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UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE

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In re:

Milk in California

[AO]

Docket No. 15-0071

**POST-HEARING BRIEF SUBMITTED ON BEHALF OF
DEAN FOODS COMPANY**

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March 31, 2016

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Post-Hearing Brief on Behalf of Dean Foods Company

Dean Foods Company (“Dean Foods” or “Dean”) is a member of the Dairy Institute of California and is part of the coalition represented by Davis Wright Tremaine in this promulgation proceeding. However, on behalf of Dean, the undersigned has been retained to brief Class I specific issues pertaining to Proposal 1, which are discussed herein, and offers this supplemental post-hearing brief.

Dean Foods is the largest fluid milk processor in the U.S., with 67 plants in 32 states. While fluid milk represents the bulk of Dean Foods’ business, Dean also manufactures ice cream, cultured products, juices and teas. Dean owns and operates three bottling plants located in the state of California; Berkeley Farms, which serves northern California, and Alta Dena Certified Dairy and Heartland Farms, both of which serve southern California. Dean also owns and operates one ice cream plant located in Buena Park.

As a threshold matter, under current market conditions Dean opposes the adoption of a Federal Milk Marketing Order covering California. The hearing record does not establish that there is disorderly marketing and thus there is no evidence that the adoption of a California order would tend to effectuate the purposes of the Agricultural Marketing Agreement Act of 1937 (“AMAA”). The hearing record reveals testimony about the struggles of dairy farmers in California in past years, but notably the testimony did not sound in the uneconomic milk movement, cutthroat price competition, or the inability to find a home for California dairy producer milk. Instead, it is clear that price enhancement remains the primary focus of the proponents of Proposal 1 (“Coops”).

In Bulletin No. 27, entered into evidence as Exhibit 112, the United States Department of Agriculture (“Department”) explained that with the enactment of the AMAA, the Federal Milk

Market Order program transitioned from one of focusing on income level for dairy farmers to one that is focused on the inherent instability in milk marketing. The same concept was again noted during Federal Milk Marketing Order Reform (“FMMO reform”) in the rulemaking documents issued by the Department, which said “[w]ith regard to pricing, it is recognized that the objective of the AMAA is to stabilize the marketplace with minimum prices, not to set market prices.” Milk in New England and Other Marketing Areas, 64 Fed. Reg. 16,026, 16,109 (Apr. 2, 1999).

Thus, to the extent Dean Foods argues herein for or against particular order language, Dean’s threshold position is that all of this can and should be avoided. There is, after all, a state regulatory body, the California Department of Food and Agriculture, which has shown a willingness to adjust aspects of the system to respond to changing circumstances.

A. A California Federal Order Must Implement Three-Factor, Not Two-Factor Class I Pricing To Ensure Uniform Pricing and Equity Among Fluid Milk Handlers Due To California’s Fluid Milk Standard Requirements.

Dean Foods urges the Department to adopt a three-factor Class I pricing formula that prices based on *butterfat, solids nonfat and fluid carrier* by separating the skim portion of milk out into solids nonfat and fluid carrier. (Blaufuss, Tr. 6767:10 - 25). The Coops essentially included the default of Federal Milk Marketing Order language from elsewhere, which bases the Class I price on two-factors - *butterfat and skim*; however, the Coops presented no analysis of the implications of using a two-factor Class I pricing formula in a marketing area where because of state-mandated fluid milk standards, fortification of fluid milk is common place.

On the other hand, companies like Dean Foods, whose costs are directly and significantly affected by Class I raw milk pricing – it is by far the biggest cost factor in processing, packaging

and delivering fluid milk products¹ - did perform an analysis. Rob Blaufuss presented mathematical proof that all things being equal, under a two-factor pricing formula a fluid milk handler being supplied raw milk from farms with low solids nonfat tests (“low test milk”) faces higher costs than those who are supplied raw milk from farms with high solids nonfat tests (“high test milk”). The spread between high test and low test milk priced under a two-factor formula is striking and significant.

If the producer milk coming into a fluid plant differs by even tenths of a percentage point from its competitors, it can have significant implications. According to Mr. Blaufuss’ uncontradicted analysis, the 2010-2014 per-gallon cost using a two-factor price formula for reduced fat milk at 9.2% test skim (*i.e.*, high test) averaged \$ 1.5973, while milk with 8.8% skim averaged \$1.6356 (*i.e.*, low test), a difference of \$0.0383 per gallon. (Blaufuss, Tr. 7112:4 - 14) That price difference averaged \$0.0372/gallon for low-fat milk over that same period. (Exhibit 148a).

In contrast, the cost difference between milk that would need more fortification and milk that would need less fortification, simply because of the way it came from the cow, is minimized with a three-factor formula that separates out fluid carrier from solids nonfat. The 2010-2014 reduced fat per gallon cost with 9.2% skim milk under a three factor formula averaged \$1.6925 while the 8.8% skim milk per-gallon price averaged \$1.6900, a difference of only \$0.0025 per gallon. (Blaufuss, Tr. 7112:15 - 20). Lowfat per-gallon costs for 9.2% and 8.8% test skim solids milk under a three-factor pricing formula averaged \$1.6321 and \$1.6295, respectively, a difference of only \$0.0026 per gallon. (Exhibit 148a) The Coop proposal would create a nearly

¹ Matt Williams testified on behalf of Dean for another subject and stated that the raw milk cost is over 70% of the finished product cost. (Williams, Tr. 6376: 10 – 15).

4-cent per gallon advantage to fluid milk processors receiving only modestly higher test raw milk.

By separating out fluid carrier from solids nonfat, a three-factor pricing formula more precisely values the solids. Given the increased fluid standards in California, there is a need to standardize the skim solids costs in the pricing formula. Not doing so allows for unequal raw product costs for plants depending on how they source raw milk. The addition of a fluid carrier would equalize raw product costs for similarly situated handlers.

Given the nature of the fluid milk markets generally, and specifically in California, a nearly 4-cent per gallon *regulatorily-imposed* cost difference carried into a bidding process where fluid milk plants are competing for retail business will create handler inequity in the form of competitive disadvantages (Blaufuss, Tr. 6766:18-22) and incentives to eschew lower test raw milk. (Blaufuss, Tr. 6766:22 - 25; Tr. 6767:1). Importantly, the lack of attention to this matter would violate one of the core principles of the AMAA – 7 U.S.C.A. § 608c(5)(A) (2015) requires the Department to develop milk marketing orders to provide for uniform prices among handlers subject to a limited set of adjustments.

Moreover, the competitive inequity that will be created runs afoul of that which the Department said in Bulletin No. 27 on page 5, made part of the record as Exhibit 112, when it said:

Milk marketing orders also benefit handlers. They are assured that their competitors are not paying less for their milk than the minimum prices set by the order. They also can expect steady supplies of milk year around. Milk handlers thus can focus inwardly to concentrate their efforts on improving plant and marketing efficiencies to compete for larger and more profitable shares of the market.

Under a two-factor formula, competitors will not pay less than the minimum, but the result will be nearly as bad - it will allow competitors in the same line of business to have a lower minimum price than others.

To put this disparate pricing into context, it is noteworthy that in other testimony at the hearing, Mr. Blaufuss explained that “[t]he fluid milk industry operates in a highly competitive market where business can be won or lost over fractions of a penny a gallon.” (Blaufuss, Tr. 6372:22 - 24). According to the uncontroverted analysis of Mr. Blaufuss, a nearly four-cent disadvantage will make a significant difference among competitors and will negatively impact those processors who are not able to eschew enough low test milk. Thus, the Department is obligated to avoid such inequity under the authority of the AMAA.

Importantly, there is no downside to the pool in adopting the three-factor Class I formula on this record. Mr. Blaufuss’ analysis demonstrated that using the three-factor Class I formula versus the two-factor Class I formula would actually generally increase the Class I obligation. (Blaufuss, Tr. 6767:20 - 23). He nevertheless explained that the potential for disorderly conditions in the Class I market brought on by unequal raw product costs for similarly situated handlers outweighed their concern for higher per-gallon prices. (Blaufuss, Tr. 6767:23 - 25)

During his testimony Mr. Blaufuss indicated that for his analysis he used the current California fortification credit formula for condensed skim and presented a modestly different fortification formula from that which was submitted by the Dairy Institute in order to more precisely reflect current California fortification credits. (Blaufuss, Tr. 6756:9 - 23). That language is included herein below and the Department is urged to adopt the following revised language, as well as the three-factor formula included in the Dairy Institute Proposal.

§1051.60(a)(5) Each handler, using nonfat dry milk for fortifying Class I products to meet the State of California’s fluid milk standards as described in §1051.43(d)(3) during

the current month, may deduct for each pound of milk nonfat solids in the nonfat dry milk a maximum charge equal to the current Class 1 nonfat solids price less the current Class IV nonfat solids price.

§1051.60(a)(5)(i) In no case shall the deduction calculated in §1051.60(a)(5) be less than zero cents (\$0.0000) nor more than nineteen and eighty-five hundredths cents (\$0.1985).

§1051.60(a)(6) Each handler, using condensed skim milk for fortifying Class I products to meet the State of California's fluid milk standards as described in §1051.43(d)(3) during the current month, may deduct a maximum charge of nine and eighty-seven hundredths cents (\$0.0987) for each pound of milk nonfat solids in the condensed skim.

B. The Coops Did Not Carry The Burden Of Establishing The Justification or Need For Class I Differentials Or The 'Higher-of' Provision Under Present Marketing Conditions Let Alone Where Mandatory Pooling Is Proposed.

"Higher of" and Class I differentials were not justified based on the record. Dean incorporates by reference the Burden of Proof discussion as set forth by Dairy Institute² with respect to the Coop proposal and asserts that those arguments apply with full force here where the Coops failed to provide current evidence or evidence specific to the California-style proposal sponsored by the Coops to support: (a) the basis or need for Class I differentials, (b) the level of Class I differentials, or (c) the basis or need for the "Higher of" pricing.

Coop witnesses simply relied on data and policy conclusions drawn by the Department back in 1999. For instance, Dennis Schad's effort to support the continued policy of basing the advanced Class I price on the "Higher of" the Class III or Class IV price was a recounting of the comments by the Department in the FMMO reform decision. Exhibit 70, p. 29 – 30.. He did not explain how today's marketing conditions or the California-style order proposed by the Coops were similar enough or otherwise to the facts and circumstances under consideration in 1999 to apply the FMMO reform reasoning to justify the adoption of the "Higher of" concept in a newly formed California Federal Order. For instance, there was no explanation of how it is that the Department should even concern itself with price inversion and concomitant depooling, when the

² Brief and Proposed Conclusions of Law Submitted by Dairy Institute of California, Part III.

Coops are proposing mandatory pooling thereby obliterating depooling. If there can be no depooling under the Coop proposal, one of the principal justifications for the “Higher of” concept of course disappears. Yet there is no mention of how or whether the other considerations raised by the Department in 1999 currently exist and/or are sufficient to nevertheless justify the “Higher of” concept.

And, should the Department have the good sense to reject mandatory pooling,³ but it nevertheless adopts a California Federal Order, it is not demonstrated on this record that price inversion will prevent milk from reaching the Class I market. Mr. Blaufuss explained that fluid plants have milk supply contracts and the ability to pay premiums, if not overburdened by regulated minimum prices. Exhibit 130, p. 2-3). Moreover, Mr. Blaufuss explained that in markets like California and the Upper Midwest, the “Higher of” concept is really just a price enhancement tool. (Exhibit 130, p. 2 – 3).

However, Mr. Blaufuss explained that Class I price enhancement does nothing to help drive sales. (Exhibit 130, p. 2). Fluid milk continues to lose customers during high price periods and fails to regain some during low price periods. (Exhibit 130, p. 2). Mr. Blaufuss also explained that the price enhancement of the “Higher of” is not needed if performance standards are strong enough. (Exhibit 130, p. 3).

Nor did the Coops adequately support the continuation of Class I differentials under a California-style order. Mandatory pooling cannot be reconciled with Class I differentials; the Department itself has said “[t]he higher Class I price encourages all milk to be used first to satisfy Class I needs.” Milk in New England, 64 Fed. Reg. 16,109. The Department further explained “performance standards for *pool supply* plants are designed to attract an adequate

³ The Brief and Proposed Conclusions of Law Submitted by Dairy Institute of California, Part VI(F)(1) is incorporated here by reference.

supply of milk to meet the demands for fluid milk in a market.” *Id.* at 16,133. Still further, the Department explained that it was important that Market Administrators “would be able to adjust shipping percentages to encourage needed shipments or to prevent uneconomic shipments.” *Id.* And, the Department noted that performance standards necessarily required consideration of local circumstances. *Id.* Mandatory pooling would, of course, abandon these principles even as the Coops purportedly rely on FMMO reform analysis to bootstrap their proposal. Mandatory pooling is antithesis to making Class I plants pay more through the regulated price. Under traditional federal orders, Class I plants pay more, but at least get performance requirements as one means of helping to attract milk for fluid purposes.

Finally, Coop witness Dennis Schad discussed the components of the base Class I differential of \$1.60 as their support for using Class I differentials from FMMO reform for a California State Order. (Exhibit 70, p. 31). However, with respect to the first component – 40-cents described as the cost to maintain Grade A status (Exhibit 80, p. 31) - the Coops did not present current data. For all the Department knows, maintaining Grade A status in California costs mere pennies today. If milk must be Grade A to be pooled, why must Class I milk and not all pool milk bear the burden? With respect to the second component – marketing costs of 60-cents - Mr. Schad offered no current analysis of those costs or how it relates to an order with mandatory pooling. (Exhibit 70, p. 31). And, with respect to the third component of 60-cents – a portion of competitive premiums – Mr. Schad offered no current analysis or circumstance specific analysis of the premiums. (Exhibit 70, p. 31).

In summary, the Coop proposal seeks to continue the historical approach of placing a greater regulated cost burden on Class I milk, but as proposed, would remove the minimal corresponding privileges that came along with those costs.

C. The Coop Proposal To Jettison Shipping Requirements Strikes At The Underpinnings Of Federal Order Principles

Under current Federal Order regulations Class I processors pay, in most months, the highest price, are the only handlers that cannot de-pool, and are the only handlers that are not allowed to forward contract. In return Class I processors receive one thing – shipping requirements. The Cooperative California FMMO proposal however does not require milk to be shipped to distributing plants in order to be eligible to be pooled (Hollon, Tr. 2845:9 - 18).

“A supply plant is a plant approved by a duly constituted regulatory agency for the handling of Grade A milk that receives milk directly from dairy farmers and transfers or diverts fluid milk products to other plants or manufactures dairy products on its premises.” 7 C.F.R. § 1000.6. “Each [Federal] Order has a specified shipping percentage that the supply plant must ship to the distributing plants in the specific order for the supply plant to become a pool supply plant.” (Schaefer, Tr. 382: 7 – 10). In return for supplying distributing plants with milk, supply plants are eligible to share in the Order’s Class I revenue (Blaufuss, Tr. 5478:19 - 20). The shipping percentages for an individual order are typically set at or near the Class I utilization level of the order. (Exhibit 120, p. 3). For example, FMMO 30, an order with low Class I utilization, requires a 10% shipping requirement while an order with high Class I utilization, FMMO 7, has a 50% shipping requirement. *See e.g.*, 7 C.F.R. §1007.7(c), §1030.7(c). Where Class I plants must pay dollars into the pool instead of directly to their producers, supply plant shipping percentages are an important provision in the Federal Order system. They serve as a tool that helps pool distributing plants have access to a milk supply to serve the needs of the Class I market. (See Discussion Part B).

Under the Coop proposal, all milk would enjoy the privileges of being in a Federal Order pool without ever actually having to meet any of the basic shipping requirements found in all

other Federal Orders. (Exhibit 120, p. 4 – 5). The Coop proposal could ultimately lead to increased 'pool riding' in California. Pool riding occurs when milk is allowed to attach itself to a Federal Order without ever actually performing (Blaufuss, Tr. 5481:16 - 19). Patrons of non-performing supply plants would be allowed to enjoy the same privileges as the patrons of those plants which are serving the Class I market, in most instances the higher blend price, without any contribution to the Class I market or the marketwide pool (Blaufuss, Tr. 5481:19 - 22). A Federal Order without performance standards will make it much more difficult and/or more costly to attract an adequate supply of milk for fluid purposes. (Blaufuss, Tr. 5480:23 - 25; Tr. 5481:1 - 8)

In the absence of shipping percentages, Mr. Christ explained premiums will have to be the means by which milk is attracted to Class I facilities. (Christ, Tr. 2535: 8 – 25; Tr. 2536: 1 – 2). However, consideration must be given to the burdens that are being placed on Class I. Not only are the Coops seeking to raise the Class III price (often the mover for Class I), they are also seeking to retain the "Higher of" with its price enhancement, as well as maintaining Class I differentials without reviewing the individual components of the base differential developed in the 90s. Despite this, they have now proposed a system that will force Class I plants to pay more in premiums than ever before. To ensure adequate supplies of fluid milk, as the AMAA contemplates, the Department has a duty to not only scrutinize each factor burdening Class I milk, but also the Department has a duty to consider the cumulative effect of the various burdens.

D. Automatic Pooling Status of DFA plant in Fallon Creates A Loophole for Dilution of Any California Federal Order Blend

A key provision to the Coop proposal revolves around mandatory pooling. All Federal Orders today allow Class II, III and IV plants to elect not to pool when it is economically advantageous for them to do so. In the Coop proposal, *all* plants are mandated to remain in the pool. A troubling aspect of the Coop proposal relates to the pool status of an out-of-state dairy

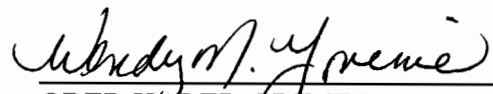
ingredient plant. The Coop proposal would grant automatic pool status to, “a plant located in Churchill county Nevada that receives milk from producers located in Churchill County or in the marketing area or from a cooperative marketing the milk of a producer located in the marketing areas or in Churchill County.” This provision would allow DFA to pool milk on the California order, including milk not previously associated with the California state order and allow them to siphon dollars out of the CA pool, potentially lowering producer blend prices. A more fulsome explanation of the record on this point can be found in the Dairy Institute’s Post-Hearing brief, Part X(B), which is incorporated herein by reference.

Conclusion

In conclusion, Dean Foods urges the Department to recognize it is being asked to preempt the authority of a state agency without the evidence required to justify the action under the Department’s authorizing statute. Further, Dean urges the Department to recognize that the action requested has the potential to put additional burdens on Class I without corresponding benefits and without full consideration of its implications.

Dated: March 31, 2016

Respectfully submitted,



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