLUSION

For all of the reasons submitted during the USDA hearing, in CPHA's proposed findings of fact and conclusions of law, this reply, and the record as a whole, CPHA urges the USDA to preserve exempt quota along with the preservation of any other type of quota that remains in a California FMMO.

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Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby certify that on May 13, 2016, I served a copy of the foregoing **REPLY BRIEF ON BEHALF OF CALIFORNIA PRODUCER-HANDLERS ASSOCIATION** on the following, in the matter indicated below:

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