UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

Re: Proposal to Establish a Federal Milk Marketing Order for California

Docket No. AO–15–0071; AMS–DA–14–0095

Hearing in Fresno, California,

September – November 2015

Post-Hearing Brief for Hilmar Cheese Company

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Hilmar Cheese Company (HCC), owned by dairy farmers, is the largest cheddar cheese manufacturing company in California. At its California facilities, HCC also operates a whey plant that makes concentrated whey products and dry lactose. HCC recently began operating a new skim milk powder plant in California.

HCC appeared and participated in the 9-week hearing in Fresno by authorized representatives, employees, and witnesses. The hearing was called by USDA to consider a proposal by three cooperative associations to create a federal California Milk Marketing Order. The proposed order would replace minimum classified milk price regulation by the California Department of Food and Agriculture (CDFA), which has controlled producer milk prices in California since the mid-1930's.

HCC is a member of the Dairy Institute of California, a trade association that also appeared in the Fresno hearing, and which offered alternative proposals for consideration if USDA determines that federal regulatory intervention is merited.

In their proposal to USDA, and in the course of hearing, the cooperatives explained that their primary objective in seeking federal milk price regulatory intervention was to increase minimum prices that must be paid for raw milk by dairy products manufacturers – particularly cheese plants. This post-hearing brief is limited to the merits of federal intervention, and cooperatives' proposal to raise Class III (cheese use) and Class IV (butter and powder use) milk prices, in a California Marketing Area, to the current level of Class III and IV prices in federally-regulated marketing areas elsewhere. As shown below, the cooperatives' proposal is untenable because it does not conform to AMAA standards and would result in negative returns on investment for California manufacturers of Class III and IV products.

I. Background for the Proposed California Federal Milk Marketing Order

Over 80 years ago, the Supreme Court held that the government may lawfully regulate milk prices, subject to constitutional constraints applicable to all forms of price control. *Nebbia v New York,* 291 U.S. 502 (1934). Since that time, USDA has regulated minimum prices that manufacturers and distributors must pay to producers (dairy farmers) in individual marketing areas throughout much of the nation. The California Department of Food and Agriculture (CDFA) has similarly regulated minimum producer milk prices for in-state transactions.

USDA-regulated prices are subject to a statutory standard of reasonableness based on "supply and demand for milk and its products in the marketing area to which" the price control regulations apply. 7 U.S.C. § 608c(18). CDFA-regulated milk prices, similarly, must be reasonable in relation to supply and demand for milk and dairy products. Ca. Food & Ag. Code, § 62062.

In 1999, USDA completed reform of its Federal Milk Marketing Order ("FMMO") price regulations applicable to eleven regional markets. 64 Fed. Reg. 16206 (Apr. 2, 1999). The resulting price formulas were based on comprehensive examination of supply and demand for milk and its products during 1995 - 1998 in each of the eleven markets, as required by § 608c(18). Regulated prices for milk used in Class III and IV manufactured products (cheese, powder (i.e., NFDM (nonfat dry milk)), and butter) were based on monthly national average commodity values for finished products, minus a make allowance (manufacturing costs and a return on investment). California retained its state system of milk price controls, which continued use of similar product price formulas for milk used to make cheese (class 4b) and butter/powder (class 4a), based on product prices, manufacturing costs, and sound economic relationship with national milk product values. Food & Ag. Code, §§ 62062 and 62071. These CDFA prices have been lower than corresponding Class III and IV prices in the federal system.

Milk and Dairy Product production in California has grown with exuberance during most of the past two decades. From 1998 to 2014, California's annual milk production nearly doubled from 22.61 to 42.34 billion pounds, now representing over

20% of the nation's milk supply. Much of the added milk was used in cheese production, which also nearly doubled to 2.4 billion pounds in 2014, 21% of U.S. cheese production. There has been an increasing spread between product values in California and in the FMMO-regulated markets, and a corresponding increased spread between California and FMMO regulated prices for milk used to produce manufactured products, particularly cheese.

During the past few years, however, California milk producers have been financially stressed by drought, high feed and production costs, relatively low milk prices, and competing land use pressures. Milk production has declined in 2015, and some producers have exited dairy farming. These events, understandably, have been perceived as threat to California's dairy industry.

In response, California's three largest dairy farm cooperatives, Dairy Farmers of America, Land O'Lakes, and California Dairies ("Cooperatives"), have requested USDA to bring FMMO regulation to California. The proposal seeks to increase regulated farm milk blend prices by adopting, for use in California, the "pricing grid" for federally-regulated markets that resulted from the 1996 – 1999 FMMO reform process.[1] The largest difference in the level of USDA versus CDFA regulated milk prices is the price for milk used to produce cheese.[2] The Cooperatives' proposal is conditioned upon: (1) achieving price enhancement by adoption of the FMMO pricing grid, and (2) retaining California's unique quota system for distribution of regulated milk revenues to producers.

The fact that many California milk producers have experienced periods of financial stress during the past several years is undisputed, and is overwhelmingly demonstrated in the 9-week Fresno hearing record. California's dairy industry is

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[1] Cooperatives claim that if FMMO regulations and the FMMO pricing grid had been in effect since 2010, California dairy farmers would have received $1.5 billion in increased blend price revenue. Hollon, Sept. 25 Tr pp. 796, 769-70, 797-98; Sept. 30 Tr pp. 1431-32, Oct. 8 Tr pp. 2724 - 27. February 3, 2015, Proposal for a California Milk Order, pp. 2. 6.

[2] Hollon, Sept. 25 Tr pp. 834-36; Feb. 3, 2015 Proposal at 6.

experiencing the kind of stress which producers in other regions often experienced during California's rapid expansion of milk and dairy products production.

Dairy product manufacturers are, of course, dependent upon dairy farmers for raw milk to make their products. Manufacturers have an interest in the financial well-being of milk producers.

The Cooperatives' 2015 proposal to raise regulated prices for milk used to produce cheese, milk powder and butter in California, by adoption of the 1999 FMMO "pricing grid," however, would result in negative returns on investment to California dairy products manufacturers. The proposal therefore fails critical tests of consistency with: (1) USDA FMMO policy and precedent, (2) federal statutory requirements, (3) rational economics, and (4) federal constitutional law applied by *Nebbia* and its progeny – requiring the opportunity for a reasonable return on investment where the government undertakes to regulate prices. The proposal should therefore be denied, leaving in place the existing California state milk pricing authority to address California's dairy industry challenges.

II. Proponents of a Federal FMMO for California Have the Burden of Proof, and Have Failed to Meet That Burden.

The Notice of Hearing explained that this proceeding "is governed by the provisions of Sections 556 and 557 of Title 5 of the United States Code." 80 Fed. Reg. 47210 (Aug. 6, 2015). Section 556(d) places the burden of proof on proponents of a California Federal Milk Marketing Order.[3] This means that the Cooperative Proponents have the obligation to present persuasive facts in support of their petition to USDA, and each part of their proposal.[4] For milk price regulation, like other forms

[3] "Except as otherwise provided by statute, the proponent of a rule or order has the burden of proof." 5 U.S.C. § 556(d). The relevant statute, the Agricultural Marketing Agreement Act of 1937, as amended, 7 U.S.C. §601, et seq., does not otherwise provide.

[4] *Director, Office of Workers' Compensation Programs v. Greenwich Collieries*, 512 US 267, 275-76 (1994); *Minnesota Milk Producers Ass'n v. Glickman*, 153 F. 3d 632, 642 (8th Cir. 1998).

of price control, the agency may reasonably expect proponents to present "their best economic case to the price-setting agency."[5]

Proponents' primary objective is simple producer milk price enhancement, which USDA has consistently rejected as a reason for FMMO regulatory intervention.[6] Agency adherence to this policy is sufficient to put this matter to rest without addressing other issues.

In support of proposed higher regulated prices in California, for milk used to make Class III and IV products, proponent cooperatives did not reveal market prices they paid or charged for milk in these uses, nor did they reveal prices for which they have sold the cheese, powder and butter they produced in California, which is relevant to the California value of milk derived from product prices. The cooperatives' proposal asserts that the California price for milk used to make cheese should be the same as the Federal Class III price. But a 2013 economic study prepared for the cooperatives by respected dairy economists Mark Stephenson and Chuck Nicholson, which cooperatives withheld from disclosure in this FMMO proceeding, revealed that the "California price for milk used for cheese ought to be 70 cents less than the Federal prices."[7]

In short, proponent cooperatives have utterly failed to meet their burden of proof to present a persuasive case that the California price for milk used for cheese

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[5] *Tenoco Oil Co. v. Dept. of Consumer Affairs*, 876 F. 2d 1013, 1027-28 (1st Cir. 1989) (gasoline wholesale price regulation). A corollary of the burden of proof. requiring price control proponents to present their "best economic case" for a particular price or price formula, is that failure to produce relevant evidence in proponents' control allows the decision-maker to infer that the evidence, if presented, would be adverse to proponents' case. See analysis of law in Ex. 78, Memorandum on Negative Inference of Failure to Introduce Relevant Evidence.

[6] The AMAA of 1937, amending the AAA of 1935, "turned the program to dealing with the problems associated with the inherent instability in milk marketing rather than the severe income problems that arose with the depression." AMS, USDA *The Federal Milk Marketing Order Program*, p. 8, Reproduced in Ex. 112, Part A. See also Ex. 112 part B, USDA letters denying requests to raise FMMO prices to deal with producer income distress from drought, high feed costs, and other factors. These letters repeatedly reaffirm that "The FMMO Program is a marketing tool. not a price support program"

[7] Erba, Oct. 5 Tr pp. 2131-32.

ought to be the same as current Federal Class III prices. As demonstrated below, the same conclusion applies to the cooperatives' Class IV pricing proposal.

III. Proposed Findings of Fact

The Hearing Notice admonition that this proceeding "is governed by the provisions of Sections 556 and 557 of Title 5 of the United States Code" incorporates authority for party submission of proposed findings of fact and conclusions of law, and requirements for rulings by the agency on "each" proposed finding and conclusion. 5 U.S.C. §557(c).

The following proposed findings relate to the cooperatives' proposal to adopt, for California milk used to produce cheese, milk powder and butter, the same regulated Class III and IV prices currently used in FMMO markets.

A. The value of milk and dairy products, like any commodity, varies by location. This is a function of supply, demand, and transportation costs.

1. The interaction of supply, demand, and transportation costs to produce geographically variable commodity prices is simple to understand. It explains why fresh seafood is more expensive inland, why grapefruit is dearer in Ithaca than Miami, why apples are higher priced in Miami than Oregon or New Hampshire, and milk is more valuable in the Southeast than the Upper Midwest. [8]

2. It has long been acknowledged in FMMO pricing rules that the value of milk varies by location. The difference in value from one location to another is a function of supply, demand, and transportation costs.[9] Federal Class I milk prices expressly incorporate these variable location values.

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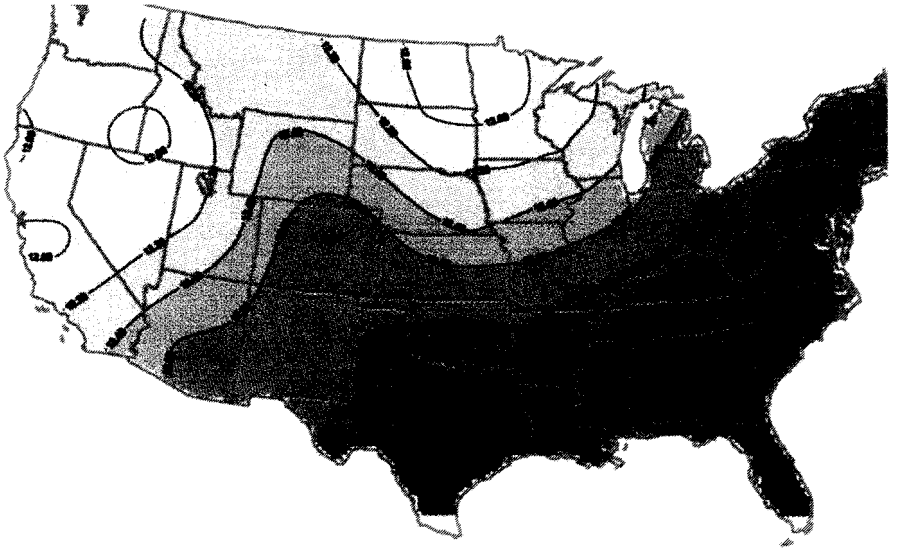
[8] Bishop, Phillip M., et al. *Normative Estimates of Class 1 Prices Across US Milk Markets.* Department of Agricultural, Resource, and Managerial Economics, College of Agriculture and Life Sciences, Cornell University, 1998, ("*Cornell Normative Class I Prices*") p. 1-2, http://ageconsearch.umn.edu/bitstream/122691/2/Cornell_Dyson_rb9805.pdf ; Pratt, James E., et al. *US Dairy Sector Simulator: A Spatially Disaggregated Model of the US Dairy Industry.* No. 121192. Cornell University, Department of Applied Economics and Management, 1996 ("USDSS 1996"). http://dairy.wisc.edu/pubPod/pubs/SP9606.pdf

[9] *Schepps Dairy, Inc. v. Bergland*, 628 F. 2d 11, 15-16 (DC Cir., 1979); AMS, USDA, *The Federal Milk Marketing Order Program* (1989) ("AMS, FMMO Program") (Ex. 112 – A), pp. 6, 24-25.

3. Milk for manufacturing (Class III and IV) in FMMO markets has been priced uniformly at surveyed or derived values in low cost, high production areas such as the Upper Midwest.[10] But the value of milk used for manufactured products is also variable by location. [11]

4. The Cornell U.S. Dairy Sector Simulator (USDSS) estimates US geographic price surfaces for milk in various uses by assembling information on supply, demand, and transportation in the most efficient manner possible to produce relative differences in milk value at various locations. The 1996 USDSS report revealed a price surface with lowest 1993 values of milk for cheese use in the Upper Midwest and California – Pacific Northwest, and lowest price surface values in California for milk in butter and NFDM. The 1993 milk cheese use price surface looked like this: [12]



Simulated Class III Price of Standardized Milk at Cheese Plants, $/cwt.
Based on 1993 Annual Data
PRELIMINARY

[10] AMS, FMMO Program at 22-23, describing the Class III Minnesota-Wisconsin ("M-W") price based on manufacturing grade milk values. The 1999 FMMO Reform replacement formula for Class III and IV prices was found to correlate very favorably to previously employed M-W and BFP Class III price formulas. 64 Fed. Reg. at 16040.

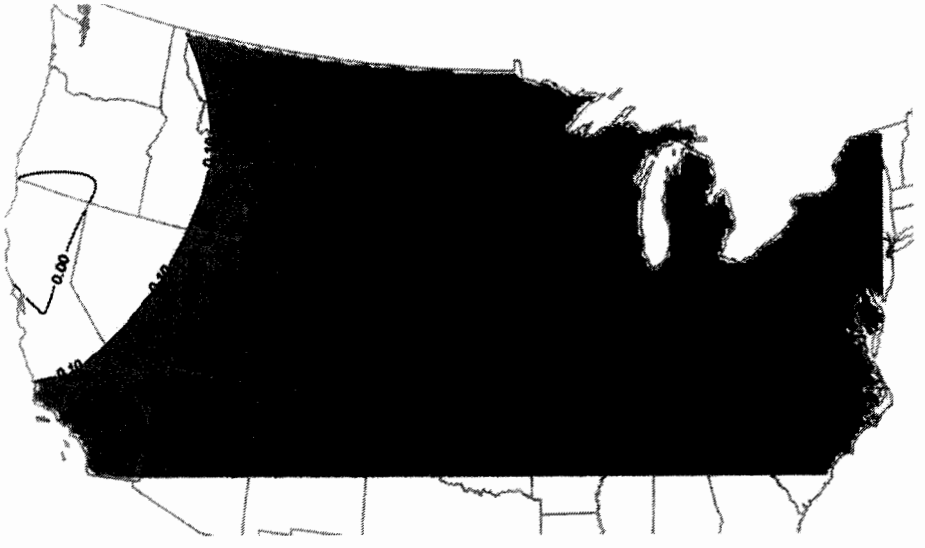
[11] Shiek, Ex. 79, pp 27-28; Stephenson, Ex. 133.

[12] USDSS (n. 7) pp. A10-A11, and *Cornell Normative Class I Prices*, (n. 7) pp. 1-2, 20-23, 39-43; Ex. 127 p. 6. The USDSS study was expressly employed by USDA in its FMMO reform decisions. 63 Fed. Reg. 4801, 4903-04 (Jan. 30, 1998) (Recommended Decision); 64 Fed. Reg. 16026, 16307 (Apr. 2, 1999) (Final Decision).

5. Later USDSS observations for May 1995 reveal a somewhat greater spread of about $0.30/cwt in the value of milk for cheese in the Upper Midwest compared to central California.[13]

6. The West's share of US cheese production has increased dramatically since these 1993 and 1995 observations. In 1993, California produced 848 million pounds of cheese, 13% of total US production of 6,528 million pounds. In 2014, California produced 2,444 million pounds of cheese, 21% of US Cheese production of 11,450 million pounds. Other western states have also increased their share of US cheese production during this 21-year interval. The 11 NASS "Western Region" states produced 26.6% of US cheese production in 1993. In 2014, the Western Region states produced 43% of total US cheese production.[14]

7. The difference in marginal value of milk at cheese plants between California and the Chicago region increased to $0.60/cwt in 2007, and to $0.70 in 2014, by USDSS analysis of most efficient movements.[15] The 2014 USDSS (most efficient) marginal value Class III milk price surface looks like this:



[13] Testimony of Mark Stephenson, Ex. 133, p. 6.

[14] NASS, Dairy Products 2014 Annual Summary (April 2015), p. 30; and NASS, Dairy Products 1994 Annual Summary (May 1995), p. 25. All NASS Dairy Products Annual Summaries are available at: http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1054

[15] Testimony of Mark Stephenson, Ex. 133, p. 7.

8. Bulk commodity cheese, however, is not marketed as efficiently as in USDSS program simulations. There are numerous marketers who make independent marketing decisions, not a single marketing czar, although each marketer may be presumed to maximize its own efficiency. Significantly, the USDSS model also assumes that cheese is marketed directly from cheese plant locations to 424 aggregated consumer demand locations.[16]

9. Most bulk commodity cheese in trucklot or carlot quantity is marketed by cheese plants to intermediary plants, "converters," which age, cut, shred, process, and wrap cheese for wholesale to supermarkets, warehouses, retail stores and institutional customers such as Kroger, Wal-Mart, Costco, and Sysco.[17] Thus, it is from intermediary converter locations that most cheese is supplied to consumer demand centers. Converter plant prices paid to cheese plants are adjusted for the cost of transportation to the plant, so that cheese from near or far arrives at the same cost.[18]

10. Sales of commodity cheddar cheese by plants to converters are captured in prices reported to AMS (formerly to NASS), which are aggregated in agency reports of average prices in the National Dairy Products Sales Report ("NDPSR").[19] The average NDPSR prices, in turn, are used to calculate monthly minimum FMMO regulated prices for milk (or milk components) used to make Class III (and other) milk products. [20]

11. The USDSS model does not capture transactions from cheese plant to converters as a marketing step before cheese is sent on to consumer demand locations.

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16 Testimony of Mark Stephenson, Ex. 133, p. 2; Nov. 4 Tr. pp, 6066-67.

17 Dryer, Oct. 23 Tr. pp 4299-4300; De Jong, Oct. 23 Tr. pp 4521-22, 4457-61; Stettler & Buholzer,Nov. 3 Tr. pp 5761-62; [etc]

18 Id.

19 De Jong, Oct. 23 Tr. pp 4456-67, 4461.

20 7 C.F.R. § § 1000.50(l) (butter price survey), 1000.50(m) (nonfat dry milk price survey), and § 1000.50(n) (cheese price survey).

This is an example of actual commercial practices that add costs not captured in the "most efficient" USDSS market simulation.[21]

12. There are relatively few large companies operating converter plants that receive bulk commodity American style cheese from cheese manufacturing plants. The major converters are: Pacific Cheese, Great Lakes Cheese, Schreiber, Sargento, Marathon, and Saputo. These companies operate converter plants in Nevada, Utah, Idaho, Texas, Wisconsin, Tennessee, Ohio, and Missouri. There is no large converter plant purchaser of commodity cheddar cheese in California.[22]

B. The commodity value of cheddar cheese is lower in California than in FMMO markets.

13. As predicted by the USDSS model, the observed market value of commodity cheddar cheese as surveyed and reported by USDA and CDFA varies from region to region. The lowest cheddar cheese market prices are observed at plants located in California and western states.

14. From March 1997 through March 2012, at the request of AMS, NASS surveyed and reported commodity cheddar cheese prices fob manufacturing plants. Prices were reported weekly in a "Cheddar Cheese Prices" report from March 1997 through September 1998, and in a weekly "Dairy Product Prices" report from October1998 through March 2012.[23] Since March 2012, dairy product prices have been reported by AMS in the weekly National Dairy Products Sales Report.[24]

15. The 1997 – 98 NASS weekly Cheddar Cheese Prices reported average prices for commodity cheddar 40 pound blocks in three regional price groups: (1) U.S. national, (2) Minnesota and Wisconsin, and (3) West, defined as California, Oregon,

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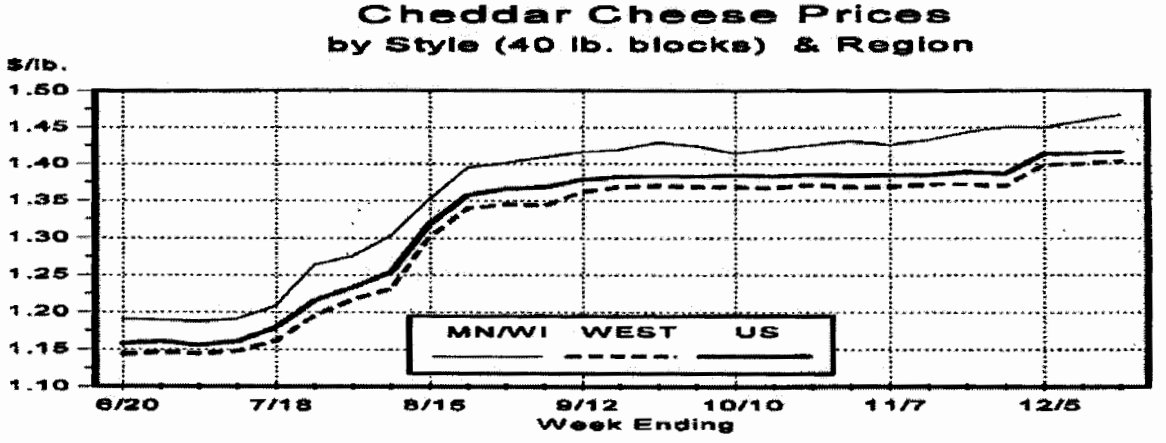
[21] Stephenson testimony, Nov. 4 Tr. pp 6066-67.

[22] De Jong, Oct. 23 Tr. pp 4521-22, 4457-61.

[23] NASS, USDA, *NASS Dairy Products Prices; How does that work?* published at http://www.nass.usda.gov/Data_and_Statistics/Dairy_Products_Mandatory_Program/NASS_Dairy%20Products_Prices_Disscussion.pdf . Dairy Product Prices reports are published at: http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1450 .

[24] The Weekly AMS Dairy Products Sales report is published online at: http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1845

Idaho and Washington. During the nineteen month period this report was published, it consistently revealed that cheddar cheese values were lower in the West Coast than the U.S. average, and higher in Minnesota and Wisconsin than the U.S. average.[25] This is illustrated by the graph published in the December 29, 1997, Cheddar Cheese Prices report, reproduced below:



These NASS-surveyed cheddar cheese prices were expressly considered by USDA in the course of FMMO reform: "At the time the proposed rule was published the NASS survey included prices for cheddar cheese only." 64 Fed. Reg. at 16093.

16. The 1997 – 98 Cheddar Cheese Prices reports do not reveal how cheddar sales volume or price was weighed among the four western states – California, Oregon, Idaho, and Washington. But the corresponding NASS Dairy Products report for 1997

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[25] The 1997 – 98 Cheddar Cheese Prices reports are not easily accessed online, but are available in .pdf format showing prices for March 1997 – December 1997, and in archived.txt format for December 1997 – September 1998 at the following locations (accessed March 15, 2016):

NASS Survey Cheddar Cheese Prices 1997

http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-05-23-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-06-27-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-08-01-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-09-05-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-10-10-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-12-19-1997.pdf
http://usda.mannlib.cornell.edu/usda/nass/ChedCheePr//1990s/1997/ChedCheePr-12-29-1997.pdf

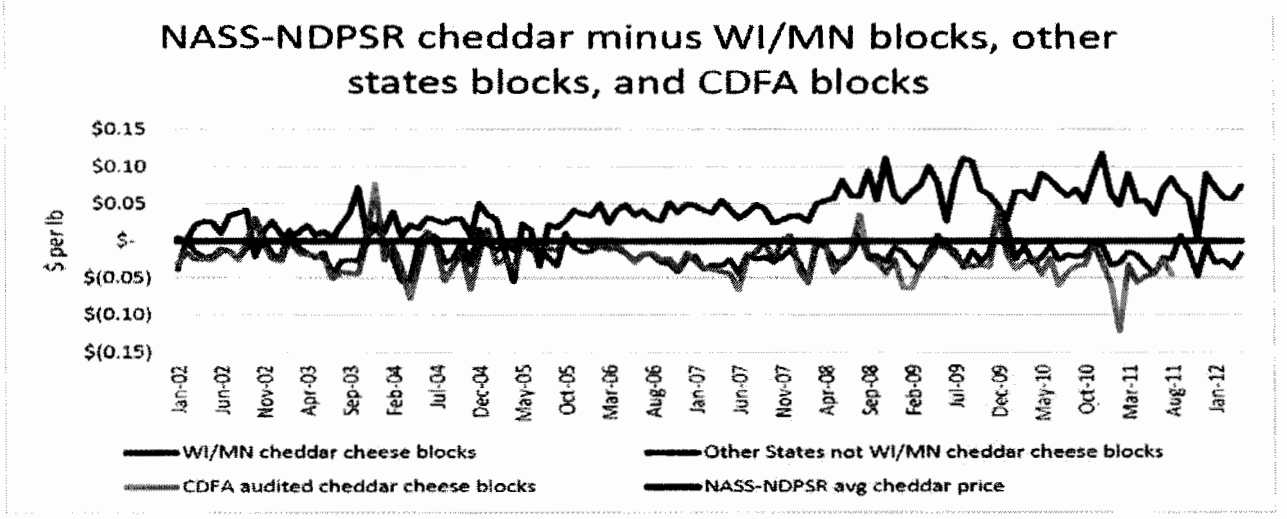
NASS Survey Cheddar Cheese Prices 1998

https://web.archive.org/web/20010927214152/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/ccpr012398.txt
https://web.archive.org/web/20010929213302/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/ccpr022098.txt
https://web.archive.org/web/20000920064456/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_03.20.98
https://web.archive.org/web/20000920064437/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_04.24.98
https://web.archive.org/web/20000920064416/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_05.29.98
https://web.archive.org/web/20000920064354/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_06.26.98
https://web.archive.org/web/20000920064332/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_07.31.98
https://web.archive.org/web/20000920064317/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_08.28.98
https://web.archive.org/web/20000920064255/http://usda2.mannlib.cornell.edu/reports/nassr/price/cheddar/1998/cheddar_cheese_prices_10.02.98

and 1998 reveals cheddar cheese production for California, Idaho and Washington, along with American cheese production of all four states.[26] California's share of the four states' American cheese production was 44% in 1998 and 46% in 1997. Oregon (for which there is no specific cheddar information) produced less than 5% of the four-states' total American cheese in each year.

17. For 2002 to mid-2011, CDFA reported weighted average cheddar cheese prices received by California cheddar plants. This data was gathered as part of its annual audit of plant manufacturing costs, and was reported in a separate publication that also compared audited California cheddar prices to cheddar prices reported by the Chicago Mercantile Exchange ("CME").[27]

18. The CDFA-audited California cheddar cheese prices are compared to NASS reported average cheddar prices for the U.S., Minnesota-Wisconsin, and Other States, contained in the weekly NASS Dairy Products Prices for 2002 – March 2012, below:[28]



These data confirm the geographic price surface in the value of cheese, and therefore in the value of milk used to make cheese, with an increasing spread over time between

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[26] NASS, Dairy Products 1998 Annual Summary (April 1999), published at http://usda.mannlib.cornell.edu/usda/nass/DairProdSu//1990s/1999/DairProdSu-04-22-1999.pdf

[27] California manufacturing cost surveys for 2002 - 2014, audited California cheddar cheese prices for January 2002 – August 2011, and audited California butter prices for January 2002 – July 2015, can be found at: https://www.cdfa.ca.gov/dairy/uploader/postings/manufacturingcost/

[28] See also, Dryer, Ex. 91, pp 17-18 (comparing M-W to other states' average cheese prices).

the lower value of cheese (and milk) in California versus the higher value of cheese (and milk) in Minnesota and Wisconsin. These geographic price differences continue. Commodity cheddar prices received by California's largest cheddar maker averaged four cents below US average NDPSR prices from 2010 – 2013.[29]

C. The effect of geographically variable value of cheddar cheese prices on make allowances, manufacturer return on investment, and ability to pay for milk at U.S. NASS-NDPSR Class III price averages.

19. Since January 2000, the FMMO minimum Class III price for milk used to make cheese has been based on US average NASS-NDPSR cheese prices, less a manufacturer make allowance. The current FMMO cheese manufacturer make allowance is $0.2003/lb., calculated from the 2006 CDFA cheddar cheese plant manufacturing cost survey plus a marketing cost of $0.0015/lb. The 2006 CDFA cheddar cheese manufacturing cost survey, adopted by USDA, includes a return on investment of $0.0082/lb.[30]

20. In its final FMMO reform decision, USDA explained that the objective for pricing Class III and IV milk is to provide a regulated price that will "not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit."[31]

21. The observed geographical price surface for commodity cheddar cheese, like the simulated price surface produced by the USDSS model, demonstrates that national use of the US average cheddar cheese price in the Class III formula (including California, as proposed) produces margins between cheese prices and regulated milk prices, or effective allowances for manufacturing, that are smaller in some regions and greater in others than the regulated allowance of $ 0.2003 for plants that sell cheese at U.S. average prices, as shown below:

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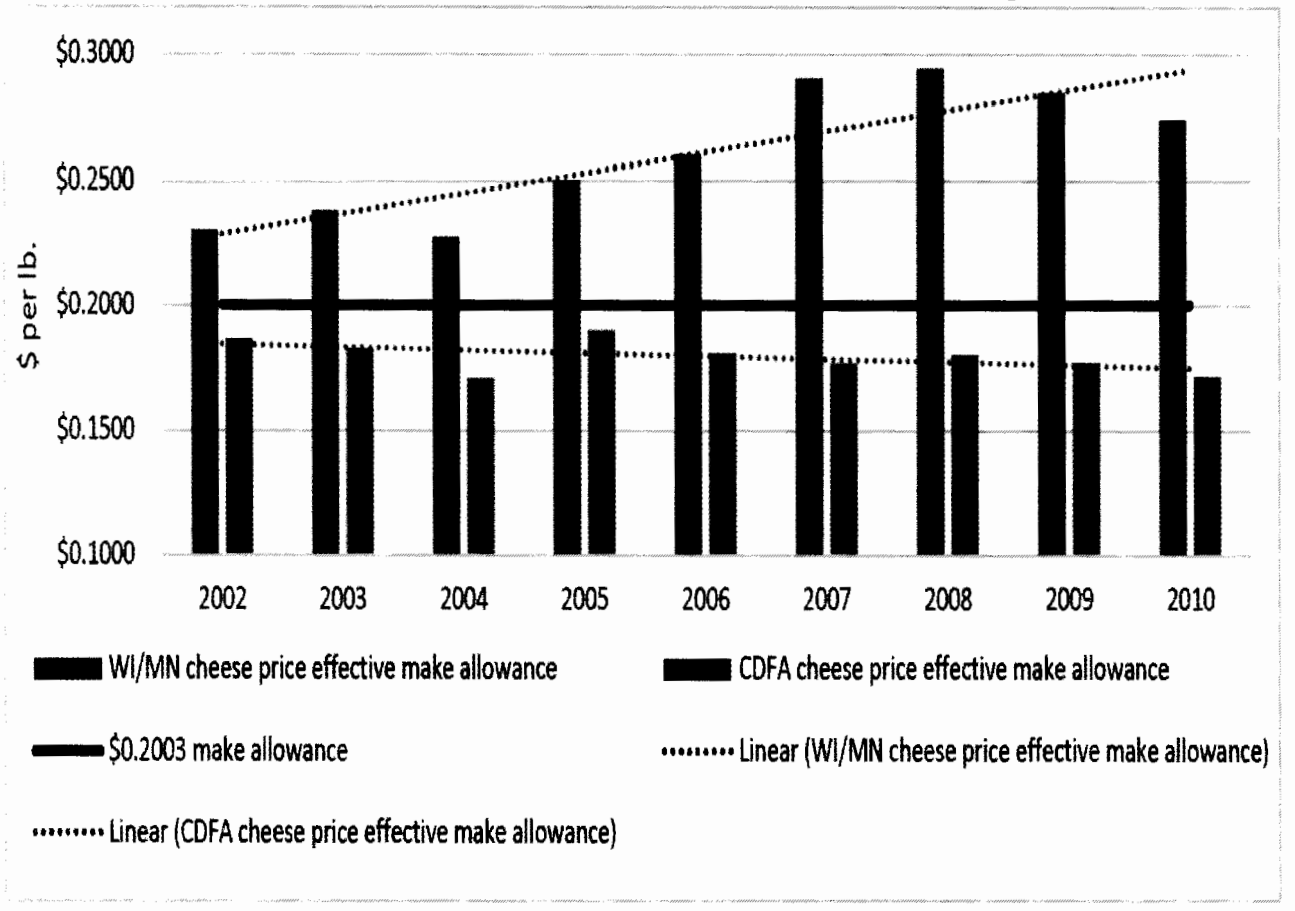
[29] De Jong, Oct. 23 Tr. pp 4436-37.

[30] 78 Fed. Reg. 9248, 9272 (Feb. 7, 2013) (Final Decision on make allowances following hearings in 2007). CDFA 2006 audited manufacturing costs are published at: https://www.cdfa.ca.gov/dairy/pdf/ManufCostExhibit2006.pdf . The return on investment used by CDFA is based on Moody's "BAA" corporate bond index.

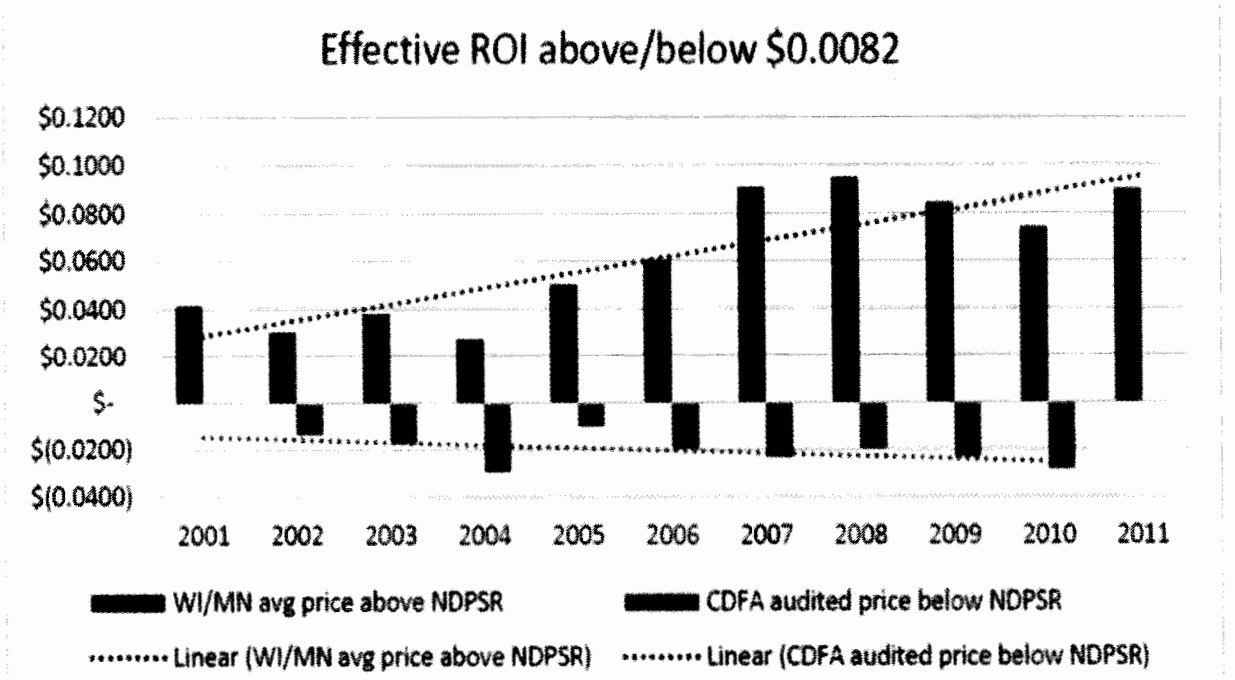
[31] 64 Fed Reg 16026, 16094 - 95 (April 2, 1999).

FMMO Effective make allowance 2002 – 2010, W/Mn vs. California cheese plants[32]



22. The most significant aspect of these regional differences in plant margin between cheese price and regulated milk price (or proposed regulated price for California, in this case) is the impact on the cheese manufacturer's return on investment. USDA has adopted CDFA's conclusion (from the 2006 CDFA manufacturing cost study) that a reasonable return on investment is less than a penny per pound - $0.0082/lb. cheese. If applied to California, however, there would have been a negative ROI in every year under the Cooperatives' proposal, as shown below.

[32] Regional NASS M-W and CDFA cheese prices, minus NDPSR / NASS US average price, plus FMMO cheese make allowance of $0.2003.



This result is aggravated by a 10-year old make allowance that should be increased by 3.7¢ or more.[33]

D. The commodity value of NFDM and butter is lower in California than in other markets. This adversely affects manufacturer return on investment and ability to pay for milk in California at U.S. NASS-NDPSR Class IV price averages.

23. The value of milk used to produce NFDM and butter also varies geographically. This is illustrated in USDSS model results for 2014 March and September production, and for 1993 annual production, published in 1996. The USDSS 1993 butter and NFDM price surface maps are reproduced below.[34]

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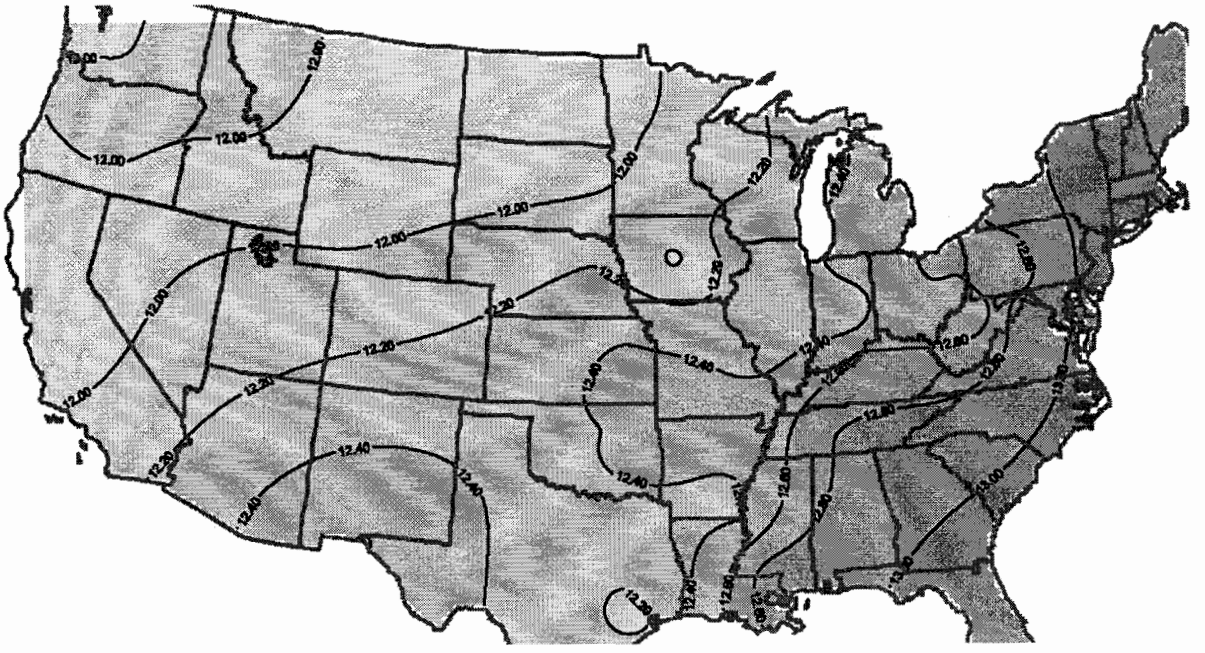
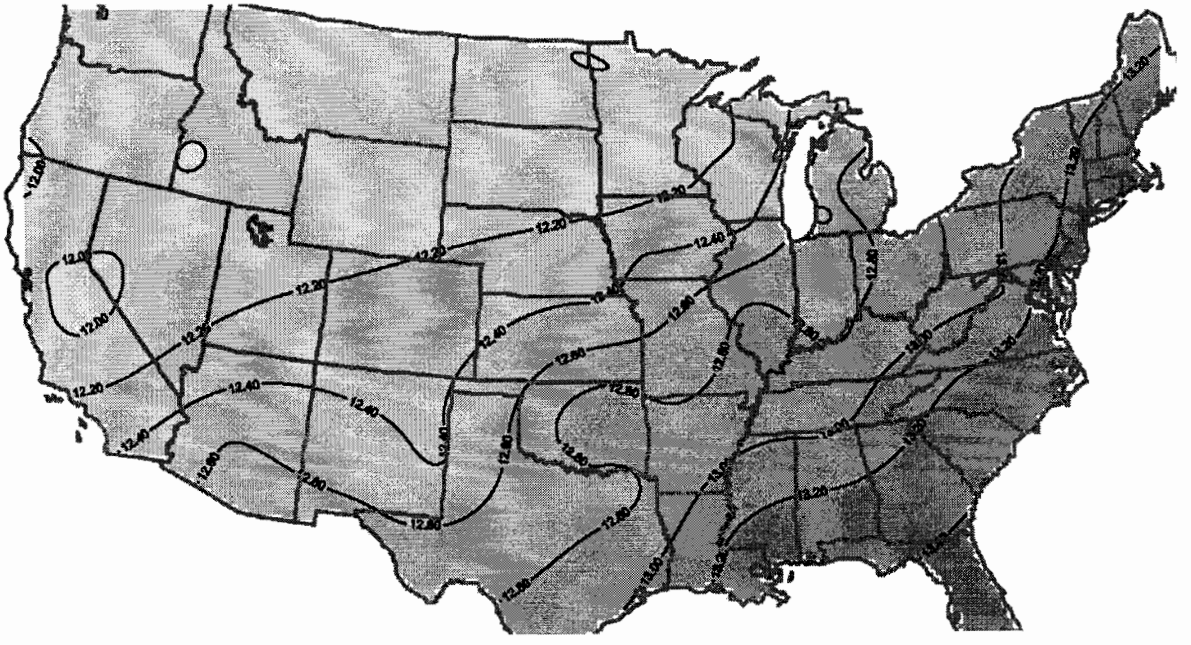
[33] Although cheddar cheese does not represent a majority of total cheese production, market prices for "most other commodity cheeses, including Mozzarella" are based on cheddar values, and net returns to manufacturers of non-cheddar varieties "equilibrate over time" with net returns to cheddar manufacturers. Taylor, Nov. 5 Tr. 61170, 6204-05.

[34] USDSS 1996, http://dairy.wisc.edu/pubPod/pubs/SP9606.pdf . The butter and powder price surface maps are on p 11 of the publication. USDSS results for 2014 Class IV Spatial Price Differences are accessible at http://dairymarkets.org/CA/

USDSS Simulated Value of Standardized Milk at Butter Plants, $/cwt, (1993)



USDSS Simulated Value of Standardized Milk at Powder Plants, $/cwt, (1993)



Geographic variability in NFDM and butter prices is conclusively demonstrated in product price reports by CDFA and USDA since 1999.[35]

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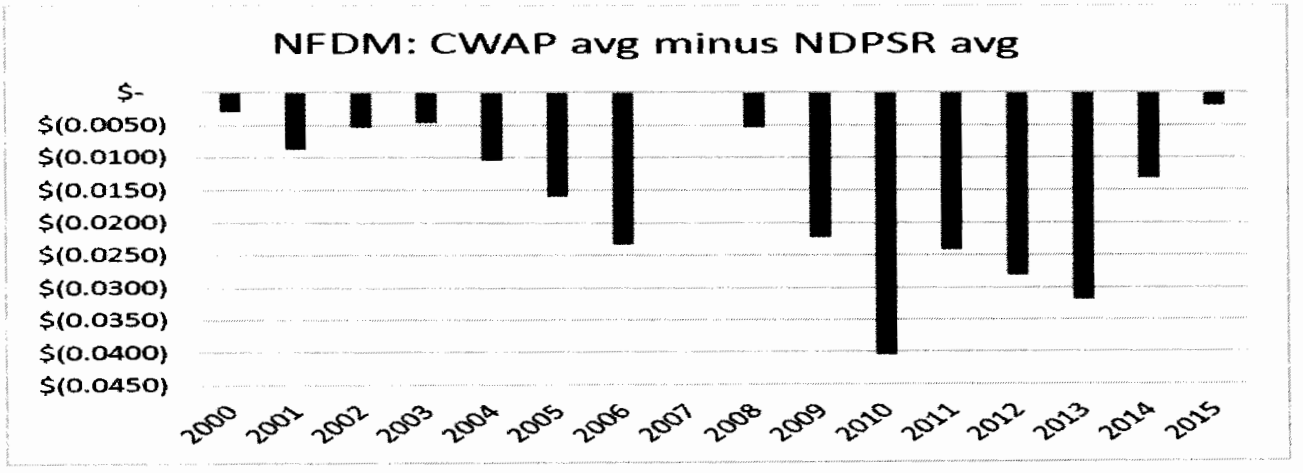
[35] CDFA's California Weighted Average Prices (CWAP) for NFDM, reported weekly from 2000 to March 2016, are at https://www.cdfa.ca.gov/dairy/uploader/postings/nfdm/ Excel files also contain monthly CWAP NFDM prices from July 1999 – February 2016. CDFA audited

NFDM Production and Prices

24. NFDM production in California has long dominated US total production. California's share of US total NFDM production was about 40% in 1998, during the course of FMMO reform. California has retained that market share through 2014. NDFM production in the NASS western region represented 65% of the US total in 1998 and 68% of US NFDM in 2014.[36]

25. As may be expected by this production pattern, NASS and NDPSR prices for NFDM have been closer in value to CDFA-reported NFDM prices for California than California cheese prices to NASS and NDPSR values. Annual California weighted average prices (CWAP) for NFDM have been consistently below US average NFDM prices since 2000, as shown in the following graph.



26. The USDA NFDM make allowance in the FMMO Class IV price would have resulted in lower effective make allowances for California NFDM plants if FMMO

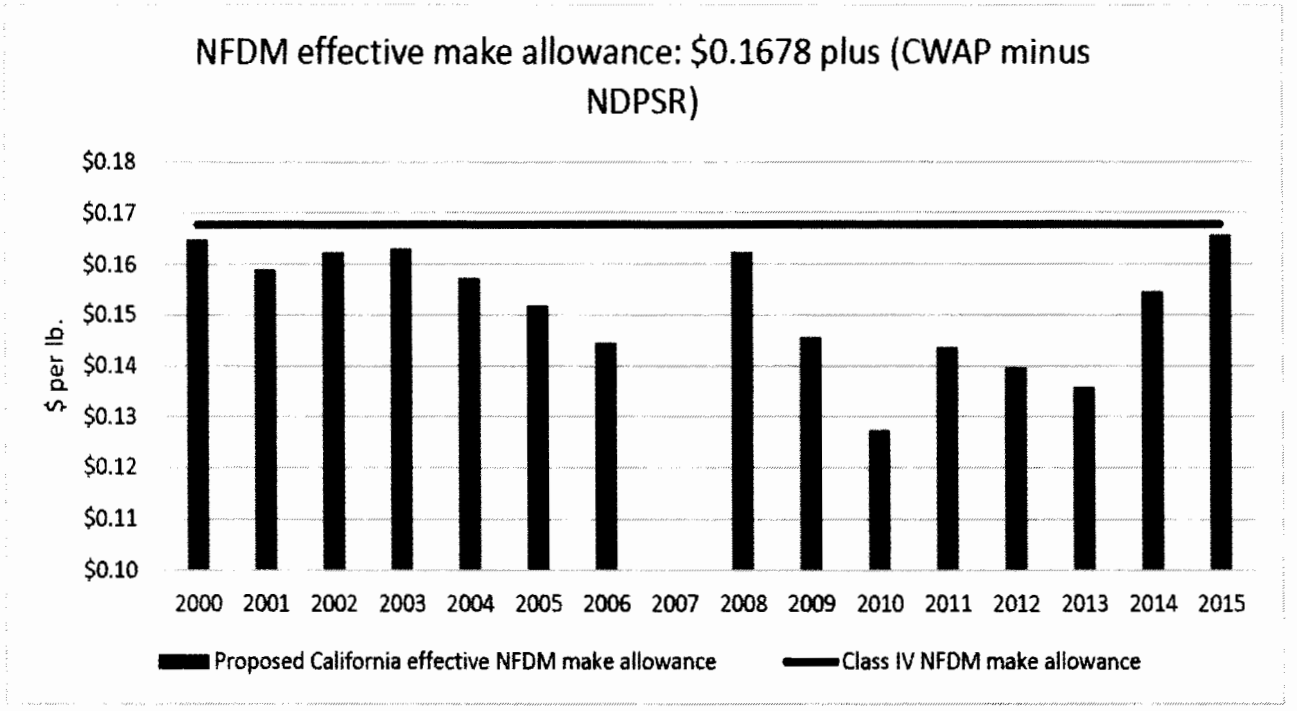
[fn. 35, cont] California commodity butter prices reports for 2000 through July 2013 are accessible at https://www.cdfa.ca.gov/dairy/uploader/postings/manufacturingcost/

US average commodity prices for NFDM and butter are contained in USDA's weekly NASS Dairy Product Prices Report for October 1998 through March 2012, and accessed at http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1450

Since April 2012, US average NFDM and butter prices have been reported by AMS at http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1845

[36] NASS Dairy Products 1999 Annual Summary (April 2000), p 38; and 2014 Annual Summary (April 2015), p 44..

prices had applied during 2000 through 2015, as shown below:[37]



27. This demonstrable California market product revenue shortfall, below prices attributed to NFDM manufacturers in the Federal Class IV price formula, would have provided negative returns on investment to California NFDM plants during most years. CDFA's 2006 manufacturing cost report (used in part by USDA) allows a return on investment to NFDM plants of only $0.0079/lb.[38] Negative ROI in future years is aggravated by a 10-year old FMMO make allowance, which should be increased by at least 3.5 ¢ per pound according to CDFA's 2014 survey.

Butter Production and Prices

28. Butter manufacturing in the United States is more geographically diverse than NFDM. But California has long been the largest butter producing state. California's share of the US butter market, along with the NASS Western Region share, has grown since 1998. In 1998, total US butter production was 1.2 billion

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[37] In the foregoing two NFDM price graphs, divergent outlier data for 2007, a -$0.11 difference between CWAP and NDPSR prices, is omitted.

[38] 78 Fed. Reg. 9248, 9271 (Feb. 7, 2013); CDFA's 2006 manufacturing cost summary is reproduced at https://www.cdfa.ca.gov/dairy/pdf/ManufCostExhibit2006.pdf .

pounds, of which California's share was 27% and the Western Region share was 36%. In 2014, total US butter production was 1.9 billion pounds, of which California's share was 33% and the Western Region share was 50%. [39]

29. Similar to the geographic variation in market prices for cheese and NFDM, market prices for commodity butter in California, as reported by CDFA, have been consistently lower than the US average butter prices as reported by NASS and AMS NDPSR publications.[40]

30. Because California market prices for butter are lower than US average market prices reported by NASS and AMS, California butter makers would have a lower effective make allowance than the $0.1715 per pound Class IV butter allowance if the FMMO Class IV minimum price is exported to California, as proposed by the cooperatives.[41]

31. The effective average butter make allowance for California butter plants for the period of January 2002 – July 2015, under the Cooperatives' proposal, is shown in the graph below:

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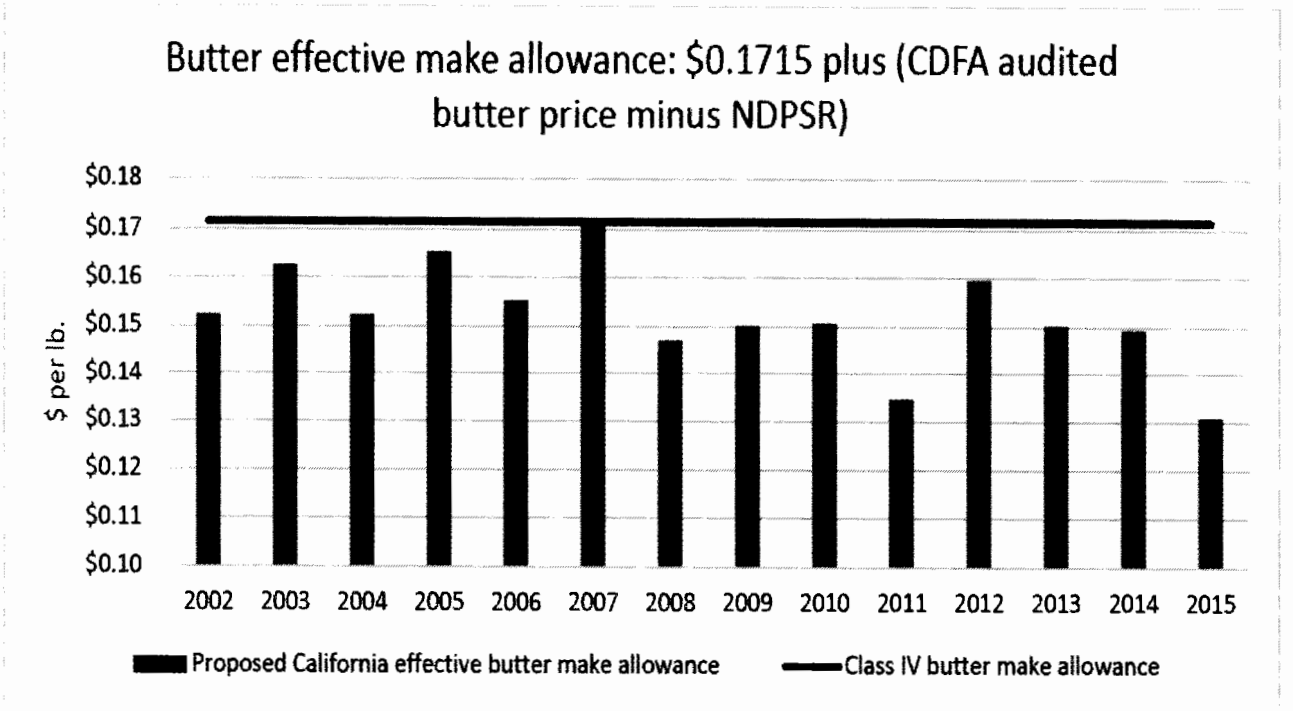
[39] NASS Dairy Products, 1999 Summary (April 2000), page 32 (butter), http://usda.mannlib.cornell.edu/usda/nass/DairProdSu//2000s/2000/DairProdSu-04-25-2000.pdf ; NASS Dairy Products, 2014 Summary (April. 2015), page 42 (butter), http://usda.mannlib.cornell.edu/usda/current/DairProdSu/DairProdSu-04-29-2015.pdf .

[40] CME Butter Prices vs. Audited California Butter Sales, January 2002 – July 2015, accessible at https://www.cdfa.ca.gov/dairy/uploader/postings/manufacturingcost/ ; NASS Dairy Products Prices Annual Summary 2009 – 10, accessible at https://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1815 NASS Dairy Products Prices, weekly, 1998 – 2012, accessible at http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1450 AMS, NDPSR dairy products prices, weekly, April 2012 – current week, at http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1845 .

[41] The current FMMO butter make allowance of $0.1715 per pound was adopted following hearings in 2007. 78 Fed. Reg. 9248, 9271 (Feb. 7, 2013); CDFA's 2006 manufacturing cost summary, upon which USDA relied in part for the butter allowance, is reproduced at https://www.cdfa.ca.gov/dairy/pdf/ManufCostExhibit2006.pdf



32. The observed shortfall in California plant margin, between audited commodity sales prices and Cooperatives' proposed regulated milk prices (FMMO Class IV), is of critical importance for evaluation of whether the proposed prices would provide a reasonable return on investment. The return on investment allowed in the 2006 CDFA butter manufacturing cost study, which USDA factored into its make allowance decision, was $0.007 cents per pound. For butter plants, as for cheese and NFDM plants, the cooperatives' proposal would result in a negative return on investment. Again, the result is aggravated by a 10-year old make allowance, which should be increased by about 4.7 ¢/lb, according to CDFA's most recent study.

E. The Cooperatives' Proposal to include imputed revenue from the sale of whey powder in a federal Class III price for the proposed California Marketing Area – where California cheese manufacturers predominately make whey protein concentrate, not whey powder, as a cheese byproduct – would aggravate negative returns on investment in the proposed Class III price formula.

33. The preceding findings on cheese values in California for FMMO Class III pricing purposes do not include cheese maker revenue and costs for the byproduct of cheese – whey. Since the time of FMMO reform, a surveyed value for whey, and a calculated value of imputed whey revenue to cheese makers, has been included in the

Class III pricing formula. The product surveyed for this contribution to the Class III minimum price is "dry whey." 7 C.F.R. § 1000.50(o).

34. USDA explained in its final FMMO reform decision that whey product values were incorporated into the Class III price "to assure that the Class III price reflects most of the value of milk used in Class III products," and "the dry whey price was determined to be the best indicator of value for other solids." USDA also relied on "more market activity" for dry whey, compared to other whey products such as whey protein concentrate that might be used in calculating or imputing revenue to cheese makers from whey byproducts. Surveys of dry whey prices were therefore deemed to be "a better price series" and "the best indicator of value" for milk "other solids" not captured in cheese. 64 Fed. Reg. at 16099 (1999).

35. During 1998, the time of FMMO reform, there were 49 plants in the United States that made dry whey, including 14 dry whey plants in California. There were also 31 plants in the United States that made whey protein concentrate ("WPC").[42]

36. During 2014 there were 37 dry whey plants in the United States, 46 WPC plants, and 16 whey protein isolate plants. California has only one remaining plant dedicated to making dry whey.[43] Most California cheese plants do not make whey products, but several plants concentrate whey solids by removing some water, and marketing the liquid concentrated whey to whey specialty plants, or for animal feed.[44]

37. As suggested by the 1998 – 2014 decline in whey powder plant numbers, and increase in whey protein concentrate and whey protein isolate plant numbers, there has been a significant decrease in dry whey and increase in other whey products as a percentage of whey solids produced in the course of cheese making.[45]

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42 NASS Dairy Products, 1999 Summary, pp 41-42.

43 NASS Dairy Products, 2014 Summary, pp 21, 46; Barry Murphy, Ex. 117, p. 2.

44 Ex. 117, p. 2.

45 Dryer, Ex. 91, pp. 3, 7.

38. The manufacturing alternative to dry whey is WPC and dry lactose. But market prices for dry whey do not change in close correlation with WPC and dry lactose prices.[46]

39. The inadequate correlation between dry whey and WPC/dry lactose prices, along with higher processing and investment costs for WPC/dry lactose manufacturing, results in imputed revenue to FMMO cheese makers that frequently overstates product revenue for which they are charged in the FMMO Class III price formula. [47] For example, dry lactose product prices can drop below production costs for extended periods, while the FMMO "other solids" price implies value and imputes revenue to manufacturers.

40. For California plants that market liquid whey concentrate rather than making their own whey products, WPC market prices rather than dry whey prices serve as the common pricing index, as is the trend in national markets.[48]

41. A few years after FMMO reform, CDFA modified its Class 4b (cheese milk) price formula to correspond more closely with FMMO Class III pricing by incorporating imputed whey revenue based on dry whey prices. This proved to be untenable, because very little whey from California cheese plants was processed as dry whey. When dry whey prices spiked in 2006 – 07, without a corresponding increase in the value of WPC, the regulated revenue allowed to be retained by California plants – difference between product price or imputed product price revenue and the minimum Class 4b price – decreased substantially, producing severely negative returns on investment. California cheese plants responded by declining to receive milk for cheese use, and some plants closed during this period. [49]

42. In order to address the marketing disorder created by use of dry whey in the Class 4b price formula, CDFA again amended its Class 4b price formula with a "whey

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[46] Ex. 93, p. 6; De Jong, Ex. 98, pp 28-29; Ex. 99, pp 9 – 10 (Fig. 16 & 17).

[47] Ex. 93, p. 6; De Jong, Ex. 98, pp. 16, 28 – 29, Ex. 99, pp. 9 – 10; Buholzer, Ex. 124, pp 3, 5; Stettler, Ex. 125. P 2.

[48] Dryer, Ex. 91, p. 4; Paris, Ex. 134, p. 4; Taylor, Ex. 135 p. 16;

[49] Schiek, Ex. 79, pp. 20-25; Dryer, Ex. 93, p 4; De Jong, Ex 98, pp 3-6; Taylor, Ex. 135, pp 12-13.

factor" disconnected from extreme fluctuations in dry whey values, thereby restoring order to California's market for milk used to make cheese.[50]

43. In its most recent decision of July 2015, the CDFA hearing panel made the following findings concerning the predominant use of WPC and WPC index values in the California market.

> [S]ince dry whey is produced consistently by only one of approximately 57 California cheese plants, a whey factor based on dry whey does not appear to accurately represent the manufacturing conditions of most California cheese plants. There are 10 California cheese plants that make WPC ranging from 25.0 percent to 89.9 percent protein content. As a group, these 10 plants represent a significant percentage of California cheese production: 96.5 percent, 72.3 percent, and 57.5 percent of California's Cheddar, Mozzarella, and total cheese, respectively. Additionally, testimony indicates that there are some plants that do not make a dried WPC product, but do concentrate their wet whey stream. The revenue derived from selling the concentrated wet whey stream is based on the WPC34 price, albeit at a reduced rate. Compared to dry whey, it appears that a whey factor based on WPC34 could relate better to a larger portion of California cheese plants.

The state agency will continue to examine the issue.[51]

44. Compounding the problem of imputed but not realized dry whey revenue to California cheese makers under an FMMO Class III price, as proposed by the cooperatives, the current FMMO Class III formula overstates revenue for all whey uses by a make allowance that has not been updated for a decade. The current allowance to cover costs of converting the whey stream from the cheese vat to a finished dry whey product, and marketing that product, is $0.1991 per pound dry whey. This was based upon a 2007 hearing and a 2006 survey of dry whey manufacturing costs in 7 plants.[52] Although CDFA no longer surveys manufacturing costs at whey plants, changes in NFDM manufacturing costs are instructive, since both NFDM and dry whey require water removal from the raw product. Dry whey is a

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50 Schiek, Ex. 79, pp. 22-23.

51 CDFA Hearing Panel Report based on hearing of June 3, 2015, page 11, https://www.cdfa.ca.gov/dairy/uploader/docs/Panel%20Report%20Final%207.15.pdf . The Report continued, on p. 13: "The whey factor based on WPC34 appears to have merit, but the concept needs to be vetted further in order to verify and validate the commodity price and manufacturing cost factors that will be associated with the proposed whey factor."

52 78 Fed. Reg. 92848, 9251, 0271 (Feb. 7, 2013).

bit more energy intensive, since more water must be removed. CDFA manufacturing cost surveys reveal that NFDM make costs increased by 21% (3.47 cents) from 2006 to 2014, through the return on investment was only a penny.[53] USDA's failure to update make allowances would aggravate the negative returns on investment to California cheese and whey plants if the cooperatives' proposed FMMO Class III pricing formula is adopted for a California Marketing Area.

IV. Proposed Conclusions of Law, Policy, and Supporting Argument.

The foregoing findings demonstrate that cooperatives' proposal to significantly enhance the regulated price for milk used to produce cheese, NFDM, butter and whey products in the California marketing area is untenable. In the words of a cooperative representative less than three years ago, the minimum price for milk used to produce cheese in the California market "ought to be 70 cents less than" prevailing FMMO Class III prices. The minimum price for milk used to make NFDM and butter in the California market, similarly, ought to lower than prevailing FMMO Class IV prices, as each of the cooperative proponents have repeatedly advocated to the California milk price control agency since USDA's reform of the FMMO milk price structure for milk markets in other regions of the country.

Cooperative proponents of a federal milk marketing order for the California marketing area have not met their 5 U.S.C. §556(d) burden of proof to justify federal intervention in producer milk price control in California. The Class III and IV price levels proposed by cooperatives for an FMMO California marketing area, in addition, are unsupported as a matter of law under AMAA statutory and federal constitutional standards.

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53 CDFA Summary of Weighted Average Manufacturing Costs, 2006 (NFDM $0.1661/lb) and 2014 (NFDM $0.2011/lb). https://www.cdfa.ca.gov/dairy/pdf/ManufCostExhibit2006.pdf and https://www.cdfa.ca.gov/dairy/uploader/docs/Manufacturing%20Cost%20Exhibit%202014%20Data.pdf . The 2006 survey also reported, for 3 plants, dry whey manufacturing costs of 28.5 cents in 2005, and 30.1 cents/lb in 2006. CDFA no longer surveys manufacturing costs at dry whey plants because there is now only one dedicated dry whey plant in the state.

A. The Cooperatives' proposal is not supported by evidence of marketing disorder conforming to USDA decision-making standards for 80 years; but is rather for the purpose of producer price enhancement where the market has abundant supplies of milk for fluid use, contrary to USDA's consistent statements of policy.

For many decades, USDA's Agricultural Marketing Service has clearly explained that FMMOs are authorized as a "marketing tool" to address "problems associated with the inherent instability in milk marketing" in an unregulated market.[54] None of the "conditions indicating need for an order" relied upon by USDA during the past 80 years of FMMO regulatory promulgation, as illustrated by AMS in its program brochure,[55] exist in the state-regulated California milk market.

Consistent with agency construction of the AMAA as a marketing tool, USDA has consistently denied proposals designed to enhance regulated minimum milk prices where fluid milk markets are adequately served by existing supplies of milk. In a letter to Congressman Philip English, dated June 16, 2003, during a time of low milk prices and high feed costs, USDA's Undersecretary for Marketing and Regulatory Programs explained:[56]

> The FMMO program is a marketing program with the objective of assuring that fluid (drinking) milk markets are adequately supplied and is not intended to be a price support program.

This agency policy has been iterated by USDA in numerous FMMO decisions and responses to proposed minimum milk price increases for several decades.[57] Regulated class price increases have been granted only where there was a threat of inadequate

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54 AMS, USDA, *The Federal Milk Marketing Order Program* (pp. 6 and 8), Reproduced in Ex. 112, Part A.

55 Ex. 112, AMS, USDA, *The Federal Milk Marketing Order Program*, pp. 11 – 12.

56 Ex 112 (Part B) p. 48.

57 73 Fed. Reg. 78917 (Dec. 24, 2008) (denying Class I and II price increases after "an extended period of below-average milk prices, high production costs and low farm returns" for milk producers).; Ex. 112 Part B, USDA correspondence in response to requests for FMMO price increases.

supply of milk for fluid use in specific markets.[58] By any measure of supply and demand, California's market is adequately supplied with milk for fluid use, which represented only 13% of California market (Grade A) milk production in 2015.[59]

Cooperative proponents of federal milk price control intervention did not acknowledge these long-established policies in their petition for a federal California milk marketing order. It is nevertheless clear that federal agencies have leeway to depart from their own precedent if the departure is explained and the law permits a new approach. As explained in *Motor Vehicle Mfrs. Assn. v. State Farm Mut. Automobile Ins. Co.,* 463 US 29, 41-42, 57 (1983):

> A "settled course of behavior embodies the agency's informed judgment that, by pursuing that course, it will carry out the policies committed to it by Congress. There is, then, at least a presumption that those policies will be carried out best if the settled rule is adhered to." Atchison, T. & S. F. R. Co. v. Wichita Bd. of Trade, 412 U. S. 800, 807-808 (1973).
> * * * *
> "An agency's view of what is in the public interest may change, either with or without a change in circumstances. But an agency changing its course must supply a reasoned analysis . . . ." Greater Boston Television Corp. v. FCC, 143 U. S. App. D. C. 383, 394, 444 F. 2d 841, 852 (1970) (footnote omitted), cert. denied, 403 U. S. 923 (1971).

See also, *People of State of California. v. FCC,* 905 F. 2d 1217, 1234 (9th Cir. 1990). As explained below, the course of regulatory behavior that proponent cooperatives ask USDA to apply in a proposed federal milk marketing order for the California marketing area is not authorized by the AMAA, and would be prohibited by federal constitutional law.

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58 69 Fed. Reg. 67670 (Nov. 19, 2004), and 73 Fed. Reg. 11194 (Feb. 29, 2008), increasing Class I prices in southeast markets.

59 CDFA, *California Dairy Statistics Annual (2015)*, p. 3. The 2015 statistics are available at: https://www.cdfa.ca.gov/dairy/pdf/Annual/2015/2015_Statistics_Annual.pdf

B. The cooperatives' proposed Class III and IV price formula would fix prices that are not based upon "market supply and demand for milk and its products in the [California] marketing area." as required by the AMAA, 7 U.S.C. § 608c(18), and without "due recognition to the differences in production and marketing of" milk, cheese, whey, NFDM, and butter in the California marketing area, as also required by the AMAA, 7 U.S.C. § 608c(11)(C).

For the past 80 years, CDFA has regulated minimum producer prices for milk in California at levels the state agency determined are reasonable in relation to supply and demand for milk and dairy products. Ca. Food & Ag. Code, § 62062, 62071. Similarly, Congress directed USDA to apply supply and demand standards in each FMMO market prior to establishing minimum producer milk prices for that market. 7 U.S.C. § 608c(18). Paraphrasing this statutory directive, AMS has explained.[60]

> The policy to be followed in pricing milk under Federal milk orders was established by the Congress and is stated in the Agricultural Marketing Agreement Act. The Act directs the Secretary of Agriculture to establish milk prices that will reflect economic conditions which affect *market supply and demand in the affected marketing area*, insure a sufficient quantity of pure and wholesome milk to meet current needs and further to assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs and are in the public interest. A public hearing is held to gather evidence on the supply-demand conditions in an area and on other relevant economic conditions. *[italics supplied]*

This explanation of the Section 608c(18) market-by-market supply and demand standard in the AMAA was reaffirmed by USDA in 2012, rejecting proposals to raise regulated milk prices in a period of drought, high feed costs, and low dairy farm margins.[61]

In a separate provision, applicable to all AMAA marketing orders (not limited to milk orders), the Secretary is required to conform each provision of a marketing order

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60 Ex. 112, AMS, USDA, *The Federal Milk Marketing Order Program*, pp. 21-22.

61 Ex. 112, .pdf pp. 51 – 53, letters of Sept. 17, 2012, from Agriculture Secretary Vilsak and AMS Deputy Administrator for Dairy Programs, also published online at: http://www.dairyprogramhearing.com/getfile55055505.pdf?dDocName=STELPRDC5100786

to the unique characteristics of individual markets to the extent practicable, 7 U.S.C. § 608c(11)(C):

> All orders issued under this section which are applicable to the same commodity or product thereof shall, so far as practicable, prescribe such different terms, applicable to different production areas and marketing areas, as the Secretary finds necessary to give due recognition to the differences in production and marketing of such commodity or product in such areas.

AMAA sections 608c(11)(C) and 608c(18) reinforce each other, as explained by a federal court following USDA's final FMMO reform decision: "The AMAA statutory system mandates local regulations tailored to particular marketing conditions." *St. Albans Co-Op. Creamery v. Glickman,* 68 F. Supp. 2d 380, 383 (D. Vt. 1999). "Congress specifically provided in § 8c (11) (C) of the Act that the Secretary's price-fixing powers were to be exercised on a regional basis rather than a national basis whenever practicable." *Lehigh Valley Cooperative Farmers, Inc. v. United States*, 370 US 76, 103, n. 10 (1962) (dissenting opinion by Justice Black). In *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 147-49 (1963), the Supreme Court observed that the AMAA's local conditions regulatory standard stood in sharp contrast to "uniform" national standards for tobacco inspection, contemporaneously mandated by the same Congress.

Proponent cooperatives observe that USDA has employed in all FMMO markets a uniform national price formula for milk used to make cheese, whey, NFDM, and butter since the 1960's; that Class III and IV price formulas have been uniform nationally in all 10 remaining FMMO markets since the conclusion of FMMO reform in 1999. Cooperative proponents assert that this national Class III and IV pricing grid should, as a matter of established USDA policy, apply to the proposed California Marketing Area as well.[62]

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[62] Sept. 25 Tr. at 768-69 (Marvin Beshore, proponent cooperatives' opening statement); Dennis Schad, Ex. 70, pp. 5 – 16 (tracing the regulatory evolution of national Class III and IV prices), Oct. 5 Tr. 3067 – 73.

In the final 1999 FMMO reform decision, like every milk order amendment decision since, and every promulgation and amendment decision for decades prior to 1999, the Under Secretary of Agriculture made requisite §608c(18) supply and demand findings to support the minimum prices adopted for the "the aforesaid marketing areas." 64 Fed. Reg. at 16169-70. The California market was not a milk marketing area to which these 1999 findings applied. USDA expressly explained that its analysis was limited to "47 contiguous states, *not including the State of California*." 64 Fed. Reg. at 16044 (italics supplied). USDA has never made any § 608c(18) supply and demand findings for the California marketing area, nor for a federally-regulated system of milk markets that includes a California marketing area.

USDA has, as proponents argue, used a national minimum price formula for Class III/IV minimum pricing for several decades. But "national," for purposes of USDA policy declarations in prior FMMO decisions, necessarily meant all milk marketing areas under USDA regulation, which thereby excluded California.

The M-W price series was used by USDA from the 1960's to the 1990's to fix minimum monthly Class III prices for milk used in manufactured products. This price series was based on a surveyed average competitive price for manufacturing grade milk in Minnesota and Wisconsin – the most productive milk and dairy products producing region in the FMMO system. USDA concluded that milk had its lowest value in the high surplus region of Minnesota and Wisconsin, so all manufacturing uses were regulated at the low M-W survey price, and Class I prices were adjusted upwards based in large part on distance of milk delivery from Wisconsin. The post-FMMO reform Class III and IV structure extended these principles.[63]

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[63] The NASS cheddar cheese price survey of 1997-98, while FMMO reform was pending before the Secretary, revealed that US average cheese prices were significantly lower than Minnesota-Wisconsin cheese prices, and four-state western average cheddar prices (California, Oregon, Washington, and Idaho), were close to US average cheddar prices. (See Finding 15, above). It would not have been unreasonable for USDA to conclude at that time, particularly in the informal rulemaking process for FMMO reform, that US average cheese prices could serve as a new lowest reference price for Class III pricing purposes without overstating value to handlers in any of the FMMO markets.

There is no inconsistency between this policy of pricing manufacturing use of milk in all markets at a common low price, and the §608c(18) supply and demand standard that must be applied to individual markets. After all, FMMO prices are "minimum" prices. Competitive price adjustments can be made in the form of premiums on milk for manufacturing use when and where values are greater. But because regulated prices are minimum, prices cannot be reduced below manufacturing class levels unless buyers can avoid regulation (an option the cooperatives would deny to California milk buyers). Class IV pricing for milk used to produce NFDM and butter evolved because the uniform Class III price, previously applicable to all manufacturing uses, was determined to be too high, producing negative returns on investment, for this segment of milk manufacturers. That determination, for NFDM and butter use in the 1990's (Class III-A) and Class IV since FMMO reform, was supported by §608c(18) supply and demand findings in each decision and for each market. For similar reasons, FMMO Class III and IV prices in federal markets outside of California are demonstrably too high for the California segment of U.S. Class III and IV manufacturers. Lower Class III and IV prices for this segment must therefore be established and made applicable to a California milk marketing order if the Secretary decides to extend FMMO regulation to California.[64]

C. The cooperatives' proposal for Class III and IV prices in the California market at the same level as markets to the east, because that is what manufacturers must pay in those markets, would tend to "limit" the marketing of California cheese, NFDM, butter and whey products in eastern markets contrary to 7 U.S.C. § 608c(8)(c)(5)(G)..

The cost of transportation to move a commodity or product over distance serves as a natural trade barrier.[65] The barrier is mitigated by lower product costs in

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64 Alternatively, the Secretary could rationally create new Class III and IV price formulas for all federal milk markets at California milk price values, recognizing that California milk and dairy product values would be similar in function to M-W values in past decades when California was not part of the system.

65 Rousslang, Donald J., and Theodore To. "Domestic trade and transportation costs as barriers to international trade." *Canadian Journal of Economics* (1993): 208-221, https://theo.to/_media/domestic.pdf ; Anderson, James E., and Eric Van Wincoop. *Trade costs.* No. w10480. National Bureau of Economic Research, 2004,

shipping markets, thereby equalizing product costs delivered to demand markets. Geographically variable market prices for manufactured dairy products reflect costs of transportation from supply to demand centers, creating a competitive equilibrium at converter plants and other demand locations that receive dairy products produced in multiple locations.

The cooperatives' proposal to increase California prices for milk used to produce dairy products to the same level as currently paid by FMMO dairy product manufacturers to the east would negate the existing competitive equilibrium. The proposal is unsupported by any evidence that the value of bulk commodity dairy products in California, and imputed value of milk used to produce these products, is or has been at FMMO Class III and IV levels. The proposal to export average U.S. dairy product values and imputed average milk revenues to California would therefore create an effective trade barrier. The proposal would limit the ability of California manufacturers of cheese, NFDM, butter, and whey products to compete in FMMO markets to the east.

One of the most unequivocal congressional restraints on the Secretary's FMMO regulatory authority is a proscription, in 7 U.S.C. § 608c(5)(G), against provisions that would "in any manner limit" the marketing of manufactured dairy products between markets.[66] *Lehigh Valley Cooperative Farmers, Inc. v. United States*, 370 U.S. 76, 91-97 (1963). This proscription can only be avoided by Class III and IV milk prices in California that reflect the value of Class III and IV products in California, conforming

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(fn. 66, cont.)
http://www2.econ.iastate.edu/classes/econ655/Lapan/Readings/Trade%20Costs%20Anderson%20and%20van%20Wincoop.pdf

66 "[T]he words of § 8c (5) (G), "in any manner limit," must be taken, in the context of their legislative history, as referring only to milk products..." *Lehigh Valley Coop.*, 370 U.S. at 97. "The conference agreement also denies the authority to limit in any manner the marketing in any area of milk products (butter, cheese, cream, etc.) produced anywhere in the United States." *Cranston v. Freeman*, 290 F. Supp. 785, 804-5 (ND New York 1968) (quoting 1935 House report); *Sani-Dairy, a Div. of Penn Traffic Co. v. Espy*, 939 F. Supp. 410, 416, (WD Pa 1993); *aff'd per curiam, Sani-Dairy, a Div. of Penn Traffic Co. v. Yeutter*, 91 F. 3d 15 (3rd Cir. 1996).

a Federal California Milk Marketing Order to § 608c(5)(G), as well as 7 U.S.C. § 608c(18) and § 608c(11)(C).

D. The cooperatives' proposed Class III and IV price formula would result in regulated prices to manufacturers in the California marketing area that do not provide for a reasonable return on investment, contrary to established USDA policy, and would in fact result in negative returns on investment, contrary to constitutional limits on USDA's milk price control authority as established by Nebbia v New York (1934), and its judicial progeny.

The Supreme Court's decision on milk price controls in *Nebbia v New York,* 291 U.S. 502 (1934), set the stage for evolution of federal and state price controls on a variety of products and services in the succeeding eight decades. "The constitutional test for the validity of state price controls was established in Nebbia v. New York." *Calfarm Ins. Co. v. Deukmejian*, 771 P. 2d 1247, 48 Cal.3d 805, 816 (1989). The *Nebbia* Court's opinion concluded (at 539): "Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty." As described below, price control regulation falls short of the constitutional standard if a reasonable return on investment is not provided for a regulated entity or a class of regulated entities.

USDA's milk price control agency, AMS, has endorsed a return on investment economic standard for pricing milk used in Class III and IV products in its policy studies,[67] as well as in its price control decisions. The final FMMO reform decision, which cooperative proponents invoke to support sharply higher manufacturing use milk prices in California, explained:[68]

> The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect

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[67] USDA, *Milk Pricing Policy and Procedures, Part II, Alternative Pricing Procedures,* Report of the Milk Pricing Advisory Committee, March 1973, pp. 14, 44-53, 58-60, http://dairy.wisc.edu/PubPod/Reference/Library/Knutson,etal.03.1973.pdf

[68] 64 Fed Reg 16026, 16094 - 95 (April 2, 1999).

> supply and demand, and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit.

The cooperative proponents appear to maintain that the "make a profit" (i.e., return on investment) policy should apply to average manufacturing plants in the national market. Rules advocated by proponents would allow no departure from that average for plants in a California milk marketing area, nor a means for California handlers to opt out of regulated status for their plants or milk supplies. For this reason, we summarize constitutional limitations on the result advocated by cooperatives, which reinforce the wisdom of AMAA statutory limitations in 7 U.S.C. §§ 608c(18), 608c(5)(G) and § 608c(11)(C).

1. *Clear judicial authority for 80 years since Nebbia v New York prohibits price control agencies from fixing prices that result in an unreasonable return on investment. Break even revenue, or negative returns on investment, are impermissible results.*

When government price control regulates the margin between costs and price that a regulated entity may retain, *Nebbia*'s judicial progeny instructs that a reasonable return on investment to regulated entities is a constitutional minimum to avoid confiscatory results. As explained in *FPC v. Hope Natural Gas Co.*, 320 US 591, 603 (1944):

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. *Cf. Chicago & Grand Trunk Ry. Co. v. Wellman*, 143 U.S. 339, 345-346. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital

This rule of constitutional law summarized in *Permian Basin Area Rate Cases*, 390 US 747, 769-70 (1968), which involved a single maximum price for a class of regulated natural gas producers in the Permian Basin production area:

> No constitutional objection arises from the imposition of maximum prices merely because "high cost operators may be more seriously affected . . . than others," *Bowles v. Willingham, supra*, at 518, or because the value of

> regulated property is reduced as a consequence of regulation. *FPC v. Hope Natural Gas Co., supra*, at 601. Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness. [citation omitted]
>
> It is, however, plain that the "power to regulate is not a power to destroy," [citations omitted], and that maximum rates must be calculated for a regulated class in conformity with the pertinent constitutional limitations. Price control is "unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt . . . ." *Nebbia v. New York*, 291 U. S. 502, 539. 539. Nonetheless, the just and reasonable standard of the Natural Gas Act "coincides" with the applicable constitutional standards, *FPC v. Natural Gas Pipeline Co., supra*, at 586, and any rate selected by the Commission from the broad zone of reasonableness permitted by the Act cannot properly be attacked as confiscatory.

Although *Permian Basin* involved federal gas price ratemaking, it is by now clear that the reasonable return on investment standard, as a rule of constitutional law, is not dependent upon the product, service or industry regulated, nor upon the type of statute authorizing price controls. The return on investment standard has been applied to rent control, insurance rates, communication services, gasoline wholesale prices, utility rates and other products or services. [69]

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[69] *E.g.*, Birkenfeld v. City of Berkeley, 550 P.2d 1001, 17 Cal.3d 129, 165 (1976) (rent control, quoting *Nebbia*); *Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal. 4th 761, 771 (1997) (rent control, citing *Nebbia*); *Tenoco Oil Co. v. Dept. of Consumer Affairs*, 876 F. 2d 1013 (1st Cir. 1989) (wholesale gasoline pricing); *Texaco Puerto Rico, Inc. v. Ocasio Rodriguez*, 749 F. Supp. 348 (D. Puerto Rico 1990) (gasoline pricing, on remand); *Pennell v. San Jose*, 485 U.S. 1 (1988) (rent control); *Calfarm Ins. Co. v. Deukmejian*, 771 P. 2d 1247 (1989} (insurance rate control, citing *Nebbia*); *Michigan Bell Telephone Co. v. Engler*, 257 F. 3d 587 (6th Cir 2001) (communications services prices, quoting *Nebbia*); *Guaranty National Insurance Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990) (a "break even" insurance rate standard is constitutionally defective); *Hutton Pk. Gardens v. West Orange Town Council*, 350 A. 2d 1, 68 N.J. 543, 569-72 (1975) (rent control).

2. *Where a price control agency tightly constrains returns on investment for a group or class of regulated entities, such as milk manufacturing handlers in an FMMO marketing area, a method for relief from or avoidance of regulation – such as non-pool plant status in the case of milk marketing order Class III and IV price regulation – must be provided.*

The *Permian Basin* decision addressed but did no resolve claims that high cost gas producers should be "proffered opportunities either to withdraw from the regulated activity or to seek special relief from the group rates." The Federal Power Commission had adopted procedures for such relief, which the Court was assured would be expeditiously provided. 370 U.S. at 770-72. Other courts, on review of a variety of price controls, have been guided by *Permian Basin*, to determine whether there are: (1) effective procedures for individual relief from group price control, and (2) opt-out opportunities for individuals in the regulated class.

Applying the *Permian Basin* "special relief from group rates" alternative, the California Supreme Court voided part of an insurance rate law where the standard for relief from price control was limited "to insurers substantially threatened with insolvency." *Calfarm Ins. Co. v. Deukmejian*, 771 P. 2d 1247, 48 Cal.3d 805, 815 (1989). This limitation in the law was deemed to conflict with due process constraints because it "precludes adjustments necessary to achieve the constitutional standard of fair and reasonable rates." *Id.* at 821. Similarly, the federal 9th Circuit voided a Nevada insurance statute under which rate adjustments were limited to "break even" revenue, with no return on investment: "Thus, section 686B.050(3) guarantees only that an insurer will break even; it does not guarantee the constitutionally required 'fair and reasonable return.'" *Guaranty Nat. Ins. Co. v. Gates*, 916 F. 2d 508, 515 (9th Cir. 1990).

Even where individual relief from price control is available, the remedy must be timely. In *Birkenfeld v. City of Berkeley*, 17 Cal.3d 129, 170-71 (1976), The California Supreme Court found that a procedure for individual landlord relief from rent price control was too cumbersome and lengthy. In *Tenoco Oil Co. v. Dept. of Consumer Affairs*, 876 F. 2d 1013, 2027 (1st Cir. 1989), a federal appeals court explained:

> Of course, the reasonableness of a procedure for seeking exemption from or alteration of a regulation which may temporarily confiscate property will depend upon the nature of the regulation, the length of the delay and the impact on a citizen of the challenged order. *** A price regulation which forces wholesalers to sell gasoline for a price which does not cover operating costs and a reasonable profit may, in short order, become so onerous that the wholesalers will be unable ever to recover their earlier cumulative losses through subsequent price increases and may be forced out of business

On remand from the *Tenoco* decision of the 1st Circuit, the federal district court examined the gasoline price controls under the opt-out alternative described in *Permian Basin*:

> To avoid a finding that a taking exists, those most severely affected must be afforded the opportunity to leave the regulated market. "It is well established that government price regulation does not constitute a taking of property where the regulated group is not required to participate in the regulated industry...."

Texaco Puerto Rico, Inc. v. Ocasio Rodriguez, 749 F. Supp. 348, 359 (D PR 1990).

In an FMMO price control context, it is possible that the opportunity to opt-out of regulated status from time to time by "de-pooling" may be sufficient to avoid a confiscatory taking, or to recover losses from inadequate regulated margins in later months when a plant elects not to participate.[70] The need for opt-out (de-pool) opportunities would be particularly acute in a California federal milk marketing order because any FMMO regulation of Class III and IV prices in California would squeeze manufacturer's returns on investment significantly more than USDA milk price controls on manufacturers in other regions.[71] But even the opportunity to opt-out

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[70] *E.g*, De Jong, Ex. 98, pp. 7, 18-20 (explaining the need for de-pooling opportunity, and use of de-pooling by manufacturing plant handlers in the adjoining Pacific Northwest FMMO marketing area to offset inadequate returns under FMMO price margins). There is no FMMO regulation, and therefore no regulated price constraint on manufacturing plant profitability, in the nearby Idaho market, where an increasingly significant part of cheese production in Western states originates, and serves Eastern markets in direct competition with California plants.

[71] See Proposed Findings, 21-22 (cheese manufacturing margins), 26-27 (NFDM manufacturing margins), and 31-32 (butter manufacturing margins), above.

would not protect California milk manufacturers from unreasonably low (negative) returns on investment unless California-specific product values, milk values, and manufacturing costs are reflected in regulated Class III and IV pricing for a California milk marketing order.

Proponent cooperatives maintain that their proposal for a federal milk marketing order for the California Marketing Area cannot allow for de-pooling; the plan would not work without mandatory pooling. This alone is sufficient for the Secretary to conclude that federal milk price control is not appropriate for the California market.

E. The cooperatives' proposal for a federal California Marketing Order is not the "only practical means of advancing the interests of" California milk producers. 7 U.S.C. § 608c(8)(c)(9)(B)...

The AMAA's FMMO decision-making standards are not limited just by express terms that may be included in milk orders (7 U.S.C. §608c(5)), market-specific price consideration (§ 608c(18)), regional distinction (§ 608c(11)), and trade barrier proscriptions (§608c(5)(G)). In the end, should the Secretary decide to promulgate a federal milk marketing order for California, he must also determine "that the issuance of such order is the only practical means of advancing the interests of the [California milk] producers." 7 U.S.C. § 608c(9)(B).

While there are a variety of USDA programs other than FMMO regulation that may help address the recent economic distress of California milk producers (Ex. 112, part B), the state of California system for regulating minimum producer milk prices and distributing regulated milk revenue among producers has been, and remains, a "practical means" of advancing the interests of California milk producers. Federal intervention is not warranted to displace the California system.

CONCLUSION

For the foregoing reasons, the Secretary of Agriculture should determine that proponent cooperatives' proposal for a federal California Milk Marketing Order should not be adopted.

Should the Secretary nevertheless determine that federal intervention is necessary, consistent with 7 U.S.C. § 608c(18), a California FMMO should provide for California-specific Class III and IV minimum prices that do "not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit" (64 Fed Reg at 16094), and also provide individual manufacturing use handlers the opportunity to avoid regulation by de-pooling to the same extent currently allowed for handlers and plants in the adjoining Pacific Northwest federal milk marketing area.

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