

**BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURAL MARKETING SERVICE**

In the Matter of Milk in California;  
Notice of Hearing on a Proposal to  
Establish a Federal Milk Marketing  
Order

7 CFR Part 1051  
Docket No.: AO-15-0071;  
AMS-DA-14-0095

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Clovis, California, November 10, 2015

Testimony of Richard Shehadey

In Support of Proposal 3 of the California Producer-Handlers Association

Proposal to Establish a Federal Milk Marketing Order for the  
State of California

## **Introduction**

My name is Richard Shehadey and I am the Chief Executive Officer of Producers Dairy Foods (“Producers Dairy”) and an owner in Bar 20 Dairy, LLC (“Bar 20 Dairy”). I am submitting this testimony in support of Proposal Number 3, submitted by the California Producer Handlers Association (“CPHA”), regarding a potential Federal Milk Marketing Order for the state of California. I support the adoption of a Federal Milk Marketing Order, as proposed by the Cooperatives in Proposal Number 1, preserving the quota system “intact” as Dr. Eric Erba testified to in this hearing in Exhibit 42. With the addition of CPHA’s Proposal Number 3 to the Cooperative’s proposal, the quota system will be preserved “intact” because it will include both types of quota, regular and exempt.

## **Producers Dairy History**

I wish to start by explaining the Producers Dairy story. It first began as Producers Dairy Delivery Company in December 1932 by a group of ambitious men wanting to package and deliver high-quality milk products in the local community here in Fresno, California. It started with a small milk processing plant and a few trucks to deliver fresh milk directly to people’s homes in glass bottles.

In 1949, my father, Larry Shehadey, bought an interest in that then-small milk delivery business. By 1955, my father bought out the other partners such that Producers Dairy has been an entirely family-owned, independent company ever since. And though my father did not have a college degree, he worked incredibly hard to make Producers Dairy the number one dairy in the area in a very short period of time.

One of his creative and pioneering marketing decisions was to associate Producers Dairy with Hopalong Cassidy, who, for the benefit of younger generations, was a well-known and respected fictional cowboy who was also just called “Hoppy” in TV shows that ran in the 1950s and 1960s. This helped build up Producers Dairy’s market of its Class 1 products by marketing and creating brand recognition of our products with efforts such as putting photos of Hoppy on Producers Dairy’s milk containers and trucks, distributing product coupons available at grocery stores to attend Hoppy’s Saturday matinees, and creating a Producers Dairy radio jingle that ran on local stations. All these efforts helped develop Producers Dairy’s Class 1 sales. These unique efforts really encouraged people to not only think positively about Class 1 milk and drink it but to also look for Producers Dairy products in the stores where they shopped. I have included Exhibit A to my testimony a picture of our early advertisements with Hoppy and a picture of my father with one of our Hoppy branded delivery trucks.

In 1957, my father decided he could better control milk quality and help when supplies were tight by having his own dairy farm. As a result, he built our first dairy cow milking operation, which he named “Bar 20 Dairy” after Hoppy’s ranch. Over the years, our family continued to invest and expand our Bar 20 Dairy cow milking operations to continue to control the quality of the milk that goes into Producers Dairy products.

Operating a vertically integrated business allows us to protect the quality of our product and, in turn, the quality of our brand. Bar 20 Dairy's operations have been key and fundamental to Producers Dairy's reputation of providing some of the highest-quality milk available in the market. Our first dairy farm included a glass viewing room to accommodate busloads of school children taking field trips there. We have connected our brand equity to Bar 20 Dairy's farm operations by our unwavering commitment to "healthy, happier cows" on our farms and exceptional milk quality. We are Validus certified for our farm practices and animal welfare. Attached as Exhibit F is an explanation of this certification.

We pride ourselves on operating an efficient plant, distribution system, and supply chain. We understand that price is a critical component to our business, and we work hard to control and manage our operating costs. We reinvest in assets and technology to remain as efficient and as lean as possible in our operations. But we have a great deal of urban market customers (in deficit areas), and we have to absorb the cost of shipping to those markets. We do not and will not receive any transportation funds for delivering to these deficit areas. The net impact is that it saves the pool money and this is a regulatory disadvantage to us as compared to our competitors.

Our customers appreciate our family-owned status, our high-quality products (including our ability to affect and ensure quality all the way from our farm to our customers), our focus on customer satisfaction, the strength of our brands, our knowledge of the industry and farms, our reinvestment into the future, our philosophy and direction as a business, our control over our supply chain. These are the factors that we utilize to secure our customer base and compete against other fluid processors.

### **Personal Background**

For more than 50 years I have been involved in our family dairy business. I have done everything in our operations from running tractors, milking cows, and holding various leadership roles. I received my Bachelor of Science degree in Business Administration from Fresno State College in 1965. I am currently on the board of Dairy Council of California (30 years), California Milk Processor Board (a founding director, and board member for 22 years), the local California Milk Advisory Board (District 8 committee) (15 years), and the Milk Industry Foundation, a member organization of the International Dairy Foods Association (25 years and past secretary). I have been a member of the Holstein Association for more than 40 years. I also sit on numerous local community and non-profit boards.

I have previously been appointed and served on the California Department of Food and Agriculture ("CDFA") Quota Review Committee. That committee was tasked with reviewing the Quota system and whether any feasible options existed to reasonably end it. The analysis done included an evaluation of quota which was found to be worth over \$1 billion dollars in value. The committee evaluated various options but concluded that the cost to buyout all of the allocated quota and the potential impact to the pool was too great; therefore, no further action was taken.

### **California Producer Handlers Association**

Today, I present this testimony on behalf of not only Producers Dairy but also the three other exempt quota holders. The CPHA is made up of: (1) Foster Dairy Farms, Inc.; (2) Hollandia Dairy, Inc.; (3) Producers Dairy Foods, Inc.; and (4) Rockview Dairies, Inc. Their farms own exempt quota, also known as “Option 70” producer-handlers. Option 70 producer-handlers are **fully regulated**, reporting to the pool for their Class 1 sales.<sup>1</sup>

One CPHA member is located in Fresno County, and one is located in Stanislaus County. The other two CPHA members are located in southern California (San Diego County and San Bernardino County), which are deficit areas of milk production where it is increasingly more difficult to maintain milk supply and dairy operations. These four members of the CPHA are California’s final exempt quota holders (out of the original 49), and we seek to preserve our asset along with preservation of the rest of the quota system.

### **Gonsalves Milk Pooling Act – Exempt Quota**

When the Gonsalves Milk Pooling Act was enacted in 1967, Producers Dairy had already been operating for many years both its own dairy farm and processing plant, as well as carrying its own marketing efforts in building up demand for its Class 1 products.

During those years that preceded the Gonsalves Milk Pooling Act, the California milk industry was otherwise in a state of upheaval and turmoil as extreme competition for Class 1 contracts existed among other producers. The Gonsalves Milk Pooling Act was primarily created to address industry problems that did not affect producer-handlers because all the milk from our dairy operations flowed to a dedicated Class 1 plant. Legislators fashioned the California quota system under the Gonsalves Milk Pooling Act to provide for exempt quota in consideration and recognition of a producer-handler’s unique structure in creating its own Class 1 market.

Through legislation, producers and producer-handlers were allocated quota and exempt quota, both assets that over the last 50 years have become a valuable part of our business operations. Producers were issued regular quota that was assigned based on their historical production of raw milk that was sold to Class 1 handlers. Producer-handlers were likewise issued exempt quota for the historical production and sale of Class 1 milk. The producers were also assigned a base production volume, and anything produced beyond the base and quota assignments was paid as overbase production. CPHA farms hold exempt quota, regular quota, and assignments for base. The majority of the milk produced by CPHA members is paid as overbase production. All of this milk and all handler sales are reported to the pool, including those volumes covered by exempt quota. Exempt quota is treated as a deduction from (or credit to) the pool. I have included as Exhibit B to my testimony a document issued by the Dairy Marketing Branch of the California Department of Food and Agriculture that more fully discusses the policy considerations that ultimately lead to the existing quota system in California.

Exempt quota can be converted to regular quota through relinquishment of exemption treatment (by notifying CDFA), through the sale of the quota to another producer, through the

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<sup>1</sup> In contrast, “Option 66” producer-handlers are fully exempted from the pool for their entire production and do not participate in the quota system. CPHA members are not Option 66 producer-handlers.

sunsetting of the consanguinity requirements, or by falling out of compliance with the legislative limitations. If exempt quota is converted to regular quota, it is then entitled to the regular quota premium payments. So just as the farm side of our business (Bar 20 Dairy) holds the exempt quota value, it cannot receive other benefits from the pool.

### **Quota Is a Producer, Not a Handler, Benefit**

Producer-handlers operate two separate and distinct business units: Bar 20 Dairy is our farm that is a standalone separate business entity that produces the milk, and Producers Dairy is our processing plant that is a separate distinct business entity that processes the raw milk into a consumer product. They are separate legal entities and we operate them as separate business units, with separate financial books. As with regular quota, Bar 20 Dairy, our producer side of the business, receives all of the value and benefit for exempt quota. Exempt quota is an asset for Bar 20 Dairy. It is a transferrable asset that holds accounting book value, and one to which Bar 20 Dairy assigns an asset value on its balance sheet.

The California State Order regulates and audits the handler side of producer-handlers, and Option 70 producer-handlers are fully accountable to the pool in the California State Order system. Each of the CPHA members reports to the CDFA for all of the product that is processed by our handler arm of the business through the monthly CDFA 800 Report. The exempt quota is a deduction from (or credit to) the pool as a benefit to our dairy farms. **Since the inception of the quota system in California, Producers Dairy pays Bar 20 Dairy the Class 1 price for the milk received up to the amount of the exempt quota.** The plant doesn't care where they buy their milk from as long as its quality milk. It costs the same whether they buy it from our farm, as exempt quota milk, or whether they buy it from CDI. Bar 20 Dairy receives the full benefit of the exempt quota value; other milk received from Bar 20 Dairy is paid at pool prices. Approximately two-thirds of the milk we receive from Bar 20 Dairy is paid at overbase price. Proposal Number 3 preserves the quota system intact, allowing the quota benefit to the dairy farms who hold it to continue to preserve the investment they have made into that asset.

As an Option 70 producer-handler, Producers Dairy has never used the benefits from holding exempt quota to undercut or bid for fluid milk contracts with customers because **it does not have it to give**. It is critically important for me to communicate that the plant side of our business (Producers Dairy) does not receive a price advantage from our exempt quota, as **the plant does not have it to give**. Producers Dairy pays the Class 1 price to Bar 20 Dairy, and Bar 20 Dairy receives the full benefit of the exempt quota. Producers Dairy includes the Class 1 prices in the cost of production for our fluid milk, and it competes in the marketplace to sell our fluid products with customer service, with branding recognition, and based on the efficiencies we can build into our plant and distribution systems. We operate on a level playing field with all of the other handlers in the industry. Our exempt quota has **never** given Producers Dairy a competitive advantage over other handlers, as it is a benefit held by Bar 20 Dairy and the two are operated as separate business units.

Scott Hofferber with Farmdale Creamery testified about a hypothetical situation in which a producer-handler could use the financial benefit from having exempt quota and using that to secure customers and displace other handlers. Other handlers testified that they worry that the

CPHA has used its exempt quota price advantage to undercut bids or secure customer bids. This has never been the case with Option 70 producer-handlers. No Option 70 producer-handler has ever used their exempt quota to win any customer account.

Simply put, the suggestion that CPHA members use their exempt quota to secure customer bids is not based in reality. Any sales we have won were not attributed to our exempt quota holdings because that benefit goes entirely to the farm operations. Any sales that we have gained is because of our hard work, quality product, and customer service. Price is always a factor in any competitive arena, and we work hard to ensure that we build in efficiencies to our business. We offer our customers a high-quality product with impeccable customer service. We have control over the quality of our product, from the farm through to the final product that is sold to our customers. We have invested in modern technology, and we control our costs 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 customer business; it is not exempt quota and never has been because the benefit goes to the farming operations. As Producer Dairy's mission statement has stated for over twenty years is "To produce the highest quality products at the lowest cost per unit while meeting customer expectations every time."

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#### **Producers Dairy – Exempt Quota Impact/Meaning**

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~~Producers~~ Dairy was initially issued exempt quota in 1969 and later purchased quota that was allowed to be converted to be exempt quota under the last 1993 amendment to the Gonsalves Milk Pooling Act. Over the years, we have invested millions of dollars to acquire additional quota. However, since the 1993 amendments, as of March 1994 we, along with all of the other Option 70 producer-handlers, have not been allowed to expand or grow the amount of exempt quota that we hold. As a result, the exempt quota we have had since 1994 has remained fixed without the possibility to ever increase the exempt quota volumes. I have included as Exhibit C to my testimony a redacted version of Bar 20 Dairy ~~Dairy's~~ Exempt Quota History.

Exempt quota is a valuable asset owned by Bar 20 Dairy. In addition to exempt quota, Bar 20 Dairy also owns regular quota. We agree with Dr. Erba and Lon Hatamiya that quota has a value that is both measurable and immeasurable, as noted in Exhibit 42 and 54, respectively. Regular quota has a twofold value: (1) the value that comes from the premium pricing received for Class 1 milk production; and (2) the value that can be had as a transferrable asset in buying or selling regular quota. Exempt quota not only holds the values of regular quota, but also has an additional value in that the value of that volume of milk is deducted from the pool. The measure of the exempt quota value for our farm is the difference between Class 1 and quota prices that the farm would receive if it were paid from the pool.

#### **Quota and Exempt Quota Required Investments to Acquire**

Producers and producer-handlers incurred a cost in acquiring their respective quotas within the quota system. The original assignment was based on the historical production of milk used for Class 1 milk sales; so the investment came in the form of creating markets for the milk or the buyer relationships for that milk with the processor of that milk.

As the quota system evolved with the 1978 and 1993 amendments to the Gonsalves Milk Pooling Act, regular quota and exempt quota were assigned to producers and producer-handlers relative to their additional production and sales volumes reflecting additional market expansion of Class 1 sales. Producer-handlers were also allowed to acquire exempt quota by purchasing it through legislative allowances that were ultimately capped in 1994. Bar 20 Dairy invested millions of dollars in acquiring exempt quota. The CPHA <sup>have</sup> collectively invested an additional \$9,298,677.84 to acquire this exempt quota. <sup>March 1995</sup> <sup>dairy farms of the</sup>

Preservation of exempt quota also requires compliance with ongoing business structural limitations. In order to maintain exempt quota treatment, the producer and handler business units must be over 95% common ownership as compared to the original issuance of the exempt quota in 1969. Because of the original ownership requirement for exempt quota holders that is benchmarked against the original issuance of quota, we have been prohibited from selling any part of our business – either the farm or plant side of our business. Knowing that we had to keep our business units intact to preserve our exempt quota treatment, we instead have made strategic business decisions both at the farm and the plant in order to ensure that the business units stay within the original 95% ownership requirements. All of these have been investments into obtaining, maintaining, and preserving our asset: exempt quota.

### **Quota System Is Integral to Operations**

Exempt quota has essentially allowed us to maintain the business structure that my father had already created when the Gonsalves Milk Pooling Act was enacted. It has allowed us to continue to not only exist but survive in an increasingly competitive industry that has consolidated significantly since the 1960s.

When Producers Dairy began, there were numerous producer-handlers in the Central Valley of California, but today we are one of the few remaining in the Valley. When the Gonsalves Milk Pooling Act was originally enacted in 1967, there were 49 producer-handlers in California, but today there are only four. Each of the four remaining producer-handlers is an independent, family-owned, and privately held company, which is rare in today's dairy industry landscape that is otherwise composed of large corporate conglomerates and grocery-owned captives. If the exempt quota holders held such a price advantage, you would not have seen such a decline in these numbers for the forty-five that are not here today; farmers do not usually go out of business because they are making too much money.

In evaluating whether to adopt a Federal Milk Marketing Order in California, Congress tasked the Secretary with recognizing quota value. 7 U.S.C. § 7253(a)(2) ("California shall have the right to re-blend and distribute order receipts to recognize quota value."). The Joint Explanatory Statement of the Committee of Conference reiterated the intent behind preserving the quota value, which meant recognizing the quota system:

The managers intend for the Secretary to conduct a hearing prior to the issuance of an order designating the State of California as a FMMO. The provision provides the Secretary of Agriculture with

the discretion, if a California FMMO is requested, to recognize the longstanding California quota system.

The only way by which to “recognize the longstanding California quota system” is to preserve the value of both regular quota and exempt quota together as they were both granted at the quota system’s inception. The inception of the quota system granted to both regular producers the value of regular quota, and granted to Option 70 producer-handlers the right to hold exempt quota. The value of quota for Option 70 producer-handlers is found only in their exempt quota, and if exempt quota were not adopted as part of the quota system, it would diminish the CPHA’s quota value.

*dairy farms*

The California Food and Agricultural Code has long since provided that exempt quota value would not be diminished, and we (Option 70 producer-handlers) as an ongoing business operation have relied on that protection to continue to invest in the structure and business model that will allow us to preserve our exempt quota. Cal. Agric. Code § 62716(e) (“All pool quotas initially determined pursuant to Section 62707 shall be recognized and shall not in any way be diminished.”); § 62707 (“There shall be no downward adjustment of pool quota below the quota initially established pursuant to this chapter.”).

As noted in the CPHA additional proposal, the producer-handlers quota exemption is relatively insignificant in terms of overall production in California. In July 2015, as reported by the CDFA, only 0.65% of total pooled milk fell under the exempt quota.

To look at the exempt quota through all perspectives based on the CDFA data, today exempt quota can be viewed as follows:

- 0.65% of the total pooled milk in California (note that exempt quota is calculated in the total pool and then deducted)
- 2.6% of quota (a 10% drop since 2007)
- 4.6% of the total Class 1 pooled
- 17.4% of the CPHA Class 1 production (compared to 1985 when exempt quota made up 66% of CPHA members’ Class 1)

These numbers reveal that the exempt quota as a percentage of the pool Class 1 production and even as a percentage of the CPHA Class 1 production is shrinking as the years go by.

Over the years, many of the other 45 producer-handlers have relinquished the benefit of their exempt quota in order to make changes to their business structure or to sell the quota (as regular quota) to liquefy their asset. Exempt quota holders have declined more than 91% since the enactment of the Gonsalves Milk Pooling Act, with 49 exempt quota holders in 1969, 27 in 1975, but only four today.



As the number of the exempt quota holders have decreased, so has the producer-handlers percentage of Class 1 sales. Between 1985 and today, the exempt quota holders percentage of our total Class 1 sales has decreased from 66% to 17.4% since 1985, a 48.5% decrease in 30 years.

I have included as Exhibit D to my testimony a document entitled “Key CA Milk Market Facts Regarding Producer-Handlers,” which shows the decline of Producer-Handler production during various periods between 1969 to 2009. Exhibits E are the Class 1 prices that we used to calculate the average over the last 20 years.

### **California Exempt Quota Is Not the Same as Federal Order Producer-Handlers Exemptions**

Exempt quota is not the same as the federal order producer-handlers exemptions that were addressed with the 2010 Final Rule from the USDA Agricultural Marketing Service. The quota system is a benefit (asset) held by a producer, and it was the compensation and recognition given to the producers for creating a Class 1 market: regular quota was assigned to producers, and exempt quota was assigned to producer-handlers. This is a legislative grant of an asset to producers and producer-handlers who had created the Class 1 market.

The exempt quota is a booked asset for the producer business units, not the handler side of the business, and the financial value for the exempt quota is held by the producer. The handler side of our business is fully regulated and reports all sales to the pool. Exempt quota is treated as a deduction from (or credit to) the pool. Exempt quota is a finite amount that cannot be expanded or sold. The CPHA members cannot sell their business or transfer it to anyone outside of the original ownership family line. The exempt quota will eventually cease to exist once the generational transfers have been met, and the exempt quota will then be converted to regular quota.

Federal order producer-handlers, on the other hand, were operationally and factually different from California exempt quota holders.<sup>2</sup> In the federal order system, producer-handlers used to be fully exempted from the pool. This was a benefit to the handler side of the business, as there was no pool obligation for producer-handlers. There was no financial investment required to obtain their exemption benefit, and they did not have any asset value for their exemption rights, which the California quota system offers. Producer-handlers could sell their businesses, as long as the joint ownership requirements were met. They did not have any legislative rights to a transferrable asset with book value. The exemption did not expire or sunset with the tables of consanguinity as is the case with the CPHA. The sky was the limit and their exemption was unlimited as to scope, time, volume, and potential. There was tangible evidence revealing that they had created disorder in the markets by their unlimited growth and market penetration.

As explained by Dr. Erba and Mr. Hatamiya, all of the justifications for preserving quota also apply to preserving exempt quota. Indeed, if the Secretary is going to preserve the quota

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<sup>2</sup> California producer-handlers known as “Option 66” producer-handlers are more akin to the federal order producer-handlers, in that they are fully exempt from the pool. Exempt quota holders, known as “Option 70” producer-handlers, are regulated and report to the pool.

system, he logically must include both regular and exempt quota. The Cooperatives have presented no evidence of disorderly market conditions created by the exempt quota, and the Dairy Institute of California has repeatedly stated that there are no disorderly market conditions in California.

At most, some handlers have alleged perceived competitive concerns that have never materialized into any actual evidence ("paranoia" as one handler described it). Preserving exempt quota does not present a risk of disorderly market conditions that were present in the federal order producer-handlers hearings. Indeed, 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. This is a further acknowledgement that the quota system, including the exempt quota, presents no significant disruption to the market.

### Financial Impact Analysis

As the USDA economic analysis noted, there is essentially no economic impact or change from baseline if exempt quota is preserved. This makes sense given that preserving the exempt quota simply preserves the status quo of what has existed under the California State Order system since the inception of the Gonsalves Milk Pooling Act. Further, if exempt quota were to be eliminated, the net effect on the pool would be minimal, if any, for other producers. The exempt quota would be converted to regular quota, so it would be paid at a premium and also qualify for transportation allowances. Based on our calculations and confirmed in Dr. Erba's testimony, this would result in +/- \$0.01/~~lb~~ for the pool.

If the Cooperative's proposal were adopted and exempt quota were not preserved, presumably the exempt quota would be converted to regular quota. CPHA would receive quota premium prices for its Class 1 milk (Class I). Over the last twenty years, the difference between the Class 1 price and the quota price has averaged \$1.14/cwt. By converting the exempt quota to regular quota, the CPHA would then be entitled to transportation allowances to which they are currently not entitled. In effect, the CPHA farms would lose a significant value that they obtained through investment and organizational structural preservation in return for a near zero benefit to the pool. There is no financial explanation for eliminating exempt quota; there is only a financial justification to preserve exempt quota for its holders who have invested millions in obtaining and preserving those assets.

### CPHA Proposal

The CPHA Proposal Number 3 seeks to supplement the Cooperative's Proposal Number 1 by preserving the treatment for exempt quota as part of a California Federal Milk Marketing Order that attempts to preserve the quota system "intact."

CPHA proposes to provide for an express definition of exempt quota in § 1051.17 by ensuring the value and calculations contained in the California Food and Agricultural Code §§ 62708, 62708.1, 62708.5, and 62722 are preserved. CPHA then proposes to modify the Cooperative's proposal in § 1051.60, to allow for a deduction of exempt quota volumes prior to

making any pool calculation payments for quota premium payments. CPHA believes that making these changes, along with any other changes the USDA deems necessary to effect preservation of exempt quota, will preserve the exempt quota along with the regular quota, for a collective preservation of the quota value and the California quota system.

Based on my discussions with representatives of the Cooperative's proposal, we believe that the Cooperative will not oppose preservation of the exempt quota along with preservation of the quota system.

### **Conclusion**

In conclusion, any California Federal Milk Marketing Order that recognizes a quota system must also recognize the California quota system as a whole, including exempt quota for the state's exempt quota holders *and family run.*

Exempt quota has been part of the Gonsalves Milk Pooling Act from the start and must be part of any quota system going forward. All of the justifications for preserving regular quota equally apply to preserving exempt quota as well. Exempt quota is critical for the last independent, family-owned producer-handlers that remain in the California dairy industry – not only family-owned but also family-invested.

Thank you for your time and attention in consideration of this testimony given.