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

Clovis, California, September 22, 2015

Testimony of Dr. Eric Erba

In Support of Proposal 1 of California Dairies, Inc.,

Dairy Farmers of America, Inc., and Land O'Lakes, Inc.

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

Cooperatives' Exhibit 4

Introduction

Good morning. My name is Eric Erba and I hold the position of Senior Vice President and Chief Strategy Officer for California Dairies, Inc., whom I am representing today. I have worked for California Dairies, Inc. since September 2006. Prior to that, I worked for the California Department of Food and Agriculture for ten years, with eight of the ten years employed as a dairy economist for the Dairy Marketing Branch. California Dairies is a full-service milk processing cooperative owned by 390 producer-members located throughout California and collectively producing 18 billion pounds of milk per year, or 45% of the milk produced in California. Our producer-members have invested over $500 million in large processing plants at six locations, which will produce about 385 million pounds of butter and 785 million pounds of powdered milk products in 2015.

I will be describing the history, structure, importance of the California quota program, and how we propose that the quota program be incorporated into the California Federal Order as specified in the proposal submitted by the three California cooperatives.

Introduction to the California Quota Program

California maintains a two-tiered milk pricing program for producers where ownership of financial instrument (also recognized as an asset) termed "quota" entitles the producer to an incrementally higher milk price that is paid on the amount of milk covered by quota ownership. Conversely, milk production that is not covered by quota is subject to a lower regulated milk price; this is termed the "overbase" price. The concept of a tiered pricing system was developed in the late 1960s as the California state milk marketing order was attempting to address a producer milk price equity issue.

In an economic sense, quota fits the definition of an economic rent, that is, it represents an excess payment above that required to induce or provide for production or a payment for the services of an economic resource which is not necessary as an incentive for its production. Furthermore, quota is an asset that was created by a regulatory agency with the intent of constructing an official privilege over natural opportunities, a secondary descriptor of economic rents.

Quota payments to producers are an important component of revenues to many California dairy operators. In fact, paramount to any consideration of a California federal milk marketing order (FMMO) was the assurance that the quota program would not in any way be diminished or affected. Congress recognized this and in the 2014 Farm Bill language dealing with the promulgation of an FMMO in California directed that the marketing order provisions allow for the continuation of the quota program in California. The 2014 Farm Bill (section 1410(d)) references the 1996 Farm Bill (section 143(2)),

> "Upon the petition and approval of California dairy producers in the manner provided in section 8c of the Agricultural Adjustment Act (7 U.S.C. 608c), reenacted with amendments by the Agricultural Marketing Agreement Act of 1937, the Secretary shall designate the State of California as a separate Federal milk marketing order. The order covering California shall have the right to reblend and distribute order receipts to recognize quota value."

Quota has an extensive history and has had a significant role in the California dairy industry for over 45 years and was an integral part of the Milk Pooling Plan when it was introduced in 1969. The program has been modified since its creation, but the foundation of the program has remained intact since its introduction. Under the Pooling Plan, producers were no

longer paid directly in accordance with the class utilization of the handler that receives the producer's milk. Instead, producers were paid on the basis of his or her allocated quota, base, and overbase at prices which reflect the poolwide utilization of all classes. Pool quota was established for each producer by milk fat and solids-not-fat on an average daily basis based on historic production and Class 1 usage. Any production in excess of assigned quota and base constituted overbase production. Periodically, the California Department of Food and Agriculture (CDFA) has issued additional quota to producers but none since 1992. CDFA has issued about 2.2 million lbs. of quota solids–not–fat on a daily basis (about 66.2 million lbs. of solids–not–fat monthly).

Quota enjoys a special status in that its existence is protected by state law. The importance of maintaining stability with the quota program was recognized by the California State Legislature. In fact, §62712 of the Food and Agricultural Code specifically states that all pool quota must be recognized and shall not be diminished in any way as long as the milk pooling plan is in effect. Thus, quota can only be eliminated by eliminating the entire milk pooling program.

The proposal submitted by California Dairies, Inc., Dairy Farmers of America and Land O'Lakes ("the Cooperatives") recognizes the history of quota, the financial investment made by dairy producers in quota and the federal directive to recognize the value of California quota. Thus, the Cooperatives propose that the quota program be left intact without significant modifications and continue to be administered by CDFA through a memorandum of understanding with the United States Department of Agriculture.

Before Quota – An Overview of the California Dairy Industry

The milk marketing laws passed in the 1930s, especially the Young Act of 1935, helped to regulate the minimum price paid for milk by processors to producers by establishing classified

milk prices. Class 1 utilization, which was used for beverage products, usually commands the highest price. Progressively lower prices applied to milk devoted to the manufacturing classes of milk.

However, establishing minimum prices did not address the concerns of equitable prices among producers for compositionally similar milk. Plants processed an array of products, and consequently, class utilization among plants varied. In addition, processing plants were well underway to becoming "specialized" by processing fewer products. Some plants processed 100 percent of the milk received as Class 1 products, but other plants tended to specialize in manufactured products, processing little or no milk as Class 1 products. These characterizations represented the extremes, and it was more typical to find plants with moderate Class 1 utilizations. Nonetheless, a producer shipping to a plant with all Class 1 utilization fared well financially while a neighboring producer selling milk of like quality to a plant with low Class 1 utilization typically received a considerably lower price.

In the late 1950's and early 1960's, disparate prices among producers in the same region were a source of frustration and led to destructive marketing practices. Clearly, a producer's financial welfare was impacted by his or her ability to secure a contract with a handler with high Class 1 utilization. This placed producers in a weak position to bargain with handlers, and many would agree to excessive haul charges or make other concessions to obtain or retain the coveted sales to Class 1 handlers. The lack of long–term commitments between producer and handler added to the instability in the milk market. Most contracts were subject to cancellation by either party upon thirty-days' notice.

It was difficult for producers to obtain new contracts, especially with plants that maintained high Class 1 utilization year round. Not surprisingly, the loss of a contract to an

individual producer was a severe economic blow. Producers often accepted contracts with handlers that gave the handler the permission to divert milk shipments to manufacturing facilities. Besides receiving a significantly lower milk price, producers were also expected to pay for the additional cost of hauling their milk to the designated plant. An alternative was to locate another fluid milk plant that was accepting milk but this did not eliminate the high cost of shipping the milk from the dairy to a distant plant. The uncertainty of obtaining or continuing favorable contracts restricted many producers' future planning horizon and financing capability.

During the early and mid-1960's, several events combined to place even more pressure on producers. Some dairy processors began to alter the traditional framework of the milk production sector by acquiring herds and supplying their own processing facilities with milk, thereby reducing the number and volume of Class 1 contracts available to existing producers.

Producers realized the necessity of developing a system that would bring relief to their problems and provide a more equitable allocation of the revenues generated from Class 1 milk sales. Producers and producer organizations concluded that such a system could be brought about only through legislation and introduced a number of milk pooling bills into the California Legislature. These early efforts to establish a revenue distribution program were not successful because the producer community could not agree on the basic concepts of the program.

In 1967, the Legislature passed the Gonsalves Milk Pooling Act, and it was signed by the Governor into law on November 8, 1967. This act required the California State Secretary of Agriculture to formulate a Pooling Plan via the public hearing process. The Pooling Plan became active in November 1968 after an affirmative vote of eligible milk producers. Developing the mechanics of a pool price calculation delayed implementation until July 1969. The pool area covers the entire state.

Production Base and Pool Quota

During the preliminary stages of formulating a plan, basic milk production data were gathered to establish two benchmarks for each eligible producer — a production base and pool quota. A producer's history was based on his or her milk production ("production base") and a producer's Class 1 usage during July 1966 through December 1966 or the 1967 calendar year became the benchmark to establish a producer's quota. Production base and pool quota were established for each producer by milk fat and solids-not-fat on an average daily basis. Pool quota was established at 110% of Class 1 usage, and the amount by which production base exceeded pool quota was designated as "base".

With the implementation of the Pooling Plan, producers were no longer paid directly in accordance with the class utilization of the contracting handler. Instead, producers were paid on the basis of their allocated quota, base, and overbase at prices which reflect the poolwide utilization of all classes. The monthly quota and base quantities were computed for each producer to the extent he or she produced these quantities. The maximum monthly quantity of quota was determined by the current quota allocation. The maximum monthly quantity of base was the difference between production base and quota. Any production in excess of the total of these two figures constituted overbase production.

Pool Value, Pool Prices and Pool Obligations

Under the California regulatory structure, each handler submits to the Pooling Branch a monthly report detailing the amounts of milk purchased from producers and other handlers and the amounts used in the various classes, which is then used to determine each handler's pool obligation. The total value of each class is determined by multiplying the class utilization by its

appropriate class price as announced by CDFA. Summing these respective amounts across all pool handlers results in the pool value.

The Department prepares and mails a statement for each handler on or before the 28th of each month showing the gross amount the handler owes each producer. The statement itemizes the handler's class utilization and the gross amount the handler is directed to pay producers for their quota, base, and overbase milk ("pool prices"). The statement does not include authorized deductions the handler may claim, e.g., milk hauling cost. If the total value of the milk used is greater than the amount the handler owes producers for their milk, the handler pays the difference into the pool equalization fund. On the other hand, if the amount owed producers is more than the value of the milk used, the handler draws the difference from the pool via the pool equalization fund.

Determining Pool Prices 1969 - 1994

Minimum prices for milk purchases are announced by CDFA each month. Prices are determined according to how the milk was used, meaning that milk that was made into cheese might have a different price than milk that was made into butter or into ice cream. Typically, although not always, classified prices follow a predictable and descending scale. In other words, the price for Class 1 (fluid milks) carries a higher price than Class 2 (yogurt, cottage cheese), which carries a higher price than Class 3 (ice cream and frozen dairy desserts), which carries a higher price than Class 4 (butter, milk powders and cheese).

The Pooling Plan specified that the highest value milk was allocated to the quota pool first, then to the base pool and then finally to the overbase pool, in descending order of class value. The amount of components in each pool, i.e., quota, base, and overbase, was determined by the pounds available. Once pounds of components were determined, they were multiplied by

the applicable class component price to determine revenue contained in each pool. Pool revenue divided by pool pounds provided pool price per pound. The order of priority for fulfillment was quota fat/SNF, base fat/SNF and overbase fat/SNF. Thus, the Class 1 pounds of fat were used to offset the quota fat obligation. If Class 1 fat pounds were insufficient to offset the obligation, then Class 2 fat pounds were used and so on until the quota fat needs were met. The same process was repeated for quota SNF, base fat and base SNF. All remaining milk sales revenue was assigned to the overbase pool.

Determining Pool Prices After 1994

By the late 1980s, overbase milk production had increased considerably in relation to quota milk production. There was also a growing concern among producers about low milk prices. The California dairy industry generally recognized that there was room for some milk price enhancement for Classes 1, 2 and 3. However, because of the methods in place for distributing milk sales revenues from the pool, the difficulty of increasing prices for those classes was that nearly all of the price increase would be funneled into higher quota milk prices without materially affecting overbase prices.

Following a directive from the California Legislature, CDFA appointed a committee of dairy producers in 1991 to conduct listening sessions throughout the state to receive comments and input on the milk pricing regulatory system. The stated goal of the committee was to strengthen the milk pooling and quota systems. During industry listening sessions held throughout the state, the committee concluded that overbase producers became uneasy when the spread between the quota price and the overbase price became too high (e.g., a difference of $2.00 per cwt. or more). Conversely, the quota producers were similarly troubled when the spread got too small or even became inverted. Several producers who testified at the listening

sessions proposed some type of 'known' spread between quota and overbase prices. Some proposed a floor and ceiling concept where the spread could fluctuate within a predetermined range, while others proposed a fixed spread. The committee favored the differential concept as a way of strengthening the quota system. The committee engaged in considerable discussion before settling on the fixed $1.70 per cwt. (for milk testing 3.5% fat and 8.7% SNF). At $1.70 per cwt. level, the committee felt they could reasonably conclude that the overbase milk would not subsidize the quota milk, and the quota owner would receive a reasonable return for his investment. This also represented the approximate average spread between the quota and overbase prices for the prior five years.

The committee submitted a formal report to the California Legislature that addressed several items, including the recommendation from the Committee to implement a fixed differential between the quota price and overbase price of $1.70 per cwt. Rather than implement the change using the regulatory public hearing process, the fixed differential was written into the California Food and Agricultural Code, i.e., state law. Consequently, as of January 1 1994, Chapter 3.5 of the California Food and Agricultural Code established the quota premium paid to producers who own quota at $0.195 per lb. of SNF for Southern California counties without Regional Quota Adjusters (RQAs are discussed in the next section) and at $0.195 per lb. of SNF minus the assigned RQA for all other California counties. The quota premium is discounted in all other counties of the state by the assigned RQA. The move to a fixed differential also changed the allocation of quota value by component in that all of the price differential above the overbase price was assigned to SNF, i.e., the price for quota fat was set equal to the price for overbase fat. Finally, Chapter 3.5 of the California Food and Agricultural Code also provided that the fixed differential would remain operative until the Secretary certifies that producers had voted via a

referendum to suspend the operation of the chapter. At that point, the fixed differential would be suspended, and quota milk price calculation would revert to the methods used prior to 1994.

Quota premium payments are deducted from total pool revenues, and average between $12.5 million and $13.0 million per month, depending on days-in-month and eligible production marketed. RQAs, by construction, are a deduction from quota payments out of the pool, and, consequently, RQAs actually return revenue to the pool. After the appropriate deductions to the quota premium are taken via RQAs, the quota premium paid out of the pool amounts to a monthly cost of about $0.37 per cwt. on all pooled grade A milk marketed in California.

Producer prices are paid on the basis of pounds of fat and pounds of SNF. The producer fat price per pound is equivalent for both quota and non-quota milk, a result of adding Chapter 3.5 to the Food and Agricultural code in 1994. Consequently, the producer fat price for quota and non-quota milk is basically a weighted average of the individual per pound fat prices that were determined for each of the five classes of milk. Prior to the computation of the weighted average, small pool adjustments, such as plant gains, may be made.

The calculation of quota and non-quota SNF prices is only slightly more involved than the calculation of quota and non-quota fat prices. After the quota premium is determined and set aside and pool adjustments for transportation allowances are made, an average of the remaining SNF revenues is computed, weighted by pounds associated with each class of milk. This becomes the overbase/base price per pound of SNF. The quota price for SNF is determined by adding $0.195 to the overbase/base SNF price per pound.

Adjustments to Quota Value

When pooling was instituted in 1969, location differentials were established to encourage the movement of quota milk to Class 1 plants. Location differentials were added to or

deducted from quota payments to producers and were determined by the location of the plant that first received the milk. Location differentials applied only to the hundredweight milk equivalent of quota. In following the traditional movement of milk from supply areas to deficit areas, the higher hauling cost tended to be offset by a more favorable location differential. Conversely, if milk was needed locally for Class 1 usage, a lower location differential tended to be offset by a lower haul cost.

Over time, overbase milk became a larger and larger share of the milk produced by individual producers. Consequently, location differentials based solely on quota milk were no longer able to ensure that adequate milk supplies were made available to Class 1 plants. In June 1983, location differentials were replaced by transportation allowances and RQAs. Transportation allowances partially compensate producers for the cost of hauling milk from a producer's ranch to qualified plants. These allowances apply to all market milk moving from dairy farms to processing plants which process more than 50 percent of their production into Class 1, Class 2, and/or Class 3 products. In addition, cooperative members receive transportation allowances on shipments to their plant if the plant is located in a deficit area and if the plant supplies 40 percent of its receipts for Class 1 usage.

The purpose of RQAs is less transparent because they do not provide any direct incentive to move milk to Class 1 plants. They were developed to address equity issues arising out of the elimination of the location differentials and are deducted from the quota payments to producers. RQAs are determined by the geographical location of the producer's dairy farm (currently accomplished by designating RQAs by county of dairy farm location) and apply to the hundredweight milk equivalent of quota produced at 3.5% butterfat and 8.7% SNF. Presently, these rates range from 0¢ per hundredweight for dairy farms located in Southern California

counties to a minus –27¢ per hundredweight for dairy farms located in Fresno, Kings, and Tulare counties (see Map at Exhibit 4.A hereto).

Producer-Handlers and Exempt Quota

A producer–distributor (PD; also called producer–handler) is characterized by simultaneous ownership of both the milk production and milk processing facilities. In California, there are two types of PDs. Fully exempt PDs (Option 66 PDs) do not account to the pool for any of their Class 1 production, but there are significant restrictions on production and sales:

- The entity must own both the milk production and milk processing facilities;
- The own-farm production must average less than 500 gallons per day for a 12–month period;
- Sales must average less than 500 gallons per day for 12–month period;
- The entity may not receive more than 25% of total fluid milk sales from sources other than its own dairy farm;
- The entity must have retail sales for his/her own account of not less than 50% of total Class 1 sales.

Historically, very few Class 1 processors have qualified for this designation, and the amount of milk processed by fully exempt PDs has represented far less than 1% of the Class 1 milk in the state.

The second type of PD, the option exempt PDs (Option 70 PDs), do not qualify for full exemption but have common ownership of production and processing enterprises. The option exempt PDs have no restrictions on retail sales or outside purchases and are subject to pool obligations, at least in part – they do not account to the pool for the Class 1 production that is

covered by exempt quota owned by the PD but they do account to the pool for all other production. There are four option exempt PDs operating in California, and their combined Class 1 exemptions are 57,914 lbs. per day. That equates to about 5% of the Class 1 milk produced in the state. There is no opportunity to establish additional option exempt PDs without a change a state law. Furthermore, the exempt quota owned by the PDs is not transferrable without loss of the exemption. In other words, exempt quota converts to "regular" quota if it is transferred to another production entity.

Prior to January 1, 1978, the option exempt PDs could deduct their original pool quota from their Class 1 obligations. Any purchased quota could not be deducted and was treated like quota owned by a producer. In 1994, the option exempt PDs were allowed to include the quota they had purchased after January 1, 1978 and before March 1, 1995 toward their Class 1 obligations. All four operating option exempt PDs qualify for a further daily deduction of 150 pounds fat and 375 pounds solids-not-fat from Class 1 pool obligations because none have transferred production base and pool quota after February 9, 1977.

By construct, exempt quota establishes an economic benefit beyond the value of standard quota. Standard quota entitles the owner to a higher price that is established at $0.195 per lb. of SNF per day. Exempt quota waives the obligation of the owner to account to the pool for the equivalent amount of Class 1 production. The additional benefit of exempt quota is, then, the difference between the announced Class 1 price and the announced RQA-adjusted quota price for the same month. From January 1970 to December 2014, the additional value to exempt quota owners averaged $0.58 per cwt. in Southern California (RQA of $0.00 per cwt.).

Producer Responsibility

Although producers have gained considerable independence they are still charged with responsible performance standards. Quota payments apply to only milk produced on a dairy farm located in California. A producer must produce milk of the required quality standards or lose quota entitlement as a consequence. For each day milk is rejected for not meeting the quality standards specified in the contract, the monthly quota eligibility is reduced by one day's quota amount. Rejected milk is still eligible to be accounted for in the base pool.

A producer may not have quota and simply hold it without producing milk. Failure to ship milk to a pool handler for a period of 60 days shall result in the forfeiture of all production base and pool quota. A proportionate amount of monthly quota entitlement will be lost for any milk shipped directly to a nonpool plant.

Allocating New Quota

One of the declared purposes of the Gonsalves Milk Pooling Act is to equalize gradually the distribution of Class 1 and Class 2 utilization among California producers. Allocation of new quota based on Class 1 and Class 2 growth was a necessary provision instrumental in attaining this goal. Class 1 and Class 2 sales for the most recent 12–month period, September through August, is compared to that of the previous highest identical 12–month period to determine the amount of increase necessary. The resulting amount is made available for allocation as new quota. New quota allocation to existing producers is made effective January 1, following the 12–month period during which the available new quota is determined.

Prior to January 1, 1985, the amount of new quota to be allocated was determined by comparing Class 1 and Class 2 sales for the most recent September through August period to that of the preceding period. The increase was then adjusted for the estimated Class 1 and Class 2

requirements of the succeeding year, less such estimate made the prior year and further adjusted to add standby requirements. After January 1, 1985 the amount of new quota to be allocated was determined by comparing Class 1 and Class 2 sales to the highest 12-month period (September through August) on record, which was 1990/1991. The last new quota became available in January 1992, and 80% of it was issued to existing producers. Because there were few new producers during that time, it took over four years to distribute the remaining 20% of the new quota.

Prior to 1979, when new quota was issued, forty percent of the new quota available was allocated to producers holding unequalized production base and pool quota. Unequalized meant that the quota held by a producer was below 95 percent of the production base. The allocation was based on a formula that gave a higher percentage of new quota to those producers having low quota in relation to production base. No quota could be allocated to an unequalized producer that would be in excess of that needed to bring quota to the equalized level. Any such excess quota was reallocated to the qualifying producers still below the equalization point.

The unequalized quota are those allocated to new producer entrants after the start of the pooling program. All of the original issue of production base and pool quota was brought to equalization effective July 1, 1978 as directed by statutory amendment. This one–time direct issue of quota was not conditioned on any increase in Class 1 and Class 2 sales.

After 1979, forty percent of available quota is allocated to equalized producers (those producers whose quota is 95 percent or more of production base) prorated according to the quota held by each. Forty percent is allocated to unequalized producers.

Twenty percent of the new quota available is allocated to qualifying new producer applicants who do not have production base and pool quota. In order to apply for this allocation,

a new producer must have been in continuous production for one year, and on the date of application must be shipping market grade milk to a pool handler. Available quota is allocated to these producers on a priority basis, first priority being determined on the basis of the date the application is received. Ties are broken by the longest period in continuous commercial production, and further ties are decided on the basis of the longest period in market grade production. In addition, any quota that has been forfeited after April 30, 1981, is allocated on a continuing basis to qualifying new producers.

Allocations to New Producers

The amount of quota to be allocated to new producers is based on the daily average of fat and solids-not-fat produced during the most recent three–month period from September through November. A maximum of 150 pounds of fat and 375 pounds of solids–not–fat can be considered. Allocation is made at either 95 percent of the qualifying production of each component, or 60 pounds of fat and 150 pounds of solids-not-fat, whichever is less. If a producer enters at the equalized 95 percent level, he or she is given the qualifying production as production base, and only qualifies for further quota allocation as an existing equalized producer. If the producer enters at less than the 95 percent level, production base is granted at 111 percent of the quota allocated.

After holding this initial allocation for a minimum of one year, a new producer qualifies as an existing producer to participate in future allocation of new quota. In the subsequent allocations, the qualifying period production will be used in determining the amount of quota received. Additional production base will be allocated equal to 111 percent of the additional quota until the producer eventually has quota equal to 95 percent of the qualifying period production. At that point, the qualifying period production will be assigned as production base.

Prior to January 1, 1977 the maximum allocated to new producers as production base was the average daily production during the 12–month period preceding the application, or 90 percent of the average production base of all existing producers, whichever was less. The maximum quota that was allocated was 20 percent of the allocated production base, or the lowest percentage of pool quota to production base of all existing producers, whichever was less.

Transferability of Production Base and Pool Quota

Subject to certain restrictions, production bases and pool quotas are transferable. The restrictions are imposed to prevent quota from becoming a commodity for speculation. For example, a quota owner must be a market milk ("Grade A") producer that ships to a pool plant at least once every sixty days. Also, a quota owner who buys quota may not sell any quota for two years, and a quota owner who sells quota may not buy any quota for two years. A producer may sell to another producer in the pool area, or change locations within the pool area and carry the quota to the new location. Quota that moves from one dairy location to another may be subject to a different RQA. All transfers must be approved by the Secretary of Agriculture before the transfer can be made effective, and all quota transfers are made effective on the first day of the month.

The published average price per pound of quota solids–not–fat (without the inclusion of cows) reflects the true value of the quota sold. Although the price is expressed in terms of quota solids–not–fat, the transaction carries with it the related production base solids–not–fat, production base fat, and quota fat.

Pool quota has been transferred among producers continuously since quota was introduced in 1969 (see Exhibit 4.B hereto). In the first year alone, 342 producers sold at least some quota, 624 producers bought some quota, and 273 transactions dispersed 100% of a producer's quota. In addition, 51,176 lbs. of quota fat and 127,504 lbs. of quota SNF were transferred. Since 1969, there has been an average of ten quota sellers and thirteen quota buyers every month.

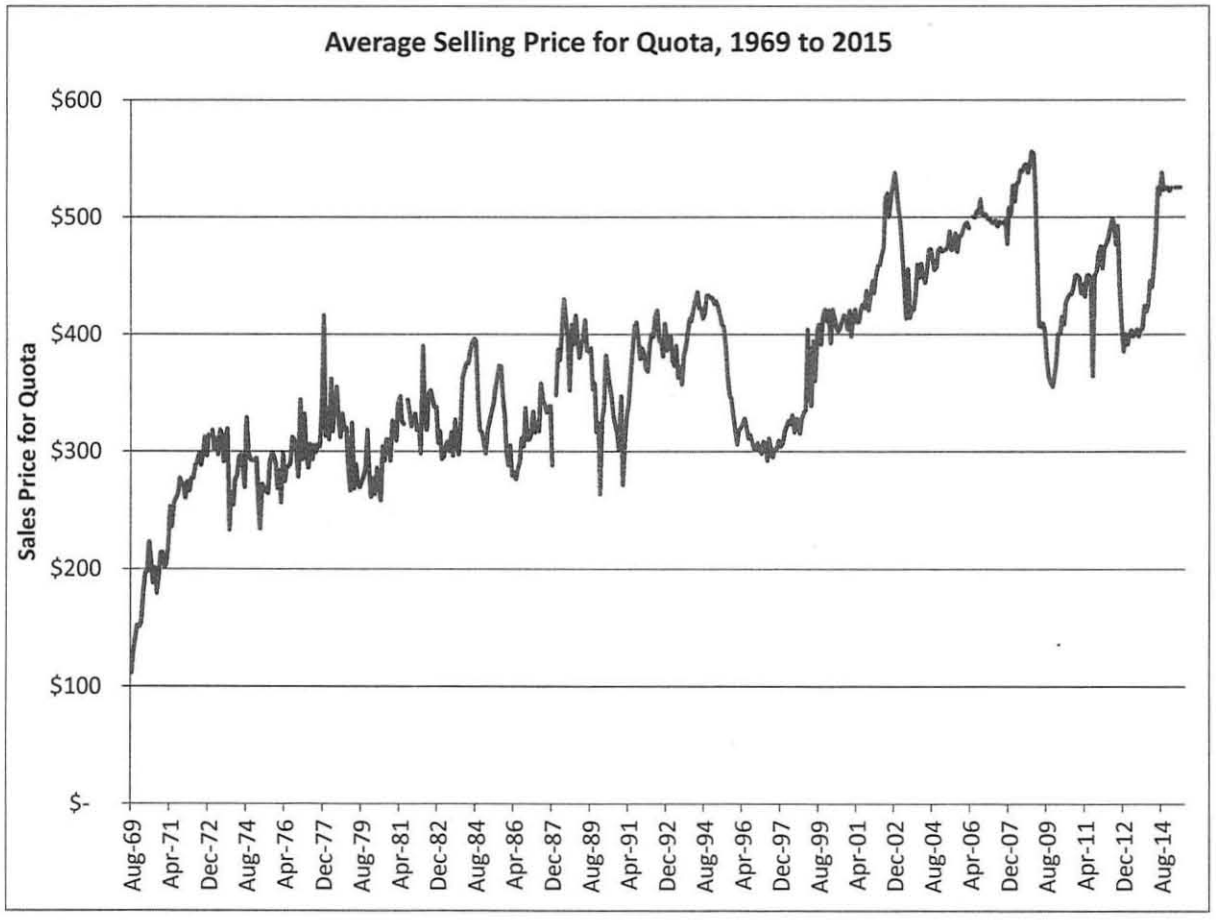
Quota transactions continue to occur nearly every month, underscoring the importance and prevalence of quota to the California dairy industry. While transacted monthly sales volumes range widely (for example, from a minimum of 0 lbs. of quota fat and SNF to a maximum of 13,345 lbs. of quota fat and 99,574 lbs. of quota SNF), on average 2,668 lbs. of quota fat and 6,603 lbs. of quota SNF are transferred each month. Over the 552 month period, which commences with August 1969, the average price for quota sold was $370 per lb. of quota SNF. Since the introduction of quota, the price has ranged from $236 to $570 per lb. of quota SNF (see "Average Selling Price for Quota" chart below). For the most recent 12-month period, quota has sold for an average of $525 per lb. of quota SNF. Thus, at current market prices, the total value of the 66.2 million lbs. of quota solids not fat owned by California dairy producers is $1.2 billion.

Producer Review Board

The Gonsalves Milk Pooling Act required the Director of CDFA to appoint a Producer Review Board consisting of 12 producer members. The function of this Board is to hear appeals of producers seeking hardship relief due to conditions beyond their control and make recommendations to the Director to either approve, disapprove, or modify the request. An example might be a producer who purchased quota and was subsequently impacted by fire or

flood and forced to liquidate his assets (including quota), thus violating the prohibition of selling quota before two full years of quota ownership.

The Board, since 1978 consisting of 12 producer members and 1 public member, also gives counsel, assistance, and recommendations on administrative matters and problem areas of the pooling program. Since its formation, it has made numerous recommendations on producer appeals and administrative issues.



Verification of Records

Personnel within the Milk Pooling Branch perform comprehensive audits of the records of handlers to determine their compliance with the reporting and payment procedures required by the Milk Stabilization and Marketing Plans and the Pooling Plan. Monetary adjustments are made to a handler's account to correct discrepancies revealed by the audit with such adjustments being reflected in the quota price calculation. The payments to producers are also monitored to ensure that payments are made in the correct amount and at the proper intervals and that no unauthorized deductions are made.

Quota Ownership

At least some quota is owned by more than half of the dairy producers in California. Conversely, about 42% of California dairy farms own no quota. However, the percentage of dairies that own no quota has increased considerably in the last twenty years (see Table 1 below). In 1995, the distribution of quota ownership was relatively uniform across all six categories. However, as the industry changed in terms of annual milk production (increased by 57%) and number of Grade A dairies (decreased by 35%), the distribution of quota ownership has changed as well. The most striking change is the percentage of California dairy farms with no quota. Most of the other categories have not changed much in the last twenty years.

Table 1. Percentage of California Dairy Farms by Quota Ownership as of January of Each Year Listed

(% of quota relative to milk production)

Quota Ownership	1995	2000	2005	2010	2015
0%	17%	28%	35%	37%	42%
1% to 20%	23%	23%	22%	21%	20%
21% to 40%	19%	17%	15%	15%	13%
41% to 60%	16%	14%	11%	11%	9%
61% to 80%	13%	11%	9%	8%	7%
Over 80%	11%	7%	8%	8%	9%
No. of dairy farms	2,161	2,003	1,828	1,566	1,407
No. of dairy farms with quota	1,786	1,434	1,185	987	815

Source: CDFA

Milk production in California over the past 35 years has become more concentrated within the counties that make up the Central Valley (see Table 2 at Exhibit 4.C hereto). From 1980 to 2015 (estimated), milk production increases in the Central California counties listed ranged from 230% to 1,211%. At the same time, milk production decreased in the counties representing Southern California and the North Coast (-1% to -53%). As the geographic footprint of milk production shrank (even as California's milk production increased), quota tended to follow dairies as they relocated to the Central Valley, particularly from Southern California. This is evident in Table 3 (see Exhibit 4.D hereto), which shows that from 1980 to 2015, quota holdings increased for all Central Valley counties listed but decreased for the counties representing Southern California and the North Coast. Thus, quota has tended to become more concentrated in a small number of counties, most of them located in the Central Valley. In fact,

the top ten counties for quota holdings account for over 92% of all quota allocated (see Table 3 at Exhibit 4.D hereto).

Continuation of Quota Program under a CA-FMMO

The proposal from the Cooperatives describes several operative definitions that are necessary to carry out the administration of the quota program; these are found in § 1050.17 (a) through (d).

"CDFA" refers to the California Department of Food and Agriculture, which is the agency of the State of California responsible for administration of the California dairy producer milk quota program as established in the California Food and Agricultural Code.

"Quota premium" means the value established pursuant to the California Food and Agricultural Code §§ 62750 et seq. "Quota premium" and "quota premium value" mean the value per pound of nonfat solids, and include adjustments by the applicable RQAs.

"Quota nonfat solids" means the pounds of nonfat solids of a producer, as determined and reported by CDFA, which qualify for the quota premium. "Non-quota milk" means pool milk not eligible for the quota premium.

While the California dairy industry's state milk marketing order is unique in many respects, the California Food and Agricultural Code contains language that anticipates that the state order may be replaced by a FMMO eventually and specifies how to reconcile the two orders. From § 62726 of the California Food and Agricultural Code, the following discussion is found:

> Notwithstanding other laws to the contrary, in the event a milk marketing order under the jurisdiction of the United States Department of Agriculture or other appropriate federal agency, is created by referendum or under the applicable laws

and procedures relating thereto, in this state or in any geographical area within this state, the provisions of this chapter or any part thereof which is in conflict with such federal order, or which is unnecessary or is a duplication thereof, shall be suspended in the geographical area covered by and during the existence of such federal order. The director shall take such steps and procedures as are necessary to wind up and conclude the administration and enforcement of the provisions of this chapter, or any part thereof, prior to the suspension date.

In effect, if a FMMO is approved by a referendum of California producers, those aspects of the California state statutes that are in conflict with the FMMO or are duplicative of the FMMO shall be suspended. Clearly, the quota program is not duplicative of any aspect of a FMMO.

The California quota program is regarded as a valuable investment option by California dairy producers. Producers who have decided to invest more money in their dairy enterprises may, for example, increase cow numbers, remodel their facilities, buy more land for crop production or buy quota, which entitles owners to a higher milk price. As I mentioned earlier in my testimony, quota payments to producers are an important source of revenues for many California dairy operators, and preservation of the quota program to the greatest extent possible is an objective of the Cooperative's proposal. The objective is consistent with the Congressional language found in the 2014 Farm Bill language dealing with the promulgation of an FMMO in California. Specifically, section 1410(d) of the 2014 Farm Bill references the 1996 Farm Bill (section 143(2)), and states:

"Upon the petition and approval of California dairy producers in the manner provided in section 8c of the Agricultural Adjustment Act (7 U.S.C. 608c),

reenacted with amendments by the Agricultural Marketing Agreement Act of 1937, the Secretary shall designate the State of California as a separate Federal milk marketing order. The order covering California shall have the right to reblend and distribute order receipts to recognize quota value."

The language from Congress makes it clear that the quota program should have the right to exist within the framework of a FMMO. The Cooperatives' proposal recognizes the importance and sensitivity of maintaining the quota program virtually intact within the California FMMO. Recall from earlier discussions that over half of California dairy producers own at least some quota, and the total market value of all quota owned is nearly $1.2 billion. Thus, we propose that the continuation of the quota program be made possible through a joint effort with CDFA and USDA via a memorandum of understanding (MOU). Joint administrative apparatuses have been established previously between USDA and state agricultural agencies. USDA maintains MOUs with CDFA for data collection and dissemination. For example, an MOU exists between USDA-National Agricultural Statistics Service, CDFA and the California Agricultural Commissioners and Sealers Association to collect and share agricultural statistics for California counties. Furthermore, USDA has had established written agreements with the States of New York and New Jersey to jointly administer ~~conterminously~~ coterminously the rules and orders for milk marketing areas in New York and New Jersey (see Exhibits 4.E and 4.F hereto, respectively). The purpose of the agreements is captured succinctly in the New Jersey agreement:

"...the procedure outlined (in this document) is hereby adopted by the Secretary of Agriculture of the United States and the Director of the Office of Milk Industry, State of New Jersey, as the framework within which the parties hereto

will cooperate with each other in connection with milk orders applicable to the handling of milk in marketing areas located in the State of New Jersey."

The expectation is that the MOU for CDFA and USDA would pursue a similar degree of cooperation and understanding. In effect, the CA-FMMO does not disturb the quota program. Instead, under the Cooperative's proposal, the quota program becomes embedded within the CA-FMMO with full information transfer between the two governmental agencies. Each month, CDFA will communicate to the CA-FMMO market administrator (MA) all financial calculations relative to the net cost to the pool of quota payments. The MA would then take all steps to assure that quota values are deducted from pool revenues and paid to producers properly. Also, the MA would remit any necessary information regarding quota payments back to CDFA to allow ongoing administration of the quota program. Thus, the proposal leaves all jurisdiction over quota administration, calculations, record keeping, and regulatory changes to CDFA. As such, the laws, regulations and policies in operation at the time of adoption of the CA-FMMO would remain unchanged. There are no provisions in the Cooperative's proposal that would alter quota payments. The quota premium of $0.195 per lb. of quota SNF is maintained, as are the applicable RQAs.

As a practical matter of providing the MA with the information specified in §~~1050.61~~ 1051.61 and §~~1050.62,~~ 1051.62 CDFA would have to determine, obtain and/or verify each month:

- The active California dairy producers;
- Amounts of quota owned by each producer after reviewing and applying quota transactions that occurred as of the 15th day of the prior month;
- Location of each producer (to verify applicable RQA);
- Number of days of eligible production;

- Individual producer quota payment after taking into consideration applicable RQAs and eligible milk production for the month.

According to the handler reporting requirements contained in Section 1050.30 of the Cooperatives' proposal, pool handlers shall report to the MA as of the 9th day after the end of the prior month the pounds of milk, butterfat, protein, and other nonfat solids contained in producer milk.[1] § 1050.31 (a) and (a.1) also allow the MA the flexibility to require additional producer information as deemed necessary by the MA, including information pertaining to producer degraded milk for the month. This producer data is to be shared with CDFA along the applicable class prices (announced by the 5th day after the end of the month). The intention is that before the 14th day after the end of the prior month, CDFA can determine and report to the MA of the CA-FMMO the applicable individual producer quota payments. At the same time, CDFA shall report to the MA the quota pounds associated with the milk supply received by each handler, which will be used to determine possible payments into (or draws from) the producer-settlement fund. To be clear, only information is exchanged between the two regulatory agencies; no money will move between CDFA and the MA.

§ 1050.61 provides detailed steps describing how the MA shall determine producer component prices per pound of butterfat, protein and other solids. After combining all values into a single milk sales revenue pool and making the necessary adjustments to that revenue pool (described in §1050.60), the MA shall deduct from the revenue pool an amount equivalent to the quota premium as reported to the MA by CDFA prior to calculating any milk component prices. As specified in §1050.62, the MA shall announce publicly the applicable quota premiums for

[1] The dates referenced for reporting information to the MA have changed from the proposal submitted in February 2015. Three days has been added to each deadline to accommodate actual accounting practices for milk receipts and utilization.

SNF to be paid to quota holders on eligible milk production and the statistically uniform price for non-quota milk, as well as other relevant prices by the 14th day after the end of the prior month.

The producer-settlement fund is established and used by the MA as the repository for all payments made by handlers and the fund from which payments are made within the federal order. Payments due any handler shall be offset by the payments owed by the handler. Payments into the fund by handlers shall follow the steps provided in §~~1050.71~~ 1051.71 and reflect announced minimum prices and utilization of the components of milk. If any payments are due by a handler, they are to be received no later than the 16th day after the end of the prior month. The procedural steps for payments due handlers from the producer-settlement fund are specified in §~~1050.72.~~ 1051.72 Payments from the producer-settlement fund reflect the monies due producers based on each handler's producer payroll, which closely follows procedures followed in other FMMOs. One significant difference for the California FMMO is that the additional value resulting from a handler receiving milk covered by quota is credited to the handler from the producer-settlement fund. This allows handlers to pay appropriate amounts for all milk received, no matter how the milk is used and no matter if the milk is covered by quota. Payments from the producer-settlement fund, if any, shall be made by the 16th day after the end of the prior month.