

TESTIMONY OF SAPUTO CHEESE USA INC.
APRIL 2007 FEDERAL MILK ORDER HEARINGS
DOCKET NO. AO-14-A77, et al.; DA-07-02

This testimony is submitted on behalf of Saputo Cheese USA, the U.S. Division of Saputo Inc., a publicly traded, international, dairy and grocery products manufacturer and marketer.

I am Greg Dryer, Executive Vice President of Administration and Services for Saputo Cheese USA Inc. I have been directly employed in the U.S. dairy industry for more than 25 years in a variety of roles. In my current role, my responsibilities include procurement of milk for the all of the Company's U.S. manufacturing facilities extending from coast to coast.

My purpose here principally is to testify in support of the positions presented by Dr. Robert D. Yonkers on behalf of the International Dairy Foods Association (IDFA), our primary U.S. Trade Association. We have several specific statements that supplement the conclusions of IDFA and one which represents the opinion of our Company individually.

Complexity of the System

We oppose on principal any proposal that adds undue complexity to a system that already exceeds the capacity of most constituents' comprehension. Progress toward streamlining and simplicity should be considered prior to the adoption of any specific proposal.

Exhibit 40

Make Allowances

Testimony at last year's make allowance hearings substantiated significant manufacturing cost increases that have taken place since the previous make allowances were established. Processors do not have the ability to recoup these cost increases under the current system. The recent interim decision appears to have largely overlooked these facts. Establishment of a floor or market clearing manufacturing milk price enables the market to adjust when prices are too low by the payment of premiums above the floor. Establishing too high a minimum price based on unrealistic manufacturing cost data can permanently damage the industry's infrastructure. That generally describes what has in fact been taking place in the industry over the past several years. It is essential for USDA to review and update cost information to the most recently available in order to sustain a viable market for manufacturing milk. The State of California updates cost information on a frequent (generally annual) basis and responds with hearings and decisions in a timely manner. USDA should meet or exceed the California standard.

USDA should not arbitrarily and selectively decide which costs to include or exclude. For example, in the recent Make Allowance Interim Decision, USDA chose to include cost data from the California survey for cheese but then excluded the whey cost data. These are joint products whose costs are inextricably linked. It is wrong to include just one or the other. If one is included, then both should be included and vice versa. We support utilization of all the California cost data.

CME versus NASS Survey

Albeit not by design, the linchpin of the U.S. dairy industry is the Chicago Mercantile Exchange Cheddar Block Market. That Market and its predecessors, despite years of disparagement for thinness of trading and susceptibility to manipulation, remains the basis for the majority of cheese pricing in the United States.

The NASS Survey was mandated to ensure that the value of cheese which serves as the principal factor in establishing milk prices is representative of a significant percentage of all cheddar cheese sold. It does absolutely nothing to alleviate underlying reservations about the vulnerability of the Block Market. It simply confirms the fact that industry generally follows the Block Market with their pricing practices. It is, however, evident that to some degree the NASS Survey has been successful in deflecting attention from, and defusing the level of disgruntlement with, the Cheddar Block Market.

Given that there is no obligation to do so, why then do processors continue to cling to this Block Market based pricing practice?

- Because they always have. It is their long standing tradition.

- Because they rely on it correlate to some degree with their principal cost, that of raw milk.
- Because it provides customers with a basis of comparison between suppliers and with published, open-market, commodity values.
- Because experience has shown that unilateral attempts to depart from the practice have characteristically ended in dismal failure.
- Because the industry is precluded from discussing the issue due to anti-trust implications.

Employing the NASS Survey as a pricing base addressed certain concerns regarding end product pricing but created new ones. We now have the issue of circularity. Cheddar manufacturers' attempts to recover rising costs with price increases are automatically offset by higher milk prices. Furthermore, price increases implemented by cheddar manufacturers relative to the Block Market narrow the disparity between the NASS cheese price and the Block Market, resulting in compressed margins for makers of other cheeses.

The NASS Survey has produced another unwelcome side effect known as "the lag." The built-in time delay or "lag" in collecting and reporting price data disrupts the correlation between prices based on the current Block Market and milk costs derived from cheese prices from several weeks in arrears. This often puts cheese companies in the unenviable position of selling cheese on declining prices while at the same time paying milk prices that may be rising.

Finally, with the introduction of the NASS Survey came the inclusion of both block and barrel cheese in the combined NASS cheese price. An arbitrary three cent figure was added to the barrel price to arrive at a supposed block equivalent price. Others have or will testify to the unfairness of the three cent barrel addition, especially after accounting for the 38% moisture adjustment. From our perspective, we do not make barrel cheese. When the market becomes inverted between blocks and barrels (as it has so often recently), we see an increase in our cost of milk with no mechanism in place for us to recover it.

Our first preference is for a system that allows us to purchase milk at a price that is fair to producers and, after converting that milk efficiently into desirable products, provides both a good value to our customers and a reasonable return to our owners, many of whom are our employees. We observe the futures market with great interest and wonder whether ultimately there could be a similar auction market for current milk where large numbers of buyers and sellers come together to arrive at prices that reflect current market conditions. Such a market could establish the value of milk for all of its alternative uses - not just current cheddar in the form of blocks and barrels. Until that is feasible, we prefer pricing similar to that employed by the State of California: end product pricing based on as current a Block Market as possible that would eliminate circularity, the block/barrel controversy, and the dreaded "lag." The NASS survey could be maintained as an independent verification that the Block Market continues to fairly represent the current market value of commodity cheddar.

Failing that, we would defer to the will of the majority of our associates who prefer to maintain the current NASS Survey, work to lessen the "lag" impact, improve the accountability, and eliminate the three cent barrel price adjustment.

We would support any initiative undertaken by the government to assist the industry with the migration away from milk prices derived from end product values to one where a fair value is established for the price of milk based on supply and demand for it. End product prices could then be established by the processor after due consideration of cost, competition, and value. To decouple milk cost from end product prices, however, without first enabling the industry to extricate itself from Block Market based pricing, would be a great injustice.

Other Solids or Whey Factor

None of the proposals before USDA today address the critical problem confronting the processing sector relative to the Class III Other Solids or Whey factor. I would be remiss to leave here today without sounding the alarm about the economic hardship it is inflicting and will continue to inflict on cheese manufacturers. The presumed value to be recaptured by the Class III formula with today's unprecedented whey market is well beyond reason, especially for smaller companies that have neither the scale nor the capital to justify whey processing facilities. Without some type of corrective action, we will likely experience significant fallout and accelerated consolidation in what has been the largest outlet for U.S. milk.