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TART CHERRIES GROWN IN) Docket Number(s)
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UTAH, WASHINGTON, AND) FV-10-930-5
WISCONSIN) AMS-FV-10-0087

Brief of Proponents in Support of the Amendment of 7 CFR 930 et
seq

BEFORE:

JILL S. CLIFTON, Administrative Law Judge
One Division Avenue,
Grand Rapids, Michigan
(707) 364-8996

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ISSUE 1: PORTIONS OF THE TART CHERRY INDUSTRY MARKETING ORDER SET OUT IN 7 CFR § 930 ET SEQ. SHOULD BE AMENDED TO EXCLUDE IN-ORCHARD DIVERSION ACTIVITIES FROM THE DEFINITION OF "HANDLE" AS SET FORTH IN §930.10

Introduction:

The specific goal of all marketing orders is to improve grower returns. These orders should be amended by their respective industries in ways that will maximize returns to growers. The current amendment, a change to how "handle" is defined in the order, would do just that.

Definition of "Handle"

"Handle" is a central and key concept within the marketing order. From the definition of "handle" various things flow, including the degree of restriction of the current crop calculated under the Optimum Supply Formula (OSF) in §930.50, the setting of handlers' opportunities for selling in the open market in any given year and the degree of inventory reserves that must be maintained by handlers in compliance with the annual restriction. Thus, the proper definition of handle is of critical importance to growers and handlers within the tart cherry industry.

The marketing order defines "handle" as including both (1) the cherries processed by handlers during the year and (2) the volume of grower diversion certificates received during the year. (§930.10) The current definition of handle is:

"§930.10 Handle.

Handle means the process to brine, can, concentrate, freeze, dehydrate, pit, press or purée cherries, or in any other way convert cherries commercially into a processed product, or divert cherries pursuant to §930.59, or obtain grower diversion certificates issued pursuant to §930.58, or otherwise place cherries into the current of commerce within the production area or from the area to points outside thereof: Provided, That the term handle shall not include:..." (Emphasis added)

By definition, "handle" includes cherries diverted in the orchard which have not been processed and, therefore, are not available for sale in the marketplace.

The proposed amendment will exclude from the definition of "handle" the act of obtaining grower diversion certificates. The impact of this change will be twofold. First, the "supply" component of the OSF as set out in §930.50 will be reduced by the volume of in-orchard diversion activities in any given year. Second, grower in-orchard diversion activities will continue as compliance tools for handler restriction obligations, but they will do so with an enhanced worth.

The Impact of Including In-Orchard Diversions in the Term "Handle"

In-orchard diversions are authorized by the marketing order under §930.58. This is an option extended to both growers and handlers to deal with the excess supply of cherries that might occur in any given crop year. As was attested to by any number of those who testified, with this tool the potential oversupply of cherries for the year can be partially addressed at the grower level and in advance of the processing of cherries. (See testimonies of Messrs. Ray Rowley, Jim Nugent, Tom Facer and Perry Hedin)

Upon completion of the in-orchard diversions done in accordance with the rules of the Cherry Industry Administrative Board, growers are issued diversion certificates that represent the cherries that were left in the orchard. These grower diversion certificates (GDC's) are then used by handlers in compliance with their restriction obligations established under the OSF.

The inclusion of in-orchard diverted cherries in the definition of "handle" serves to overinflate the volume of cherries included in the supply portion of the OSF.¹ This, in turn, increases the supply of cherries in excess of the "optimal supply", as that term is defined in the order (§930.50 (a)), which leads to larger preliminary restrictions (§930.50 (b)) and final restrictions (§930.50 (d)). Thus, even though growers make an effort to deal with the potential oversupply of cherries by not harvesting and delivering cherries for processing, this is not reflected in the operation of the OSF as presently constructed. To the contrary, the diversion activities are included in the supply portion of the OSF.

In the current formulation of the OSF the worth of the growers' efforts is diminished. Grower in-orchard diversions are effectively discounted by the amount of the restricted percentage under the present operation of the supply formula. Since orchard diversion credits are included in the supply portion of the OSF and are consequently subjected to the restriction percentage, their worth to handlers as a compliance tool is diminished to the extent of the restriction percentage set for the year. (See Hedin, Exhibit 15, pp 2-5; Sherman, Exhibit A of Exhibit 16) This produces the anomalous outcome that, as the restriction gets higher and the need for in-orchard diversions becomes greater, handlers are less inclined to accept in-orchard diversion certificates as part of their compliance programs and instead process more cherries. (Nugent, Transcript pages 105-106) If the restriction percentage exceeds 50%, it is counterproductive to the handlers' interests to accept in-orchard diversion credits.

Thus, whereas handler post-harvest compliance activities such as exports, new market development and charitable contributions are granted pound-for-pound credits against restriction obligations under the order (§930.55 (a)), the pre-harvest diversion activities undertaken by growers are not. Grower diversion activities are discounted by size of the restriction percentage for the year. It is this inequity in the treatment of diversion activities that the current amendment seeks to address.

¹ In the parlance of the industry the inclusion of in-orchard diverted cherries in the supply is described as "top line" credits. This is because on the CIAB's Form 4 the handler includes in the upper portion of the form as part of its supply of cherries the volume of in-orchard diversion certificates received by it. The annual restriction percentage is applied to the total of the processed tonnage, the in-orchard diversions and the at plant diversions.

In the testimony and the exhibits presented during the hearings, reference is made to "bottom line" credits. These refer to credits that handlers use to meet their restriction obligations after the restriction a percentage is applied to a processor's handle. "Bottom line" credits are applied against the restriction obligations imposed upon handler.

The Proposed Amendment Will Continue to Properly Supply the Market

The purpose of the OSF is to ensure that the markets for tart cherries are properly supplied. It provides that the operation of the order must supply 110% of the three-year average of sales of the industry in the "free" market. (§§930.50 (a), (g)) This key aspect of the order will not change with the proposed amendment. It will remain intact. (See Rowley, Ray, Testimony pages 598 - 599)

The proposed change to the definition of "handle" does not affect the operation of the OSF in defining and supplying the free market. The board will continue to determine the appropriate supply for the "free" market under the OSF, and the operation of the order will ensure that the "free" market is, in fact, supplied at 110% of its three-year average. In the examples of the OSF cited by witnesses of the existing and the proposed OSF (See Hedin, Exhibit B of Exhibit 15; Rowley, Ray, Exhibit 18, pp 5-6), the three-year average of "free" sales remains constant. This ensures that the market will be supplied as required. In fact, the proposed amendment contemplates that, if needed, there will be a release of cherries from the restricted to the free category to maintain a free supply of 110% of the average sales.

In the examples prepared by witnesses and presented at the amendment hearing, it will be seen that the surplus of cherries under both the current and the proposed structure of the order are the same. In other words, the same volume of surplus cherries exists in both the current and the proposed formulations. The difference between the current and the proposed formulations of the OSF is reflected in the "restricted" supply portion of the equation.

In the amended OSF the supply of restricted cherries is reduced by the presumed volume of in-orchard diversion activity. Since in-orchard diversions are no longer part of the "handle", they are no longer in the supply portion of the OSF. Thus, the divisor for calculating the restriction is smaller than it is under the current structure of the OSF. This and the conversion of in-orchard diversions into "bottom line" credits are the principal impacts of the proposed amendment to the operation of the OSF.

The Impact of the Proposed Amendment on Grower Prices

The proposed amendment will effectuate the goal of improving returns to and profitability of growers. There are a number of areas related to grower pricing that will be altered and improved with this proposed change. The cumulative effect of these changes could be quite substantial for growers.

- Growers will save some out-of-pocket costs by not incurring costs associated with the harvesting of fruit and not having to pay the check-off assessments that go along with the processing of tart cherries.² The total for this was projected at up to \$0.075 per pound. (Hedin, Exhibit 15, page 14)
- Handlers will save the variable costs of processing surplus tart cherries as well as the costs of carrying the excess inventories. These savings could be used to return to growers a better price for their cherries.

² This assumes that the assessment for the promotion program funded under the marketing order at \$0.005 per pound is passed to the growers either explicitly or implicitly through reduced pricing.

- Growers will receive more for in-orchard diversion certificates since these will have a worth equivalent to handlers' post-harvest diversion credits. (Facer, Exhibit 10, pages 2-3; Hedin, Exhibit 10, page 14; Rowley, Ray, Exhibit 18, page 3, item 14)
- Inventories on hand, whether free or restricted or primary or secondary reserves, have a price depressing impact on grower prices. Since the proposed amendment will likely result in lower total inventory reserves for the industry, grower prices should be increased accordingly. (See chart "Total Production, Total Sale, Average Grower Price", Rowley, Ray, Exhibit 18)

For specific testimony outlining the way in which grower pricing and returns will be affected, please refer to the following testimony:

Facer, Transcript page 73-74;
 Nugent, Transcript pages 107-108, 126-128
 Rowley, Ray, Transcript page 569

The testimony of Mr. Facer with regard to grower pricing was particularly telling. He testified:

"As an example, one of the handlers I've worked with had the following experience in 2009. The 2009 crop was large and there was carryover from 2008 that resulted in a 68% regulation, leaving only 32% available to sell to their customers. The handler required some growers they dealt with to destroy a portion of the fruit in the orchard which they paid the grower \$.05 a pound for the fruit destroyed. The growers were paid \$.15 per pound for the crop that was harvested and delivered. The growers the handler deals with did not have enough fruit on their farms to meet the handler's sales requirements, plus destroy the amount of fruit necessary to meet the obligations."

Mr. Facer continued on to state:

"This forced the handler to purchase excess credits from other handlers and purchase cherry products that they did not market, to place into reserve. They were successful in a sealed bid offer to purchase credits for \$.20 a pound and were unsuccessful in all attempts less than \$.20. If the stated purpose of the marketing order is to improve grower returns I suggest this example points out there is a problem with the system." (Facer, Exhibit 8, pp. 2-3; Transcript pages 37-39)

In this example growers were paid less for both their processed tonnage and for their diversion certificates than the handler paid for post-harvest diversion certificates. Implicit in this testimony is recognition that growers will receive more for their in-orchard diversion activities under the proposed language than they will receive under the current construct of the order.

The situation described by Mr. Facer is a consequence of the supply formula as currently constructed. This is a situation that will be corrected by implementation of the proposed amendment.

Mr. Ray Rowley, in describing the pricing consequence of the proposed amendment, stated:

"So if you look at the bars down below and the thin red line, the important part here is to see that when a crop's low, prices are high; when a crop's high, prices are low. This amendment should help to even out that, and when we have a huge crop, a large crop, a

large restriction, it should take some of those cherries, put them on the ground, and increase the grower price. It gives the growers a tool to be part of this formula, rather than encourage them to not put cherries on the ground in high crop years, as it does currently." (Transcript, page 562, line 3-15)

The Impact of the Proposed Change on Compliance with Restriction

Compliance with the restriction percentages determined under the proposed amendment will be much like it is under the current construct of the order. Handlers will use all of the options available to them to meet the restriction requirements they face. They will continue to use primary and secondary inventory reserves, post-harvest diversion credits, such as exports, new market development efforts and charitable contributions, just as they have in past years. (Facer, Transcript page 78; Hackert, Transcript pages 170-171; Mitchell, Transcript pages 433 - 434; Seaquist, Transcript page 458, lines 11 - 14)

Similarly, handlers will use grower in-orchard diversion certificates as part of their compliance programs. Where there will be a difference under the proposed amendment is in the worth of the grower in-orchard diversion certificates to handlers as compliance options. Since these certificates are not included in "handle" under the proposed amendment, they will not be discounted by the degree of restriction as they currently are. Their "worth" as a compliance option will be exactly equal to any post-harvest diversion credit handlers might earn. If the worth of the certificates is of equal value to the handler, handlers will be inclined to use them more frequently, and handlers will be willing to pay for them just as they would for post-harvest diversion credits.

Implementation of the proposed amendment will also put handlers on more equal footing with each other in dealing with their restriction obligations. As it currently stands, those handlers who are able to take advantage of the post-harvest diversion activities noted above can more easily deal with their restriction obligations than can other handlers whose markets do not provide them with post-harvest diversion opportunities. (This is the case, for example, for the pie fill and hot pack segments of the tart cherry industry.) By making in-orchard diversion credits of equal value to post-harvest diversion credits, many handlers will be better able to meet their restriction obligations by using these grower diversion credits. (See, Sherman, Exhibit 16; Sherman, Transcript, pages 388 - 390; LaCross, Transcript pages 443-444)

Utilization of the In-Orchard Diversion Credits

There might be concern that there could be wholesale in-orchard diversion activity in any and all crop years. Such a concern is undoubtedly speculative and most unlikely.

First, as was testified by a number of witnesses, it is hard to imagine that growers can succeed in the long term by operating under a business model of growing cherries for diversion. As the growers repeatedly testified, they do not grow cherries to put them on the ground. They grow cherries to deliver them for processing. Representative grower statements on this point were:

"...And our philosophy is we don't grow the fruit to put it on the ground. It's a last resort...." (Peterson, Daryl, Transcript, page 202, line 2-4)

"...And as a grower, we don't raise them to put them on the ground. That's not our intent. We raise all our cherries to harvest for sale...." (Willmeng, Randy, page 210, lines 19 - 22)

"...as a grower, nobody is, is putting in the effort and expense of producing an agriculture product to then watch it rot on the ground throughout the month of September..." (Mitchell, Brian, Transcript, page 427, line 14 - 18)

Furthermore, the processors could not maintain markets in the event that there was wholesale destruction of cherries and not deliveries. (See Nugent, Transcript, page 102)

More importantly, economic realities and marketing needs for the tart cherry industry will be determinative of the amount of in-orchard diversions that occur. The testimony during hearing indicated that utilization of the in-orchard diversion credit process would be dependent upon the size of the crop and the volume of free carry-in for the year. In those situations where the crops are manageable, it is probable that the cherries will be delivered for processing. (In-orchard diversions done for quality purposes will continue regardless of crop size, but such diversions tend to be limited.) However, when the crops are large and the need for in-orchard diversion is more significant, growers and their handlers will take appropriate measures to leave cherries in the orchard. (See Nugent, Transcript pages 119 - 120)

"With this change I suggest grower returns will improve as was first envisioned with the original implementation of the marketing order. In years when the crop size is small to large there is unlikely a need to destroy fruit in the orchard, that does not change with this amendment. However, when there is a very large supply, crop size and/or carryover, some handlers will offer much higher payments to growers to destroy fruit than has been experienced to date with the marketing order for the reasons I have already stated. These payments for destruction will entice growers to destroy more fruit than has been destroyed in the past. In the past the fruit that will now be destroyed within the secondary reserve pool, this excessive reserve inventory costing industry carrying cost-plus in most cases frozen storage costs plus some market value depression on the free market. These expenses will be saved in market prices will be a bit less depressed, both will lead to higher grower returns. Over time production must be lined with consumption, the industry cannot produce more than is consumed. The change this amendment makes to the marketing order will aid in bringing the production/consumption closer to balance over time and allow growers to realize increased returns." (Facer, Exhibit 8, page 3; Emphasis added)

The conclusions expressed by Mr. Facer were representative of many of the growers and handlers who testified at the hearings. Grower in-orchard diversions will not be excessive with this change. Rather, they will be orderly, prudent and market driven.

The Amendment Will Make the In-Orchard Diversion Process Much Less Confusing

There is considerable confusion within the tart cherry industry caused by the way that handlers currently account for in-orchard diversions. Under the present structure of the OSF grower diversions are included in the "top line", subject to restriction and, therefore, discounted in worth to the handler. These certificates are then incorporated into the handlers' compliance plans.

This discounting of in-orchard diversion credits is confusing both to handlers and to growers. People do not realize or understand why the discounting occurs or understand the impacts it has. Growers are sometimes asked to provide a net volume of diversion credits along with their delivered cherries. To be able to do this, the grower's volume of required diversion credits must be "grossed up" by the degree of restriction in order to provide the required net volume.

A great deal of confusion surrounds this process and a very great deal of explanation goes along with it. All of this confusion and difficulty will be eliminated with adoption of the amendment. Grower diversions will be bottom line credits just like post-harvest diversions. They will not be discounted and the in-orchard diversion process will be streamlined substantially.

ISSUE 2: THE TART CHERRY INDUSTRY'S SUPPORT FOR THE PROPOSED AMENDMENT IS UNANIMOUS.

Every person who testified at the amendment hearings was strongly supportive of the proposed amendment and of the benefits that it will provide to both growers and handlers. This indicates both the support of the amendment within the industry and its equitable importance to the industry.

The following points show the breadth support for the proposal.

- Growers from Northwest Michigan (District 1), West Central Michigan (District 2), Southwest Michigan (District 3), Utah (District 7), Washington (District 8), and Wisconsin (District 9) all testified in favor of the proposal.
- Handlers from Northwest Michigan (District 1), West Central Michigan (District 2), Southwest Michigan (District 3), New York (District 4), Utah (District 7), Washington (District 8) and Wisconsin (District 9) all testified in support of the proposal.
- Growers and handlers from the two unrestricted districts, Oregon (District 5) and Pennsylvania (District 6), chose not to participate in the amendment hearings suggesting that the issue of the accounting for in-orchard diversion credits from the restricted districts was not a particularly significant issue for those in the unrestricted states.
- CIAB's motion regarding the amendment proposal passed with 17 affirmative votes and 1 abstention out of 18 potential votes.

It is particularly notable that there was no opposition to the proposed amendment voiced during the hearings. In past amendment proceedings for the marketing order for tart cherries there has always been opposition to the proposed amendments expressed by someone. Such was not the case for this proposed amendment.

It was noted during testimony and upon examination of the witnesses that there might be some opposition within the industry to the concept of "bottom line" credits for grower diversions.³ Any opposition to the proposed amendment would be most likely expressed by those processors who are able to earn significant volumes of post-harvest diversion credits and who trade these post-harvest credits with other handlers. Such opposition would arise because the market for their post-harvest diversion credits would be weakened with the advent of "bottom line" credits for in-orchard diversions, and, therefore, the post-harvest diversion credits would be worth less in the marketplace. Handlers who might previously have purchased post-harvest diversion credits could acquire "bottom line" credits from their grower bases thereby lessening demand for post-harvest diversion credits.

Assuming the speculation about the opposition to the proposal is true, this is solely an economic concern that is a statement of the reality of the marketplace and is a manifestation of the role of supply and demand. This is not and should not be an argument that is of adequate substantive

³ It must be kept in mind that any such discussion is only speculation. No one who testified at the hearings expressed any opposition to the proposal. They were only able to speculate on what opponents might feel about the proposal.

merit to derail the proposed amendment. To allow this argument to prevent implementation of the proposed amendment would be to grant and institutionalize an economic advantage for certain handlers in the industry over other handlers in the industry. That would simply be wrong.

Given the strong support for the proposed amendment expressed both by the growers and handlers of tart cherries, it is appropriate to move the proposed amendment forward.

ISSUE 3: THE PROPOSED AMENDMENT SHOULD BE IMPLEMENTED AS A MATTER OF EQUITY BETWEEN GROWERS AND HANDLERS

While the marketing order for tart cherries directly regulates handlers, everyone in the industry is impacted by the operation of the order. When there is a surplus of supply of cherries over the demand for them in the "free" market, everyone in the industry, whether grower or handler, must and does deal with this reality.

The efforts of both growers and handlers should be accorded equal worth and value in the effort to deal with surplus production. The worth and/or the value of diversion activities should be determined and defined by their impact on the surplus of cherries rather than by the point in time or the point in the process at which the diversion activities are done. The proposed amendment does just this.

As the order is currently constructed, the post-harvest diversion activities of the handler community are accorded a pound-for-pound credit against the handlers' restriction obligations. In effect, post-harvest diversion activities are the equivalent of a tax credit in dealing with restriction obligations. Furthermore, post-harvest diversion credits have a known, constant and unwavering worth to handlers as compliance tools.

By contrast, grower in-orchard diversion credits are discounted by the amount of the restricted percentage determined under the OSF. They are not granted a pound-for-pound credit against handlers' restriction obligations, but, rather, something less than this.⁴ In effect, in-orchard diversion activities are the equivalent of a tax deduction in dealing with restriction obligations. Furthermore, in-orchard diversion credits have an unknown, variable and fluctuating worth to handlers as compliance tools which makes them less desirable.

The inequity of the current situation lies in the fact that each of these types of activities removes tonnage from the "excess" or "surplus" supply of cherries. The grower in-orchard diversion credits do so before the cherries are processed; the handler post-harvest diversion credits do so after the cherries are processed. There is no logical reason that a different treatment of these diversion activities should exist under the marketing order. (See Hackert, Transcript Page 167) As was succinctly stated by Mr. Sherman in answer to a question about whether or not the amendment would create an incentive to growers to divert, Mr. Bill Sherman stated:

"...I think it will bring that more into balance and, and I think it's also equitable. Why should a handler have the, why should a handler have a piece of paper that is worth a lot more than the grower has at the field level? I mean, where's the equity in that? There's none..." Transcript, page 403, lines 4 - 10)

⁴ The worth of grower in-orchard diversion credits in the order as currently constructed cannot be determined in the abstract. Their worth as a compliance tool is a function of the restriction percentage. As the degree of restriction changes, the impact and worth of in-orchard diversion activities changes, as well. (See Hedin, Exhibit 15, pages 3-4; Sherman, Transcript, page 417-418) A point of diminishing return for in-orchard diversion credits can be reached if the restriction gets too large. After this point is reached, there is no incentive for a processor to accept in-orchard diversion credits. (See Sherman, Exhibit A of Exhibit 16)

The proposed amendment would eliminate this distinction between the pre-and post-harvest diversion credits. Both types of activities would provide handlers with pound-for-pound credits against their restriction obligations. Both types of activities would have known, constant and unwavering worth to handlers as compliance tools. In effect, both types of activities would be the equivalent of a tax credit in dealing with restriction obligations. (See Sherman, Exhibits B & C, Exhibit 16)

The proposed amendment resolves this disparate treatment of diversion activities. This equitable treatment of the two types of diversion activities would go far in resolving real and perceived discrepancies between the grower and handler communities subject to the marketing order. It would put the two communities on an equal footing with a shared sense of dealing effectively with any surplus production for the year.

ISSUE 4: ALL GROWERS AND HANDLERS, WHETHER "SMALL" OR "LARGE" BY DEFINITION OF THE SMALL BUSINESS ADMINISTRATION (SBA), WILL BE TREATED EQUALLY UNDER THE AMENDMENT TO THE ORDER.

The change to the definition of "handle" and the changes to the order that flow from this change will be universal and will apply equally to all handlers and growers in the industry.

Regardless of the size of a handling entity, its ability to meet the degree of restriction required under the OSF will be increased by the changes that make grower diversions "bottom line" credits. Neither the large nor the small handler will have to worry about accepting in-orchard diversion credits and will be able to apply them to their restriction obligations. Both the large and the small handler will be able to apply in-orchard diversion credits pound-for-pound against their restriction obligation.

The nature of the handlers' operations, the segments in which they market and the sales opportunities they have, will be more determinative of their election to utilize in-orchard diversion credits than will their size as defined by the SBA. If a handler anticipates that it can market its cherries and deal with its restriction obligation without using in-orchard diversions, it will probably opt to accept its growers' cherries. If a handler does not foresee that it will be able to move all of its production through its normal outlets, it will be more inclined to take advantage of bottom line credits. It was even suggested that small handlers would benefit more with the change since they might not have other options available to them. (See Facer, Transcript 77 - 78.) In reality, both small and large entities would benefit from this change.

Similarly, both the large and the small grower will be able to take advantage of the improvement to the in-orchard diversion process. Whether large or small, a grower can opt to deliver or divert their cherries and expect to get a better return for the credits generated by the diversion activities. What this amendment will do for growers, whether large or small, is improve their returns for the actions they do take. This election, however, has nothing to do with its SBA status.

CONCLUSION

The proposed changes to the marketing order to redefine how the industry accounts for and utilizes in-orchard diversions

- is supported by the circumstances in the industry,
- will improve returns to growers,
- will eliminate the disincentive to in-orchard diversions that presently exists in the marketing order,
- will improve and streamline the operation of the marketing order,
- will assist the industry in dealing with regulation, especially in large crop years when it will be most utilized, and
- will treat the efforts of growers and of handlers in dealing with the surplus of cherries more equitably.

For all of the reasons presented by those who testified in support of the order and discussed herein, it is respectfully submitted that the order should be amended as requested.

Respectfully Submitted,

A handwritten signature in blue ink, appearing to read "Brian Hill", written over a horizontal line.

BRIAN HILL
Attorney for the CIAB
On behalf of Perry Hedin,
Executive Director of the CIAB