BEFORE THE UNITED STATES DEPARTMENT

OF AGRICULTURE

AGRICULTURE MARKETING SERVICE

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

Clovis, California, November 2015

Testimony of Dr. William Schiek

Part 4

Introduction

California's quota system has its origins in the Gonsalves Milk Pooling Act, as testimony from earlier in this hearing indicates. Under the current state milk pooling plan, producers receive an extra $0.195 per pound of solids not fat (SNF) on their milk production that is covered by quota, as compared to the price they receive for milk not covered by quota (non quota milk). As I mentioned in earlier testimony (Exhibit 79), pool quota came about as a means of compensating producers who, historically, had a higher percentage of their milk shipments to Class 1 uses under the contract system that was in effect prior to pooling. According to earlier testimony from Dr. Eric Erba (Exhibit 42): "One of the declared purposes of the Gonsalves Milk Pooling Act is to equalize gradually the distribution of Class 1 and Class 2 utilization." The notion of quota equalization, where all producers would eventually have quota allocations that covered 95% of their production base, was anticipated as the state's population and Class 1 use grew. The goal of equalization, where prices paid to producers would become more uniform or equal, has similarities to the notion of paying uniform prices to producers under FMMOs.

Regarding our proposal on quota, I want to clarify what might be a major misperception. The Dairy Institute and its members did not set out, nor is it our goal, to destroy quota. As you have heard, some of our member companies purchase milk from farmers who own quota. We understand how important quota is to California's dairy farmers. At this hearing, we have heard the testimony of dairy farmers who own little or no quota, but who nonetheless support the quota program and the continued payment of quota value in California out of the pool first.

The question of how to deal with quota going forward is not new or unique to this FMMO promulgation proceeding. The California dairy industry has been discussing the future

of quota for quite some time. In 1978, the California legislature passed a statutory amendment that brought about the equalization of all original production base and pool quota that existed at the inception of the pooling program, noting that equalization had not occurred as rapidly as expected. Later, as Dr. Erba noted in his testimony (Exhibit 42, page 8), CDFA appointed a committee of producers in 1991 to conduct listening sessions throughout the state to receive comments and input on the milk pricing regulatory system. In 1993, a quota bill was passed in the California legislature that resulted in a change in the distribution of quota revenues. Prior to enactment of the new legislation, higher milk class revenues were allocated directly to quota milk first, before any of those revenues were made available for non quota milk. After 1993, the current "fixed differential" of $0.195 per pound of SNF ($1.70 per hundredweight at standard milk test) was put in place.

The change to the fixed quota premium (quota differential) did not put an end to discussions about possible modifications and/or termination of quota. In the early 2000s, producer representatives from different organizations met to consider changes to the milk pricing and pooling plan. The group was assisted by a trio of analysts with long experience in the California dairy industry: Jay Goold, former Manager of Western United Dairymen; Glen Gleason, former Chief, CDFA Milk Pooling Branch; and Dr. James Gruebele, former CEO of Dairyman's Cooperative Creamery Association. Quota and the possibility of terminating the program was something that was discussed during the group's meetings. In 2005, the California Milk Advisory Board (CMAB) commissioned a study of California's dairy industry that focused on how the industry could be successful in the face of mounting environmental challenges and global competition. CMAB hired McKinsey & Company to study the California dairy industry and make recommendations about strategies the industry could pursue to meet the dairy farmers'

challenges with increasingly onerous environmental regulation and associated costs. One of the options put forward was the idea of creating a debt obligation or bond that would be paid back from the pool, but which would provide revenue for quota holders to pay for costs associated with meeting new environmental regulations.

Summary of California State Level Review of the Quota Program

In 2007, then CDFA Secretary Kawamura established an Advisory Committee to analyze the current situation of California milk pool quota and consider possible changes to quota.[i] The Committee was asked to "explore if quota should continue, be modified or retired."[ii] These three options had subset questions, including identifying various modification or retirement plans, the advantages or disadvantages of each option, legal or legislative requirements for modification or retirement, and the financial consequences of modification or retirement. The committee was also requested to "seek producer input prior to making recommendation to Secretary for action."

The committee members and the process they undertook are summarized in *The California Dairy Review* from August 2007, published by CDFA. The committee held six public meetings on the issue and undertook an "in –depth review of the California milk pooling program – past and present." This publication also summarized some of the areas that generated the most discussion of the committee, including an analysis of the price formula, the financial and legal investment needed to buy out quota, how such a buyout would be funded, and Regional Quota Adjusters (RQA's) [iii] (Exhibit A).

On August 9, 2007, the committee issued its QRC (Quota Review Committee) Executive Summary.[iv] After review, the committee of 11 voted as follows: Quota Unchanged (6 votes), Modify Quota (0 votes), Retire Quota (5 votes). Since the required supermajority for retirement was not met (8 of 11), the recommendation was that quota be left unchanged.

Similar to the Dairy Institute of California discussions regarding our FMMO proposal, the committee tried to work through a number of different options to address a revision to the quota program. However, it was unable to agree on an acceptable manner in which quota could be modified or retired. As part of the third option (retiring quota), the committee considered a self-funding annuity method, a sunset provision on the quota, and a single payout via revenue bond funding. However, for a variety of reasons (which can be found in greater detail in reviewing the meeting notes of the committee[v]) these options were considered unworkable.

The committee did make some conclusions regarding the option of leaving quota unchanged. These included that quota could just "go away" or be retired with no value to quota holders (but that this outcome would be an unlikely one). It even concluded that the complication of quota helped them preserve the status quo system: "Quota helps protect the pool. If we (dairy producers) move to a referendum to change one aspect of quota/pooling, everything may be up for evaluation."[vi] They also found that quota added complexity to the California pricing structure, "increasing the difficulty to understand the system."

The committee was unable to agree on a way that the quota system could be altered when its only task was to look at the system in isolation of other provisions. It is also interesting that the group recognized that no more quota would be issued without growth in Class 1 and 2 milk utilization growth. Given the difficulty the committee had grappling with changes to quota, it is

not surprising that the cooperatives' proposal does not attempt to alter the quota system in a way that might lead to easier integration into and greater compatibility with the way existing FMMOs work.

Placing Quota within a California FMMO

As I discuss below, we have struggled with the quota issue for this proceeding, but it is important, I believe, to recognize that our struggle is not new, is not unique to our organization's discussions, and is not unique to this proceeding. Our belief is that our difficulty grappling with how to place quota into a California Federal Order is actually natural since the concept of quota does not fit comfortably within the FMMO framework.

While there have been various plans in FMMO's (such as Base-Excess plans in old Orders 4, 5, 7, 11. and 46) in the past, we understand that authorization for those provisions have expired (see Exhibits B through E). One of the central features of FMMOs is to require that minimum regulated uniform class prices are paid by handlers, and in turn that minimum uniform prices be paid to dairy farmers, subject to specific authorized adjustments.

So, the starting point in our thinking about quota was to look at the Cooperative proposal and see whether it would work, given our understanding of the purposes and goals of FMMOs. We have already noted our concerns about the mandatory pooling aspects of the Cooperatives' proposal. These concerns include its lack of traditional pooling standards that would direct milk to Class I uses and the way that it captures all manufacturing plants in the state as pool plants, not allowing those plants to operate as nonpool plants. The consequences of what we view as the implications of mandatory pooling were discussed in earlier testimony.

When we examined the cooperative proposal, we first concluded that the non quota blend price concept (setting aside the quota premium payment first from overall producer settlement fund proceeds), does not properly address the issue of out-of-state dairy farmer milk that will end up being part of any FMMO pool. Historically, out of state farmers' milk was credited at the plant blend under the California State Order (CSO). Those farmers could not, and did not, own any quota and the plant blend they received compensated them for the fact that they did not have the opportunity to receive a quota price. It is, of course, the case that FMMOs have the right to pool out of state milk, unlike the CSO. However, we believe that the out of state milk must receive the traditional FMMO blend price without subtraction of the quota premium.

The 1996 Farm Bill language, which to my knowledge, did not specifically amend the AMAA, is as follows: "...The order covering California shall have the right to reblend and distribute order receipts to recognize quota value." I will discuss this provision a bit more below, but our view is that provision does not alter uniform payment provisions of the Act (7 USC §608c(5)(B)) or the "trade barrier" language (7 USC §608c(5)(G)). While a California FMMO can (and should) include out of state milk in its marketwide pool, it is our view that paying the quota premium before calculating the FMMO non quota blend price clearly expands the California quota program to cover out of state milk, something it does not do today.

Based on the foregoing, our starting point is that USDA must instead establish first a traditional FMMO producer settlement fund in order to pay uniform prices to dairy farmers who could never own quota and, as proposed, will not be permitted to own quota going forward. Even if out of state producers were allowed to purchase quota today, the fact remains that original issued quota, which was never available to out of state dairy farmers, was free. As we heard in

testimony from Desert Hills Dairy, some of those out of state farmers have been shipping to California Class 1 plants for generations.

Given our view that out-of-state producers must be paid a traditional blend, our first thought was that we would have two pools, or pool calculations. One would pay the full order blend price to out-of-state producers first. The remaining funds would be apportioned to all California producers in the pool on the basis of quota and non quota prices that would be calculated after the payments to out of state producers have been made. Under our original concept, there would have been no option for California producers to opt out of the quota/non quota payout system, and no option for them to receive a traditional order blend. Based on our earlier concerns about mandatory pooling, our concept as we were thinking about it would also have allowed for handlers to elect not to pool their milk, subject to repooling restrictions.

We next examined the consequences of this quota concept. There has been discussion of an Arizona pool distributing plant that is presently fully regulated on the Arizona FMMO, yet with significant route disposition into California. We believe from our knowledge of that plant that it will likely easily meet the § 1051.7(a) "pool distributing plant" definition under either proposal 1 or 2. We see at least two additional problems with the cooperatives' treatment of quota as applied to that operation (or any other similarly ~~situation~~ Situated operation that this is located out of state and ends up being fully regulated under a new California FMMO).

First, it is our understanding that this plant receives producer milk from both Arizona and California dairy farmers. Again, we assert the Arizona dairy farmer milk must receive the traditional FMMO blend price and not the non quota blend price. But the California dairy farmer shipping to that plant almost certainly owns no quota based upon CDFA's quota holding requirements. So then, we have two dairy farmers, both shipping to an Arizona milk plant who

today receive the traditional FMMO blend price under the Arizona FMMO. If proposal 1 were adopted, but with the requirement that out of state milk be paid a traditional blend, the two producers would find themselves treated differently – the Arizona producer getting the traditional blend price and the California producer receiving the lower non quota blend price. That result makes us extremely uncomfortable, both 1) because that California dairy farmer is currently receiving the Arizona FMMO blend price today and would, just because a new California FMMO is created, receive a lower price that is not a traditional FMMO blend price, and 2) because that California dairy farmer shipping across state lines into that Arizona plant would receive a lower FMMO minimum price than the Arizona farmer simply because of his farm's location.

The second problem we identified is that the Arizona plant will be contributing to the quota premium through the pool on any California milk it purchases, unlike what happens today. To the extent that that plant attracts a milk supply today using at least the full FMMO traditional blend, the logical economic impact is that the California milk supply will look to recoup some or all of that lost revenue through over-order premiums. This will increase the Arizona plant's procurement costs and disadvantage that plant in distributing products into the state, and as a result will in a "manner limit," the marketing of milk products into California. That is our thinking. So when examining these transactions between California dairy farmers and out of state pool distributing plants, we conclude that such plants and the dairy farmers who supply them, must be subject to the traditional FMMO blend price program, just like out of state dairy farmers whose milk is pooled under the order.

A California dairy farmer shipping to the Arizona plant as we just described, will most certainly have neighboring dairy farmers in California who will be subject to the California quota

program. Today, that California farmer shipping to an Arizona pool distributing plant receives the traditional FMMO blend price, while the CSO producer, on his overbase milk, receives the state's announced overbase price. This situation is a consequence of the CSO and FMMO pricing systems existing side by side. Under a California FMMO as proposed by the cooperatives, and with the modifications that we believe will need to be made, you would now have two dairy farmers, located near each other, receiving non-uniform regulated prices under the FMMO. The only thing creating that new problem is the geographical distribution of their milk to plant locations in different states under a California FMMO with quota/non quota pricing.

The cooperatives will maintain that the situations we describe are why the order needs to take quota off first and establish a non quota blend for all milk, including out of state milk. But our view is that paying producers differently (as on the basis of quota holdings) would seem to violate the notion that all producers should receive a uniform price, with the exception of allowable adjustments. This is particularly true because the Farm Bill language merely says – "...The order covering California shall have the right to reblend and distribute order receipts to recognize quota value." The cooperatives and their supporters have used many terms or phrases that do not appear in the legislation that we believe alters the meaning of the words used by Congress (see Exhibit F). Of particular note is the fact that the California Food and Agricultural Code, Section 62712(e), says: "All pool quotas initially determined pursuant to Section 62707 shall be recognized and shall not in any way be diminished." Congress could have used that precise phrase, but did not. Nor did Congress amend the provisions requiring uniform payment to producers or those preventing "barriers" to out-of-state milk (§608c(5)(B)) and (5)(G)). Even if the cooperatives' altered interpretation is correct, Congress did not say that the value of quota

could only be recognized in the fashion presented in proposal 1. Indeed, the cooperatives take it even further by enhancing the value of quota at the expense of out-of-state milk, rather than simply recognizing quota. The difficulties associated with fitting quota into the FMMO structure is a conundrum that was not created by the Dairy Institute.

So our belief is that USDA cannot treat those two California dairy farmers differently relying on the "recognize quota value" language. The combined weight of these concerns is what brought us to our proposal as submitted to USDA, and is part of Proposal 2 as contained in Exhibit. First, all out of state producers will receive the traditional FMMO blend for their milk pooled in California. For California, the basic concept is that there are two options for producers. Producers may continue to receive quota/non quota prices, or they may opt to be paid the traditional FMMO blend for the California order. The traditional blend value applicable to those producers who elect to be paid on a quota/non quota basis will be transferred to California Department of Food and Agriculture (CDFA) for reblending and distribution to producers. By giving producers the choice to opt out of quota/non quota pricing, our view is that uniform payment provisions of the Act are satisfied because it is the producers are electing to be paid differently, as opposed to the order requiring that they be paid differently. We also note that by paying the traditional blend, rather than the non quota price, to out of state producers, we are not creating a trade barrier with respect to such milk.

An overview of the quota provisions and the operation of the producer settlement fund is as follows. Quota terms and reporting requirements are defined in §1051.11. The "opt out" provision (§1051.68) for producers who wish to be paid on the basis of a traditional FMMO blend is also included. Provisions regarding payments to the producer-settlement fund are contained in §1051.71, while payments from the producer settlement fund are specified in

§1051.72. The proposed order language also contains provisions for partial payments to producers and cooperative associations (§1051.73). We also note that our proposal contains plant locations adjustments for producer milk and nonpool milk (§1051.75) as is common in all other FMMOs.

I believe that most here are aware that we modeled these provisions on the Oregon program. The language used in the pool payments provisions are based on those in the Oregon-Washington order as published in the Federal Register (34 Fed. Reg. 17684, 17711-17712 (October 31, 1969.)) The mechanism for irrevocable election by a California dairy farmer is found in §1051.68. Under this provision, the market administrator gives initial notice of his intent to make payment of producers' returns to producers who participate in the quota program, which would be any California producer whose farm is received at a California plant. So producers are "in" unless they choose to irrevocably "opt out" in writing before the 1st day of the month that they want to be paid the uniform (order blend) price.

The partial payment would essentially work as with other FMMOs (§1051.73). A partial payment will be made by handlers to producers who are not being paid through cooperatives for milk received during the first 15 days of the month. Such payments to individual producers will be made on or before the 26th of the month. Partial payments for milk received from cooperative association members must be made on or before one day in advance of the date that such payment is required to be made to individual producers. Payments for milk received from cooperative association pool plants or from §1051.9(c) or §1051.9(d) handlers must also be made on or before one day in advance of the date that such payment is required to be made to individual producers. Partial payments are to be made at not less than the lowest class price for the preceding month. Provisions are made for payments by handlers to producers and

cooperative associations in unusual circumstances, such as death or inability to locate the payee in order to make payment. The information that must accompany payments to producers is also specified.

Under §1051.71, handlers make payments to the producer settlement fund. These payments must be made no later than the 15th day after the end of the month. Payment shall be the amount, if any, that the total value of milk to the handler is in excess of the aggregate amount paid to producers or cooperative associations.

In order to calculate and facilitate payment of the traditional FMMO blend and then the quota value, 100% of the final payment would be made to the Market Administrator. The Market Administrator pursuant to §1051.72 would calculate an amount due each producer based upon the volume of producer milk times the producer price differential (at location value under §1051.75), plus butterfat pounds times the butterfat price, plus the protein pounds times the protein price, plus the pounds of other solids times the other solids price, make the adjustment, if any, for somatic cell adjuster, reduced by the partial payment made under §1051.73 and less an amounts due for market services under §1051.86 and less authorized deductions from the producer. Final payment is usually a handler function, but given that money will need to move to CDFA for distribution, we could not find a way to recognize quota, meet the requirements to pay uniform prices to producers, and leave this final distribution in the hands of handlers.

California dairy farmers who do not elect to leave the California quota program would have all monies due paid by the Market Administrator to CDFA for redistribution of order proceeds under California's quota program (§1051.72(c)(2)). Out of state dairy farmers and those California farmers who elect under §1051.68 to irrevocably receive the traditional FMMO blend, would be paid directly or as a handler payment to their cooperatives for their milk based

upon this method, unadjusted for quota (§1051.72(b) and (c)(1)). Individual producers must be paid on or before the 18th day after the end of the month, while funds would be paid to cooperative associations and CDFA on or before the 16th day after the end of the month.

In putting together this proposal, we knew that there was some risk that the quota program would erode over time even as the Oregon program did over 18 plus years, but we also acknowledge that USDA's Preliminary Economic Analysis conclusions were significantly faster (in light of Oregon history) than we anticipated. Despite the Preliminary Economic Analysis conclusions on a pure economic basis, we continue to recognize that quota has had more "staying power" than would be suggested by looking at just the revenue stream of various alternatives. As noted above, regarding California non quota holders support for the quota, there is something more going on that is undergirding the California quota system.

~~CDFA~~ Exhibit 61 Table AB shows that more than 50% of the Farmers in California own 30% or less production quota. Farmers with more than 50% of the solids production hold less than 35% of the total production. Doing some calculations with the data in this table suggests that at least 62% of the producers representing 63% of the pool milk would receive a higher price under a traditional blend, than under quota/overbase pricing. Strictly speaking and looking at pure economics, one would think that political support for quota would be low. But that is hardly the case. As such, it may be that the economic decisions suggested by the Preliminary Economic Analysis and Mr. Hatamiya's testimony may not happen in the time frame expected. Regardless, the Dairy Institute does propose to "recognize quota" value, but not in the manner done by the cooperatives under proposal 1, and it is what we see as the limitations of the federal statute that pushed us to these conclusions.

So, what we proposed was based on our thinking about how to wrestle with quota within a California FMMO. It attempts to reflect both the Farm Bill language about recognizing quota, and the AMAA provisions that speak to uniform prices to producers and trade barriers. But the foregoing is not the end of the story or our discussions. We have certainly looked at options throughout this Hearing. While we do not have consensus, we have discussed an alternative concept that the Secretary might consider when reviewing his options for a California FMMO.

Recognizing the Value of Quota

A number of witnesses in this hearing, and a number of reports on the history of FMMO and CDFA milk regulation, have described the market chaos and inequity that preceded government milk price and pooling regulation. Some producers had a significant price advantage because they marketed their milk to the more lucrative Class I market. Other producers engaged in "destructive" competition to gain part of the higher-valued market. Cooperatives had little bargaining leverage to help even the playing field, and handlers played one group of producers against the other.

At the request of dairy farmer cooperatives, USDA created milk orders that required handlers to pay classified minimum milk prices, based on the handlers' use of milk, and distributed a revenue blend or uniform price to producers irrespective of handlers' use of their milk. In the FMMO model, producers who enjoyed a Class I advantage before regulation immediately lost their favored status and received the same uniform price as other producers when marketwide pooling became effective.

California's route was somewhat different. From the 1930's to the late 1960's, CDFA regulated minimum milk prices, but did not provide for market-wide pooling of milk revenues.

Producers who sold to Class 1 plants, therefore, received a much higher price than producers who did not have a Class 1 market.

The Gonsalves Pooling Act, and the subsequent pooling plan, sought to introduce market-wide pooling to the California system, but attempted to do so gradually. Producers with a high share of the Class 1 market before pooling were permitted to retain the benefit of historic use of their milk in Class 1 through the quota allocations they received, entitling them to a higher quota pool price on those allocations. This, it was thought, would induce the high Class 1 producers to approve of a pooling system. The expectation was that more quota would be issued to the less favored producers as Class 1 sales increased, and pool revenue distribution would eventually equalize among producers. As we know, this did not happen. In nearly 50 years since revenue pooling was first authorized in California, the state dairy industry, CDFA, and the state legislature have grappled unsuccessfully with the problem of quota and methods by which uniform pricing, following the federal model, might be achieved.

The 2014 Farm Bill authorized federal milk order regulation for California with a caveat that USDA "recognize quota value." The cooperative proposal (proposal 1) assumes that Congress allowed USDA to incorporate the current state quota system into a federal milk order. Perhaps so, but if this is the only option Congress intended it would have been easy to express it clearly.

A problem with incorporation of quota into a federal milk order is the tension it creates with the purpose of the AMAA. The Federal Court of Appeals decision in *Blair v. Freeman*, 370 F.2d 229 (D.C. Cir. 1966), has interesting parallels with the quota issue. In that case, USDA provided a "nearby" price differential to producers located close to population centers and close to fluid milk plants that supplied the market. "The nearby differential was designed by the

Secretary to compensate nearby producers for the reduction in their share of the fluid milk market resulting from their inclusion in the blended uniform price system." Blair at 236. Noting that "the core of the Congressional program was a uniform minimum price for producers that did not turn or vary with" handler use of milk, the Court held: "irrespective of motive, the Act forbids consideration of the use to which the milk of a particular producer or class of producers is put, historically or potentially, in adjusting the uniform minimum price to be paid to such producers." Blair at 237.

So, is adjustment of producer prices by quota – a payment based on historic use of the quota holder's class I SNF volume – permitted? In our view, no, unless the 2014 Farm Bill is read very differently (and we don't think it can or should be). But even if it is, it would still be in tension with the "core" AMAA objectives of market-wide revenue pooling, provisions that were not modified by Congress.

Our view is that the Secretary has the potential opportunity to equalize milk revenue distribution among California producers as is done in all current federal milk order markets. As long as the "value of quota" is recognized, this might be done gradually or quickly. But the US Secretary of Agriculture should be reluctant to perpetuate, with no end in sight, a payment system that strikes at the heart of the federal program.

If "incorporation" of the existing quota plan into federal regulation is authorized, USDA should expressly reserve the option to gradually correct any non-uniformity in the distribution of milk revenues to California producers. A means to commence that process in the near future, or whenever the Secretary may deem it appropriate, can be incorporated by a simple addition under "miscellaneous" provisions at the end of a Federal Milk Marketing Order for California, as follows:

Sec. 1051.91. The Administrator may, by notice and comment rulemaking, prescribe a procedure or method to equalize blend prices among producers by removing from this order provisions relating to payment of a quota premium for some milk, and non quota price for other milk. These terms are defined in Section ~~1051.17.~~ 1051.11.

Although the efforts of the dairy industry and regulators in California have not resulted in a solution to the quota problem, these efforts have been constrained by state law that does not constrain USDA's innovation in finding alternative ways to "recognize quota value."

We have not found a consensus solution that addresses all of the concerns we have outlined in the relatively short time since USDA received the cooperative proposal. Clearly, California producers are on a regulatory train that perpetuates a form of the current quota system. But given time, USDA may come up with solutions. We have, however, considered another solution.

For example, quota certificates could be converted to freely-negotiable instruments, unrelated to milk or SNF production, having the same "total economic value" of quota espoused by Cooperatives' witness Mr. Lon Hatamiya. Before proceeding, we should note, however, that the current quota price of $525 may overstate value of total quota. In a recent publication, Dan Sumner and Jisang Yu, *The Agricultural Act of 2014 and Prospects for the California Pool Quota Market* (Journal of Agribusiness, Fall 2014, pages. 193-206 (Exhibit G)), observe that the rise in quota prices during the spring and summer of 2014 may be attributed to a producer perception of lower risk in quota ownership due to the Farm Bill (page 204). The authors also suggest that if an FMMO produces higher milk prices, the value of quota will diminish, and that the opportunity of plants or producers to depool in an FMMO would also diminish quota value.

To my understanding, the view of Sumner and Yu seem to suggest that Mr. Hatamiya's calculation of total economic value of quota is probably nearly as high as it can get. The fact that interest rates are currently low would also drive up quota prices, since it takes a greater investment to produce a target income stream when interest rates are low than when interest rates are high. However, for the purpose of constructing an example, we use Mr. Hatamiya's estimate. Thus, the total economic value of nearly $1.2 billion, which creates, for all quota owners, an annual income stream of $139,329,759.23 (Exhibit 54, p. 16). That is the annual payout at variable quota rates, with some payments adjusted for farm location (RQAs). Converted to equal monthly installments, the quota payouts total $11,610,813.27 per month.

Several witnesses, including Mr. Hatamiya, likened the quota investment and payout to an annuity. An annuity is a similar asset providing an income stream over time from the annuity price investment. An annuity investor may determine what income stream a fixed investment will produce over variable durations of annuity payouts, or determine what amount of annuity investment is required to produce a targeted income stream over a targeted period of time. For quota in the aggregate, we know the investment value (~$1.2 billion) and the periodic income stream payment (~$11.6 million per month). So the full economic value of quota can be recognized by an annuity calculation to determine the number of months a payout of $11.6 million needs to be made to conform to the full $1.2 billion current economic value.

Fortunately, the calculation required is made fairly simple by banking web site annuity calculators, such as the calculator on the bankrate.com website. For the calculation, a growth rate is also required. We used an investment growth rate of 0.01% because of current low interest rates and the need to impute conservative, low-risk investments for this purpose. Any

imputed growth rate would project an increase in quota prices and thereby total economic value as defined in this example. Quota provides an income stream and not necessarily investment growth; so we use a nominal growth rate in the annuity calculator. Thus, on the annuity calculator, the starting principal is $1,163,388,061.5; the withdrawal amount is $11,610,813.00, and the growth rate is 0.01%. The solution to the inquiry – length of payouts, is 8.36 years (Exhibit H). In other words, recognition of the "value of quota" can be fully accomplished by a payout over 8 years and 4 months of exactly the same monthly amount now being paid to quota owners.

The sum of such value could be designated an obligation or debt of the California milk pool (except USDA should still deal with out of state milk in an appropriate way), and paid out as a form of annuity over a period of about 8.4 years. An illustration of this is shown on an annuity (Exhibit H of exhibit 146) calculation from the bankrate.com website, attached. The amount paid each month to retire the debt, in this illustration, is exactly the amount that is paid out each month in the form of quota premium milk prices, as calculated by Mr. Hatamiya.

As we noted throughout this testimony, quota remains difficult to incorporate into an FMMO. The solution contained in proposal 2 sought to ~~reconcile~~ recognizing the issue of reconciling quota with the need to pay producers uniformly and avoid putting up a trade barrier by forcing out of state producers to receive the overbase price. In our view, proposal 1 has the shortcomings of its mandatory pooling aspects, its perpetuation of non-uniform payment to producers, and its denying the traditional order blend price to out of state producers. We have looked at options other than what was contained in our proposal as a way to recognize quota value. The annuity proposal discussed above is one such example. Dairy Institute does not endorse this particular

solution at this time, but it illustrates that there are solutions that "recognize quota value" without unending perpetuation of non-uniform blend prices to producers.

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[i] California Dairy Review, 2007 Quota Review Committee Special Edition, found at https://www.cdfa.ca.gov/dairy/pdf/quotareview/dairyreviewspecialedition.august2007-1.pdf

[ii] Draft Guidelines for Task Force, found at https://www.cdfa.ca.gov/dairy/pdf/quotareview/blueribbonguidelines.pdf

[iii] California Dairy Review Publication, pages 1–2.

[iv] QRC Executive Summary, August 9, 2007, found at https://www.cdfa.ca.gov/dairy/pdf/quotareview/morgan.08-09-07.pdf

[v] California Department of Food and Agriculture website, at https://www.cdfa.ca.gov/dairy/quota_review.html

[vi] *Id.* at 2.