VOLUME III

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

In the Matter of Proposed Amendments: : Docket Number
to Tentative Marketing Agreements : : AO-14-A74, et al
and Orders : : DA-06-01

National Public Hearing
January 26, 2006
Sheridan Suites
801 North St. Asaph Street
Alexandria, Virginia 22314

BEFORE:
THE HONORABLE PETER M. DAVENPORT,
U.S. ADMINISTRATIVE LAW JUDGE
UNITED STATES DEPARTMENT OF AGRICULTURE

APPEARANCES:
On Behalf of United States Department of Agriculture:
Sharlene Deskins
Babak Rastgoufard
Jack Rower
Henry H. Schaefer
Jason Nierman
Erin Taylor

On Behalf of Agri-Mark:

John Vetne
Robert Wellington
Richard Langworthy
Dennis Schad

On Behalf of National Cheese Institute:

Steven Rosenbaum

On Behalf of Select Milk Producers, Continental Dairy Products and Dairy Producers of New Mexico:

Benjamin Yale
Ryan Miltner
Kristine H. Reed

On Behalf of the Association of Dairy Cooperatives in the Northeast:

Marvin Beshore

On Behalf of the National Cheese Institute:

Steven Rosenbaum

On Behalf of Upstate Farms and O-At-Ka Milk Cooperatives

Timothy Harner

On Behalf of Associated Milk Producers:

Neil Gulden

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January 26, 2006, 8:30 a.m. Day 3 -

MORNING SESSION

THE JUDGE: This is day three.

Whereupon,

NEIL GULDEN,

having been first sworn by the judge, was examined and testified under oath as follows.

THE JUDGE: Please be seated. Tell us your name, and spell your last name for the hearing reporter.

THE WITNESS: My name is Neil Gulden. It's spelled G-U-L-D-E-N.

[Whereupon, Exhibit No. 43 was marked for identification by the judge.]

THE JUDGE: Mr. Gulden, do you have a statement which you have prepared and which I have marked as Exhibit 43?

THE WITNESS: Yes, sir

THE JUDGE: Very well. Are you prepared to read your statement at this time?

THE WITNESS: Yes.

STATEMENT FOR THE RECORD OF NEIL GULDEN

I'm Neil Gulden, Director of Fluid Marketing for Associated Milk Producers, Inc. (AMPI). My office address is 315 North Broadway, New Ulm, Minnesota 56073.

I have worked for AMPI for 36 years in various capacities. The past 30 years, part of my responsibility has been to manage AMPI's milk supply in regard to the Federal Marketing Order Program and represent AMPI's --

THE JUDGE: Mr. Gulden, can you slow down just a little bit?

THE WITNESS: Sure. To represent AMPI's dairy farmer owners at Federal milk order hearings.

AMPI represents approximately 4,000 dairy farmers in seven Midwest states. Currently our milk is pooled on Federal Orders 1030 (Upper Midwest) and 1032

(Central).

AMPI supports the specific changes proposed by the Agri-Mark witness, which I believe is Exhibit 29, Table 4, to adjust the make allowances for cheddar cheese, butter, nonfat dry milk and dry whey.

Manufacturing costs, particularly energy costs, have increased since the last substantive changes were made to the make allowances in Class III and IV price formulas in January 2001. This was the effective date of the tentative decision from the hearing held in May of 2000 to reconsider Class III and IV pricing formulas.

The intent of product price formulas, in my opinion I would add, is to establish farm milk prices that allow reasonably efficient plants to earn enough revenue to be able to pay these prices and have enough money left over to cover their manufacturing costs and earn a competitive rate of return on equity. The make allowances in the formulas are critical in achieving this goal. These formulas should reflect general industry conditions and experience.

Fixed make allowances are of particular concern to order-regulated dairy plants when the manufacturing cost assumptions built into make allowances become rapidly outdated. Recent increases in energy costs are a good example. Current make allowances reflect substantially lower fuel and electricity costs than exist today, as illustrated in Agri-Mark's testimony.

If dairy product make allowances are consistently low relative to milk cost, manufacturing margins will erode, along with investment in plants and machinery necessary to remain viable. Farmers and processors are partners and both must be profitable over the long run to sustain a healthy dairy industry.

Basis for Emergency Decision.

The final decision adopting revised product-price formulas for establishing Class III and IV milk prices reads:

"The prices calculated for the components in Class III milk are intended to reflect the value of those components in products from which these prices are calculated."

That's from the Federal Register/Vol. 67, No. 216, Nov. 7, 2002, page 67,931. That logic also applies to Class IV.

Manufacturers, including AMPI, of cheddar cheese, butter, nonfat dry milk and dry whey are seeing margins and consequently reinvestment in these businesses' decline. This is not only bad for these plants, but the long-term well-being of dairy farmers and their cooperatives.

Manufactured product marketing is

national in scope and we all compete against unregulated and state-regulated plants that either don't have a formula make allowance problem or the state-regulated systems have more consistently increased make allowances to keep up with actual costs. In either case the competition is real.

For the above reasons, this hearing should have an emergency decision based on -- an emergency decision issued as soon as possible.

And that concludes my statement

THE JUDGE: Very well. Do you have anything to add, Mr. Gulden?

THE WITNESS: No, sir

THE JUDGE: Very well. Examination of this witness? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Benjamin F. Yale on behalf of Select Milk Producers, Continental Dairy Products, Dairy Producers of New Mexico. And I might add that Zia Milk Producers of New Mexico and Lone Star Milk Producers of Texas have joined us in our opposition to this provision of the rule, and we have been told to assist them in defending this action on their behalf.

Good morning.

A. Good morning, Mr. Yale.

Q. In the last year, has AMPI made any investment in any of your manufacturing operations?

A. Yes, sir.

Q. Has there been significant investment?

A. We think so.

Q. To develop higher or, what, more capacity or more efficiency or more products, or all of those?

A. Constantly trying to become more efficient, no doubt about that. Obviously, one of the bigger investments -- I'm not sure if you'd call it an investment. I guess it is. We had to -- as you know, we had a butter plant fire.

Q. Right.

A. And we have invested, through that process, more capital in that facility and rebuilt it.

Q. Are you alone in the Upper Midwest in making investments in plants?

A. I don't know. I assume not, but I don't know.

Q. You haven't seen any other plants that you are aware of making any significant changes or anything like that?

A. No, not that I -- you know, not that I could just reiterate to you right now, no.

Q. Now, you are pretty astute and try to keep track of what is going on in the industry just outside of the Upper Midwest, right? That's part of your job?

A. Most of the time the news gets through to the New Ulm plant.

Q. Right.

A. Yes.

Q. Some suggest there are no secrets in the dairy industry. But are you aware of major investments being made in cheese and other such operations throughout the country?

A. Sure.

Q. And where are some of those?

A. Well, the obvious ones would be in New Mexico.

Q. At page 3 of your statement, you make this comment that manufacturers of cheddar cheese, butter, nonfat dry milk and dry whey are seeing margins and consequently reinvestment in these businesses' decline.

But isn't it true that there truly is investment going on in the businesses today?

A. Well, sure there is. Sure, there is

investment going on. But, you know, relative to what we should be investing, probably not.

For quite a few years, Mr. Yale, we have been investing less than our depreciation, and that's not healthy

THE JUDGE: Mr. Gulden, can you pull the microphone a little closer? It looks like people are having a hard time hearing you.

THE WITNESS: I think relative to what we would need to invest for us to be comfortable with those plants being up to our standards and up to what we need to keep them viable has not been available to us.

BY MR. YALE:

Q. You are speaking specifically for AMPI?

A. That is correct.

Q. But over the -- since 19 -- let's see. The hearing was held in 2000, I believe, pertaining to the current make allowances?

A. That's when the hearing was held, yes.

Q. But you would agree that since that time, there have been, not just in New Mexico but other parts, primarily in the west, there have been new manufacturing plants built?

A. Yes.

Q. And you would agree, then, that if things were not -- were as dire as you are suggesting here, that there might be no investment in the operations?

A. No, I'm not suggesting that at all.

Q. Now, do you get involved at all dealing with the producers in your organization? Do you visit their farms and --

A. Not as much on-farm, but I certainly get involved with the producer issues.

Q. Can you speak to the type of investment that's going on at the farm level?

A. Not specifically, no.
Q. Isn't it the case, though, I mean, generally, in the Upper Midwest that a lot of the traditional-size farmers are making almost no investment in their farms because they have no money to do so?
A. I'm not aware of that, no, sir.
Q. Now, does AMPI report any sales to NASS?
A. Yes.
Q. And what do you report?
A. We report nonfat dry milk, cheddar barrels, and dry whey.
Q. And are any of the plants that produce these listed in the exhibit put together by Dr. Ling in terms of reporting as part of this study?
A. Yes.
Q. And what plants are those?
A. It would be the powder plant at Freeman, South Dakota, and the cheese plants

at Blair, Wisconsin.

Did you say for reporting purposes?

Q. No, the question was -- you indicated that you reported to NASS sales.

A. Yes.

Q. And you told me nonfat dry milk, cheddar barrels and dry whey.

A. Yes.

Q. And my question is, of the plants listed on Exhibit 35 put together by Dr. Ling, are any of these plants that are listed on that plants that make the products that you report to sales?

A. Yes.

Q. For example, you told me that --

A. Yes, they are.

Q. Freeman? Okay.

A. Freeman, South Dakota.

Q. Okay. And then cheddar barrels, you say Blair?

A. No, cheddar barrels would be

Paynesville, Minnesota.

Q. Paynesville, Minnesota. Okay.

And what about the dried whey?

A. He doesn't have the whey listed, but the plants that would have dry whey, would you like those?

Q. Yes.

A. Blair, Wisconsin; Dawson, Minnesota; and Jim Falls, Wisconsin.

Q. And you report sales from all of those plants?

A. Yes, we do.

Q. Now, you did not participate in the study in 1998, according to this document. Is that right?

A. Yes, that is correct.

Q. And had you participated in any studies prior to 2004?

A. I researched that and, no, we have not been in those studies.

Q. And --

A. Not because we didn't want to participate, but I think it was just simply an oversight at -- I was not personally approached to participate in those studies. And maybe it came through our office, but I was not involved with it at that time.

Q. And then, obviously, you did in 2004. And what made the difference, other than being asked to participate? What was the motivation to participate in the study?

THE JUDGE: Would you rephrase your question, Mr. Yale. It appears that Dr. Ling's testimony was that the participating plants have to ask.

MR. YALE: I understand.

BY MR. YALE:

Q. Why was it that AMPI was asked to participate in this study?

A. Well, we were part of a group that wanted to define the changes in the cost of production, in make allowance cost of production. And in order to do that, we wanted to define that more closely and try to define it as accurately as we could. And so, we -- that was my basic reason for including AMPI in the study.

Q. So that, among other things, it could be used at this week's hearing?

A. Yes, sir.

Q. Now, the products that you manufacture at these various plants that are listed, in addition to the commodity products that you prepare, I take it, then -- I mean, do you produce any Italian-style cheeses?

A. No.

Q. Any Euro-style cheeses?

A. No.

Q. They are all American style?

A. Yes.

Q. Are there any specialty American styles?

A. Colby, Monterey Jack. The Jack style

cheeses.

Q. Any aged cheeses?

A. Not that I know of, no.

Q. So a lot of your production is 640 for contract for --

A. Yes.

Q. And a lot of that goes into shredding and cubes and other processed cheeses?

A. Some of it, and some of it is cut and wrapped, yes.

Q. Now, your statement, you do not provide any specific data regarding your operation such as Agri-Mark does?

A. No, I did not.

Q. Is that information going to be made available?

A. No, it isn't.

Q. You indicate in your testimony that you support Agri-Mark's proposal in terms of establishing the make allowances?

A. Yes.

Q. Are you doing that in general or you willing to defend their rationale or you're just -- you are willing to accept the results and let them defend the position?

A. I am willing to accept the results, and I have so stated in my testimony.

Q. One of the things that's interesting to note is that the RBCS studies, as they begin to -- after one adds the ROI and administrative costs, exceed the California prices. Have you noticed that? Have you made that observation?

A. I guess I did not look in each case. I'm not sure it's in each commodity, Mr. Yale.

Q. In 2000, there was kind of a flip of that, was there not? You don't recall what the relationship was in 2000 when we had the hearing?

A. No, I would have to look it up, unless you have it.

Q. And I don't recall. Did you participate in that hearing?
A. Yes.
Q. I thought you did. You testified.
Did you participate with National Milk in adopting their formula that Ed Coffman testified about?
A. No.
Q. Do you recall that it was kind of a weighted blend between California and the RBCS study?
A. I guess. I don't recall Ed's testimony.
THE JUDGE: Mr. Gulden, I think they are having a little trouble in the back of the room still, so --
THE WITNESS: Okay.
BY MR. YALE:
Q. So you don't recall whether -- well, if you don't recall his testimony, I think it would be unfair to ask any other questions on

that.

You make a statement that you compete against unregulated areas and you also compete against, I think, primarily California state regulations, right?

A. Yes.

Q. Do you track the costs that plants pay or minimum prices for milk in California with what the Class III prices are as part of your --

A. I see them, yes. I don't necessarily track them, but I see them.

Q. Do you have a general observation of the relationship between Class III and the California 4(B) price?

A. Not on a consistent basis, but I do see it once in a while and I check it, and it goes both ways, higher and lower than the Class III and IV.

Q. Does it -- well, we won't go there.

Does AMPI purchase milk from sources

other than its own members?

A. On a spot basis.

Q. Do you know what those prices run in terms of the class prices?

A. No. They are different in different situations, depending whether the market is long or short. And it isn't always based on class prices. It could be just a fixed price.

Q. Are you aware of what your producer prices are that are paid to your producers in the markets in the Upper Midwest?

A. [The witness nodded.]

THE JUDGE: That's a yes, sir?

THE WITNESS: Yes, sir. Yes, sir.

BY MR. YALE:

Q. And how do those compare to the Order 30 blends at those plant locations?

A. Currently?

Q. Yes.

A. I would say generally -- well, we run seven states. And so, generally, they are either slightly higher or right at about the blend value. That hasn't always been the case.

Q. But that's a competitive price. I mean, you are beating the competition in your market at those prices?

A. We are trying to.

Q. And most of the milk in those markets are used for manufacturing, right?

A. Yes.

MR. YALE: I don't have any other questions of this witness

THE JUDGE: Thank you.

Other examination? Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Just one question. In the 2000 hearing, you did -- AMPI did provide information with respect to its cost of manufacturing at several of its plants for that record, did you not?

A. Yes, there were a few plants, but I don't recall offhand. I think it was the nonfat dry milk and maybe whey.

Q. Okay.

A. No, it wasn't whey. It was nonfat dry milk, I believe it was. Yes.

Q. Okay. Thank you

THE JUDGE: Other questions? Mr. Rosenbaum.

EXAMINATION

BY MR. ROSENBAUM:

Q. Good morning, Mr. Gulden. Steve Rosenbaum for the National Cheese Institute.

I believe you testified that three of your whey producing plants participated in the most recent survey conducted by that Rural Business Cooperative Service, is that correct?

A. That is correct.

Q. And those were the Blair, Dawson and

Jim Falls plants?

A. Yes.

Q. And do those produce dried whey?

A. Yes.

Q. And do those plants take in condensed whey from other plants?

A. Yes, most notably the Dawson facility.

Q. Do the other two facilities also take in condensed whey from other plants?

A. Yes, but very spotty, not as much.

Q. Is the Dawson plant the largest of the three plants?

A. No. No, it is not.

Q. Does -- and is the ability to take in that condensed whey from other plants, does that provide for greater efficiencies in the operation of the plant?

A. Yes, it certainly does. It adds to the volume, yes, sir.

Q. And are there a number of whey plants outside of your own that do not take in whey from other facilities? Or do many facilities in fact simply handle their own whey as opposed to handling whey from some third source?

A. Other --

Q. Non-AMPI.

A. Non-AMPI plants? I couldn't tell you for sure. I don't know their operations, whether they are taking in outside whey or not, Mr. Rosenbaum.

Q. Thank you

THE JUDGE: Other questions? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. John Vetne, counsel for Agri-Mark.

Mr. Gulden, the cheese plants in Paynesville, Minnesota; Rochester, Minnesota; and Sanborn, Iowa, what do they do with the whey associated with their cheese production?

A. Most of Sanborn's milk goes, and Paynesville, about a portion of it, those two plants go to Dawson, Minnesota, for drying.
Q. When you say a portion, what happens to the portion that doesn't go?
A. It is sold for various purposes, sold to other whey facilities that I know make WPC, food ingredients, other protein, fractioning people.
Q. It is sold in condensed form?
A. Yes.
Q. All the plants that do not produce a dry whey product do, in fact, condense the whey before it is removed from the plant?
A. Yes.
Q. And let's see. When you move whey from either Paynesville, Rochester or Sanborn to another plant, who pays the transportation cost from the cheese plant to the whey plant?
A. It's our expense, AMPI expense.
Q. What is the distance of such

shipments?

A. Probably no more than a hundred and fifty miles.

Q. Up to 150 miles?

A. Yes.

Q. And when you -- although you are not providing specific data of your operations at this hearing, you provided very specific data to Dr. Ling?

A. Yes.

Q. When you provided specific data to Dr. Ling, did you include the cost of loading and transporting condensed whey from the cheese plants that do not process dry whey?

A. No, I did not.

Q. When AMPI transfers condensed whey to a non-AMPI plant for further processing, does AMPI receive the component value of components in whey as priced by USDA?

A. No, it's an internal transfer price.

Q. I'm sorry. I was asking about when

you sell condensed whey to a non-AMPI facility.

A. To a non-AMPI. It's a negotiated price, but -- and I don't know all those prices.

Q. Is that not your department?

A. No, it is not.

Q. With respect to the whey that -- condensed whey that AMPI may purchase from other cheese -- well, let me ask first. Do you purchase condensed whey from other cheesemakers for further processing such as at Dawson?

A. Yes, on occasion. I know we do purchase. I don't know the pricing.

Q. Okay. Do you know enough about prices to make a comment of whether such prices equal or exceed the component value under Federal order pricing?

A. I'm sorry. I don't have that information with me

THE JUDGE: Mr. Vetne, can you pull your mike up just a little? Thank you.

BY MR. VETNE:

Q. In addition to the cheese and powder plant -- by the way, Freeman, South Dakota, is shown as a powder plant but not a butter plant. They do not produce butter?

A. No.

Q. Where does the cream associated with that powder production go?

A. Hopefully soon to New Ulm.

Q. And before that?

A. This past year it's been sold on the outside, to outside venders.

Q. Before the fire, you produced both products at a butter-powder plant?

A. Produced what?

Q. Both butter and powder in a single plant?

A. No, not at that plant. The powder -- Freeman is the nonfat dry milk plant. The cream gets transported to New Ulm for butter processing.

Q. In addition to supplying milk to AMPI manufacturing plants, does AMPI market milk to other handlers for other purposes? Does it supply milk to any other cheese plants, for example?

A. Not on a consistent basis. But on a spot basis, we do sell milk on occasion. And we also have -- we also have some milk trade agreements, swapping agreements that usually are a one-for-one swap where we are saving freight and putting milk into another competitor's plant, and they would put a similar amount into one of our plants.

Q. Do you sell some milk to distributing plants?

A. Yes.

Q. Since 1998, has AMPI either opened new plants or closed plants?

A. Haven't opened any new ones, but we

have closed a few. We have closed a plant in Glencoe, Minnesota.

Q. What was produced --

A. That was a cheese facility.

And I'm trying to think if there were any others. I believe -- I believe since '98 we have closed our drying facility at Turtle Lake, Wisconsin.

Let me think. And we are in the process of closing another facility at Sibley, Iowa, which was a drying facility, nonfat dry milk. It hasn't run since August of '04, and we don't anticipate it running again.

Q. Okay. In response to a question by Mr. Yale, you indicated that your producers, AMPI member producers, are paid about the Federal order blend or slightly above blend, is that correct? Do you recall that?

A. Over this last year, that would be an average -- an average number with -- with both ways, depending on what competition is doing.

Q. Well, let me talk about competition. You say you meet a competitive price?

A. Yes.

Q. After you pay a competitive price, are there any earnings that are not distributed to producers?

A. If there are any earnings, the cooperatives distributes them to their members.

Q. So let me see if I have this correct. What you do is you pay monthly a competitive price, and after the end of some accounting period, you account to producers for any earnings that have not yet been distributed or you reinvestment them, or you assess a loss?

A. That would be the scenario, yes.

Q. Thank you.

THE JUDGE: Other questions? Thank

you, Mr. Gulden.

Excuse me. Mr. Yale.

MR. YALE: Your Honor, I had a follow-up

THE JUDGE: Very well.

EXAMINATION

BY MR. YALE:

Q. You mentioned some plant closings. Has there been a change in the milk supply in the Upper Midwest? Has there been a reduction in the supply?

A. Certainly, in our procurement area in those states, those seven states that we do business in, there has been a reduction in the milk supply from 1998, for instance, yes.

Q. And that's had a -- that's one of the factors involved in the decision to close plants?

A. Partially, yes. Partially.

MR. YALE: I don't have any other questions.

THE JUDGE: Thank you. Thank you, Mr. Gulden.

THE WITNESS: Yes, sir.

THE JUDGE: Mr. Vetne. Thank you.

Mr. Weis's statement has been marked as Exhibit 44. At this time, Exhibit 43 is admitted into evidence.

[Whereupon, Exhibit No. 43 was received in evidence.]

[Whereupon, Exhibit No. 44 was marked for identification by the judge.]

Whereupon,

JOSEPH W. WEIS,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated, give us your name and spell your last name for the hearing reporter.

THE WITNESS: My name is Joseph Weis, W-E-I-S.

THE JUDGE: Mr. Weis, you have a

statement which I have marked as Exhibit 44. Are you prepared to give it at this time?

THE WITNESS: Yes, I am

THE JUDGE: Very well. Go ahead.

STATEMENT FOR THE RECORD OF JOSEPH WEIS

THE WITNESS: My name is Joseph W. Weis. I am employed by Foremost Farms USA Cooperative (Foremost) as Vice President-Consumer Products Division. My business address is E10889A Penny Lane, P.O. Box 111, Baraboo, Wisconsin 53913. This testimony is given on behalf of Foremost Farms USA Cooperative.

Foremost Farms USA is a dairy farmer-owned Capper-Volstead cooperative representing 3,476 member-owner milk producers located in seven states. In 2005, Foremost's member-owners located in Wisconsin, Minnesota, Iowa, Illinois, Indiana, Ohio and Michigan marketed 5.05 billion pounds of milk through their cooperative.

Foremost owns and operates 10 Cheese Division plants located in Alma Center, Appleton, Chilton, Clayton, Lancaster, Marshfield, Milan, Richland Center, Waumandee and Wilson, Wisconsin, producing over 500 million pounds of cheese annually. Our Ingredient Division plants located in Preston, Minnesota, Waukon, Iowa, and Plover, Rothschild and Reedsburg, Wisconsin, serve the dual roles of further processing the whey solids from our Cheese Division plants while balancing the surplus butterfat and skim solids from our member-owner milk supply by producing butter, condensed skim milk and occasional nonfat dry milk. In addition to supplying milk to our own distributing plants in DePere and Waukesha, Wisconsin, we also supply Grade A bulk milk to distributing plants located in Federal Orders 5, 30, 32 and 33.

Foremost Farms USA supports Proposal No. 1 as set forth by Robert Wellington of Agri-Mark Dairy Cooperative in his testimony at this hearing marked Exhibit No. 29.

As previously described at this hearing, current manufacturing allowances used to compute Class III and Class IV milk and component prices were established on the basis of cost surveys from cooperative manufacturing plants in 1998/99, as well as California plant survey costs from 1999. Dairy product manufacturing costs have risen dramatically since that time, resulting in substantial losses at manufacturing plants that purchase and process Federal Order Class III and IV milk.

In the face of rising manufacturing costs, Foremost has take a number of steps since the year 2000 to increase our competitiveness and efficiency in converting or member-owners' milk into an assortment of dairy products that are desired by today's marketplace. Some of these include the 2001 conversion of our barrel Cheddar cheese plant at Richland Center, Wisconsin, to Mozzarella production; the further rationalization of our product mix and the utilization of our multiple manufacturing plant system by the 2003 closings of three cheese plants (two American style plants and one specialty cheese plant), a whey processing plant, a dry products storage and distribution facility, and a milk reload station; increasing employee contributions toward their health insurance costs; and the implementation of a formal Corporate Purchasing function in 2003 to better enable the cooperative to leverage the negotiation of prices paid for our collective volume of packaging, ingredients, and other goods and services needed to operate are plants efficiently. All of these cost savings initiatives have delivered their intended results, including increasing our manufacturing plant capacity utilization levels to near 97 percent. Unfortunately, these cost savings measures alone are not enough to offset the impact of rising costs, particularly in the areas of employee health insurance costs, property and casualty insurance, packaging materials and, in particular, electricity and natural gas.

Where possible, in the face of increasing competition for markets from products produced in lower cost milk production regions as well as competition from other nondairy commodities, we have increased product prices or premiums in an attempt to offset these increasing costs while maintaining our market share. Like other manufacturers, when we are successful in increasing product prices, to the extent that these prices are reflected in the NASS Dairy Product Prices surveys, the result is higher minimum classified prices for manufacturing milk, offsetting the higher prices received for the finished products. That did not deter us, however, from passing along increased costs wherever the marketplace would allow.

Foremost's Lancaster, Wisconsin, manufacturing plant cost data was supplied by our corporate cost accounting department staff for Dr. Ling's Rural Business and Cooperative Service (RBCS) Dairy Product Manufacturing Costs 2004 survey. Our cost accounting staff also prepared an analysis of our manufacturing costs at this plant in 1999 and 2005 for comparative purposes. This plant produces 640-pound blocks of cheddar cheese and condensed whey for further processing at one of our ingredient plants. In 2004, our total surveyed manufacturing costs per pound of cheese were 25.6 percent higher than in 1999 while total pounds of cheese manufactured at Lancaster were up by 3.3 percent. Using Dr. Ling's cost categories, the major drivers of our cost increases were natural gas up 64.1 percent, electricity up 70.3 percent, employee fringe benefits (driven by increasing health insurance costs) up 57 percent. All cost categories surveyed for 2004 increased with the exception of ingredient costs down 2.8 percent, taxes down 15.2 percent and water and sewer down 30 percent, resulting from the installation of our own private wastewater treatment plant during 2004 as opposed to the costs for the use of the Lancaster municipal wastewater treatment facility in 1999. However, there were some offsetting cost increases in energy, depreciation, repairs and maintenance and insurance resulting from this investment. Condensed whey processing costs per pound of solids increased 51.4 percent in 2004 at Lancaster compared to

1999, with the same major cost drivers being responsible as previously reported for cheese, while total solids processed increased 7.35 percent.

Foremost further supports the portion of Mr. Wellington's proposal detailed on page 10 of his testimony, Exhibit No. 29 entitled, Adjusting Manufacturing Allowances to Include 2005 Energy Costs. We cannot afford to continue to absorb the impacts of last year's increase in energy prices without eroding our member-owner's balance sheet. Foremost's cost data for Lancaster comparing 2005 to 2004 shows that total costs per pound of cheese increased by 14.1 percent while natural gas increased 28.3 percent and electricity increased 17.8 percent. All other cost categories increased with the exception of insurance down 1.1 percent and water and sewer down 40.5 percent as a result of 2005's costs reflecting a full year of our private wastewater treatment plant's operation compared to a partial year in 2004. Cheese production was down slightly, 1.9 percent at Lancaster in 2005 compared to 2004. Total whey solids processed were down .31 percent in 2005 while cost per pound of solids were up 13.4 percent, again driven by the same cost categories, primarily natural gas and electricity up 28.26 percent and 13.07 percent respectively.

We are familiar with the proposal that will be brought forth by National Milk Producers Federation at this hearing to utilize an ongoing energy index to adjust manufacturing allowances on an ongoing basis. Due to the critical need for relief from the impacts of higher manufacturing costs, such that when we are able to recover them from the marketplace they result in higher Class III and IV minimum prices, we support Agri-Mark's call for an interim emergency decision using 2004 RBCS and CDFA survey data adjusted for 2005 energy costs to increase dairy commodity manufacturing allowances for cheese, butter, nonfat dry milk and dried whey. This can be followed by a thorough comment and review period before issuing a decision for the ongoing energy index adjuster to the manufacturing allowances as would be proposed by the National Milk Producers Federation.

We appreciate the cooperation of USDA Agricultural Marketing Service personnel in holding this hearing and ask that the Department consider the evidence regarding the urgency of this situation in rendering a timely interim emergency decision.

Thank you.

THE JUDGE: Questions of this witness? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Mr. Weis, you refer to the Lancaster, Wisconsin, plant on page 4 of your testimony and indicated, as I understand it, that the plant does not process any dry whey products?

A. That is correct.

Q. Does the plant condense its whey?

A. Yes, it does.

Q. And then it removes the whey and sends it to another one of your plants?

A. One of two plans located at Plover, Wisconsin, or Rothschild, Wisconsin.

Q. What factors would enter into the decision whether it goes to Plover or Rothschild?

A. Equipment availability and the product assortment that's demanded by our customers. Each of those plants has different processing capabilities.

Q. Do you incur a cost to load and transport that condensed whey to other whey -- to whey facilities?

A. Yes, we do.
Q. Were any of those costs included in data reported to Dr. Ling?
A. No, they were not.
Q. What is the distance between Lancaster and Plover and between Lancaster and Rothschild, approximately?
A. It is approximately 120 miles, at least 120 miles.
Q. For both of them?
A. Plover and Rothschild are about 30 miles apart from one another.
Q. Does Foremost also sell its condensed whey to non-Foremost facilities?
A. On occasion, if we don't have the capacity to process the solids internally.
Q. Are you familiar with the price received by Foremost for such transactions?
A. No, I am not.
Q. Does Foremost receive condensed whey from non-Foremost plants?

A. Yes, we do.

Q. Are you familiar with the price paid to the whey -- condensed whey supplier in those transactions?

A. No, I am not.

Q. Thank you

THE JUDGE: Other questions? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Ben Yale on behalf of Select Milk Producers and the others that we have named. Good morning.

A. Good morning.

Q. How are you?

A. Fine.

Q. Mr. Weis, how long have you been involved in the dairy industry in terms of management within the cooperative or other cheese processors?

A. Since 1973.

Q. And always up in the Upper Midwest and Mideast, primarily?

A. Yes.

Q. In a good part of your testimony, you make a discussion about changes in operating costs, you know, medical costs up, water costs down, energy costs up, so on and so forth. Those are discussions that you and issues you have had to deal with in operating these plants long before make allowances were created by the Federal order as part of the formulas, right?

A. Yes.

Q. And this type of analysis, although maybe the particular cost issue is different, but this is what management of a business is all about, right?

A. Correct.

Q. Now, does Foremost purchase any milk on a regular basis from any other suppliers other than its own members?

A. Yes, we do.
Q. And is that milk used in the bottle or in manufacturing?
A. Both.
Q. Are these prices at or below class?
A. Milk going to purchase from other companies for bottling pricing is determined by the regional over-order agency, Central Milk Producers Cooperative. Milk going to manufacturing plants is a combination of trade milk, which is the one-for-one exchange that Mr. Gulden described. And there are some small volumes of milk purchased from other companies with the pricing being tied to the classified value.
Q. Are over-order charges paid on that milk purchase for manufacturing?
A. Yes.
Q. The producers in your market, are you familiar with the producer prices that are paid by Foremost?

A. Yes.

Q. Are you paying at blend, above blend, below blend? How would you describe your payments?

A. We are above blend.

Q. Do you find it necessary to be above blend to attract milk and maintain a milk supply?

A. Yes.

Q. Are you members under long-term contracts or are they a month to month?

A. They are on day-to-day contracts with the exception of those producers who have entered into fuller pricing contract.

Q. So being in a day-to-day contract, you always have to maintain yourself in a competitive position for purchasing milk?

A. Correct.

Q. Now, did you have similar duties or responsibilities prior to 2000 with Foremost?

A. My duties were similar with the

exception of Federal order testimony, yes.

Q. Well, then, you have had a promotion, and I would suggest a raise would be appropriate.

Prior to 2000, the price for milk was established by what they call the M&W or the basic formula price, is that right?

A. That is correct.

Q. And that was fundamentally a competitive price?

A. Correct.

Q. And there was no adjustment for plant margins in that formula, was there?

A. There was a competitive price survey. The competitive prices that were paid were the result of each processor's own internal analysis of what his make costs were and what he could afford to pay.

Q. Right. And that's not unlike what is going on today, is that you are determining what to pay your producers based upon the competitive price and what you can afford to pay, right?

A. Ultimately, yes.

Q. I want to change topics here a second.

Dr. Ling identified the names of the plants that he used that had requested participation in his study. And under Foremost Farms, he indicated the Marshfield, Wisconsin, plant in 1998 and the Lancaster, Wisconsin, plant in 2004. But according to your testimony, you operate -- by you, meaning Foremost, operate a number of plants in addition to those.

The question that I have in that regard is, why wasn't -- why weren't all of the plants requested to participate in the study?

A. First of all, the answer to that would be we only have three plants that produce American-style cheese: Lancaster, Marshfield and Waumandee, Wisconsin.

Q. Okay.

A. I was not involved in the decision, but I asked that question after the fact. The Marshfield plant was included in the 1998-99 survey, you are correct.

And when asking the cost accounting Department and operations, in their discussions, they felt that the nature of the Marshfield plant's operations had changed significantly since the 1998-99 survey in that we produced a number of specialty American-style cheeses there, including reduced fat products, which have a significantly different yield factor for powder milk solids, if you will, than cheddar, and the Lancaster plant would be more appropriate to utilize and put into the survey because it produces strictly cheddar.

Q. And the Waumandee plant has another product mix or --

A. The Waumandee plant produces, again, specialty cheddar cheeses, some Jack and pepper Jack, which has high ingredient costs. So in order -- their interpretation was they should use a plant that most closely fit the definition of a cheddar plant.

Q. What about -- does Foremost report to NASS the sales of any cheddar?

A. Yes, we do.

Q. And what do you report?

A. We report 40-pound blocks from the Marshfield plant that meet the NASS definition. And we report dried whey from our Plover, Wisconsin, plant on occasion, as well as our Richland Center, Wisconsin, plant.

Q. So we have the cost data reported as from the Lancaster plant and the NASS -- the cheddar that's produced at the Marshfield plant is the cheddar that's reported to NASS?

A. Correct.

Q. You state in here that, as part of your pricing, that you have tried to pass on the costs to the end consumer, the end purchaser of your product, these additional costs?

A. Yes, we have.

Q. Now, you also say that these are reflected in the NASS survey.

A. To the extent the -- that we are successful in passing on price increases on those products that are incorporated in the survey, yes.

Q. Which would mean the cheddar, the 40-pound cheddar?

A. Yes.

Q. But for the specialty cheeses and the specialty American-style cheeses, those -- you are not reporting those prices, right?

A. Correct.

Q. And those tend to have a -- well, let me back up and ask this question.

Is it a good general statement to say that most cheese is sold on the basis of the CME block price, plus or minus some base number?

A. Yes.

Q. And isn't it also safe to say that, when it comes to specialty cheeses, that that basis will tend to be higher than what the simple cheddar would be from the same plant?

A. Yes.

Q. And isn't it also safe to say that the pricing dynamic and being able to negotiate prices for specialty cheeses is -- allows for more ability to negotiate individual prices for your product as compared to the cheddar that is driven more and more by a national market?

A. We are finding that to be less and less the case. As a matter of fact, we are -- some of these specialty products, "specialty products," are becoming commodities, for example, pepper Jack. We are producing less pepper Jack in 2006. We are abandoning that market and moving that milk that would have gone into that product into other areas.

Q. Which comes, I guess, to the next point in -- and you really kind of set it up. And that is, is that the -- one of the issues that you have to deal with in selling your cheese is that -- on the national market is that there are processors out there that are trying to cut their costs and be ever more efficient themselves, right?

A. That's true.

Q. And that the inability to push up prices for products are as much a reflection of the ability of some plants out to there to produce at a price at or below your own cost?

A. That's true.

Q. Do you have any involvement with the producers that are members of Foremost?

A. Yes, I do on occasion. I attend annual district meetings and give the management report.

Q. Does Foremost do any analysis of the cost issues of their producers who produce the milk?

A. No, we do not.

Q. In the marketing area in which you procure milk, is the supply of that milk declining or increasing?

A. It varies by state. And in -- in more recent times, we are seeing production increases in Wisconsin in response to the higher milk prices that began in the middle of 2003. But our Indiana milk supply is growing as well as the Michigan milk supply.

Q. During those times in which milk production has declined, that has -- a reduction in the milk supply does result in an increased cost to the cooperative for milk, does it not?

A. To the extent that it reduces plant utilization and increases competition for that available milk supply, yes.

Q. And in doing the or making the decision to support Agri-Mark, was there any consideration given to the fact that there could be a significant, at least, as Dr. McDowell mentioned the other day, at least for the up-front months, an initial significant impact and a drop in prices? Has there been any analysis of the impact on your producer base and the availability of the supply of milk in response to this change?

A. Not specifically, no.

Q. Now, Dr. Wellington provided to us detailed information regarding the cost that they had reported to Dr. Ling. And unless I missed something, you did not provide any exhibit that showed those detailed costs for that Lancaster plant?

A. That is correct.

Q. And I take it that you are not going to?

A. That is correct.

Q. As a cooperative, we have heard all kind of things, dividends, thirteenth checks, earnings, so on and so forth. Does Foremost -- I mean, I'm sure as Foremost, you have some process of allocating profits and losses to producers?

A. Yes, we do.

Q. And in recent years have you been allocating profits or losses to producers?

A. Yes, we have.

Q. Have you been allocating profits?

A. Yes, we have.

Q. Have you been allocating losses?

A. To this point, we have not allocated any losses.

Q. And this is during the period of time that you have been paying at or above blend in order to maintain and attract milk at your plants?

A. Yes. The level of milk overrun price has declined in 2005, and the audit is winding up as we speak, and our profitability has declined dramatically.

MR. YALE: I have no other questions

THE JUDGE: Mr. Rosenbaum.

EXAMINATION

BY MR. ROSENBAUM:

Q. Steve Rosenbaum for the National Cheese Institute. Good morning, Mr. Weis.

A. Good morning.

Q. I want to ask a few questions to follow up on Mr. Yale's questions regarding the comparison between what the world was like before 2000 and what the world is like now and how that effects a cheese operator like you.

Before 2000, we didn't have make allowances when it came to Class III cheese pricing, correct?

A. That is correct.

Q. As you have testified, the Class III price was based upon the Minnesota-Wisconsin price series, correct?

A. Correct.

Q. Which was a competitive price paid for unregulated Grade B milk, correct?

A. Yes.

Q. And in that scenario, as a cheesemaker, you would pay whatever that Class III price was, and then you would sell your cheese for whatever the competitive market for cheese would bear, correct?

A. Yes.

Q. And the gap between what you paid for your milk and what you got for your cheese, that was the amount of money that you could use to cover your cost and hopefully make a profit, correct?

A. Correct.

Q. And that was dictated entirely by the relationship between the competitive price for milk and the competitive price for cheese, right?

A. Yes.

Q. Now, let's assume in that scenario a situation where your nonmilk costs have gone up, okay?

A. Okay.

Q. You have listed a lot of costs that have gone up for you, so let's take as an example the situation -- and we're talking once again pre-2000 -- where, let's say, your energy costs had gone up by 50 percent over some period, correct?

A. Okay.

Q. And let's assume that had happened to all the cheese companies because energy costs tend to rise and fall relatively uniformly, correct?

A. Yes.

Q. To the extent that the price of

cheese in the marketplace would support it, you would try to pass on those costs to the cheese market, correct?

A. Yes.

Q. And presumably, other cheese manufacturers facing those exact same cost increases would also be trying to pass on those cost increases, right?

A. Yes.

Q. And assuming that you were successful in passing those costs on in the competitive market for selling cheese at wholesale, you would thereby recover those increased energy costs, correct?

A. Yes.

Q. And so, you would be, if you will, made whole for those increased costs through that mechanism. Is that right?

A. Yes.

Q. Now, let's switch now to the post-2000 era, where now make allowance is,

in fact, a part of the picture, correct?
A. Yes.
Q. As of January 1, 2000, right?
A. Yes.
Q. And under that scenario, how much you pay for your Class III milk is no longer set by the MW price, correct?
A. Correct.
Q. There is no such price anymore, correct?
A. No longer.
Q. All right. Instead, what you do is you have to pay for your milk based upon how much people are getting for cheese in the marketplace, minus the make allowance set by USDA regulation, correct?
A. Correct.
Q. And so, let's take the same hypothetical -- or, actually, it's pretty much a reality based upon your testimony -- of a circumstance in which your energy costs

have gone up 50 percent, all right?
A. Okay.
Q. And let's assume that everyone's energy, all cheese manufacturers' energy costs have gone up 50 percent, okay?
A. Okay.
Q. So everybody wants to pass on those higher costs, okay?
A. Yes.
Q. And let's assume that, in fact, the cheese market supports the higher price for cheese and so everybody does raise their cheese prices as a result of competition by enough to cover these increased energy costs, okay?
A. Okay.
Q. Now, before 2000, you, the cheese manufacturer, could hold on to that extra money and use it to cover these increased energy costs, correct?
A. Yes.

Q. But post-2000, you don't get to do that, right?

A. Right.

Q. Because post-2000, you are required by regulation to pass on to the dairy farmer the difference between what you got for your cheese and the set make allowance, correct?

A. Correct.

Q. So if the make allowance is too small because it is not capturing these increased energy costs, you have gained nothing bypassing on these energy costs in the form of higher cheese prices, correct?

A. Yes.

Q. And that all has to be passed on in the form of higher milk prices, correct?

A. Yes.

Q. And I have used energy costs, but the scenario I have outlined applies to every nonmilk cost that is incurred by a cheese manufacturer, correct?

A. Yes.

Q. That's just the way the system works, correct?

A. Correct.

Q. And for that reason, a make allowance that does not adjust for increases in nonmilk costs is just entirely incapable of allowing you to cover your true cost of making cheese, right?

A. Over time, that is correct.

MR. ROSENBAUM: That's all I have. Thank you.

THE JUDGE: Mr. Schad.

EXAMINATION

BY MR. SCHAD:

Q. Dennis Schad, Land O'Lakes.

Just a couple questions, Mr. Weis. Good morning.

A. Good morning.

Q. Can we go to page 2 of your testimony?

A. Okay.

Q. In your testimony you refer that you do produce butter, that Foremost does produce butter and also, on occasional, nonfat dry milk?

A. Yes.

Q. I noticed that you did not participate in the Ling survey for those commodities. Could you tell us why?

A. That's because the plant that produces our butter produces it in a balancing capacity, operates on limited basis based on the availability of surplus fat from our distributing plants. The production of nonfat dry milk in Sparta, Wisconsin, is very limited to the extent that the price spread between Class III and Class IV milk is sufficient to warrant prorating the costs, the added costs of drying and packaging the product.

Q. Foremost's activities in these two

products are market-clearing and balancing activities, would you characterize it?

A. Market clearing, balancing for butter and making product for internal use as opposed to buying it from the outside on the nonfat side.

Q. Are you familiar with the cost that Foremost incurs in manufacturing these products?

A. No, I am not.

Q. Thank you.

Last question. Does Foremost buy and sell cream on the outside market?

A. Yes, we do.

Q. Are you familiar with the terms of trade for those --

A. Yes, I am.

Q. -- transactions? Could you elaborate?

A. Generally, for cream bought and sold in the Upper Midwest area, the pricing is on the basis of the AA, CME AA butter market times the multiplier.

In the case of cream purchased from California, it is priced at the California solids nonfat price and California butterfat price plus an overage based on the total solids in the cream.

Q. Thank you very much

THE JUDGE: Other questions? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. I want to follow up on Mr. Rosenbaum's line of questions.

Is it your understanding that if that you are required to, upon selling cheese, let's just go to them, you sell a quantity of cheese at a particular price, that you are obligated to subtract the make allowance under the Federal order and then pay the producer everything that's left? Is that

your understanding?
A. That would not be correct in the case of a cooperative.
Q. Is it the case of anybody?
A. I'm not sure I understand your question.
Q. Well, I -- and I think that, then -- and that's a correct comment.
I mean, we need to understand because this gets confusing because Mr. Rosenbaum, in a question that he asked and you answered, suggested that, in the current world, you go out and you sell the cheese, and if you sell it for a higher price, you have to still pay that extra money back to the producer that you sold that higher price at.
A. I answered that would be correct in the context if that were cheese that fit the description of the types of cheese that are required to be reported to the NASS survey, that is correct.

Q. All right.
A. That is correct.
Q. And even then, you don't report all of the -- I mean, let's put it this way. All of the cheese that's reported to NASS does not come from Foremost, right?
A. Correct.
Q. So it's a blended price that those are sold, right?
A. Yes.
Q. And Foremost isn't required to report those sales, are they?
A. My understanding is, to the extent that we have products that meet the definition of the products that NASS is collecting data on, that we are required to report that information. That's my understanding.
Q. But you could alter the terms of the sale to take it out of those requirements, could you not?

A. I'm not sure I know how to do that, if that's possible.

Q. But for the products like sharp cheddar or pepper Jack or those others, those aren't reported, right?

A. That is correct.

Q. And if you were able to pass on to the marketplace the extra energy cost, there is nothing in these regulations that require you to give that money to the producer, is it?

A. That money goes to our producers.

Q. Right, because it is a cooperative. But you are not obligated in the pay price that you pay to put that into a pay price?

A. No, we are not.

Q. And you are not obligated to the extent that you report to the Market Administrator for pooling purposes, you are not required to add that into that, right?

A. No, we are not.

Q. So in many ways, things really haven't changed in this regard between before and after order reform in that you still in the field have to pay a competitive price or your producers tomorrow could leave you, right?

A. That is correct.

Q. And whether or not your plant can profitably produce that cheese and sell it and pay that competitive price can be a problem if the competitive price still is higher than what you can deliver under your current make allowance or sales techniques, right?

A. Correct.

MR. YALE: I don't have anything else.

THE JUDGE: Other questions? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Mr. Weis, in response to the first round of questions from Mr. Yale, you indicated that you must compete with cheese plants that have an advantage because they are more efficient than yours. Do you recall that line of questioning?

A. Yes.

Q. Do you also compete with cheese plants that have a regulated price that is lower than the Class III price or do not have a regulated price at all in their competitive area to contend with?

A. Yes.

Q. And that affects your ability to collect a price at the product sales end, correct?

A. Correct.

Q. But it doesn't change the Class III price for which you have to account or make account to the Market Administrator?

A. No, it does not.

Q. And with respect to the non-commodity cheeses that you produce, you gave an example of pepper Jack, and you indicated that that is becoming a commodity type of cheese.

In that answer, what did you mean -- describe what you mean by commodity type of cheese and the limitations that might impose upon it.

A. I guess my definition of a commodity is that it is the knowledge of how to produce the product is becoming widespread. The demand for the product has grown in the category to the extent that many other new competitors are interested in entering the market or interested competitors are willing to try to expand their sales. The competitive result is that the return from that cheese moves closer and closer to that of what we would consider commodity cheddar.

Q. So one attribute of a commodity cheese, even though it is not NASS survey cheddar, is that there are many manufacturers that make it?

A. Correct.

Q. And buyers have many sources for the product?

A. More and more sources, yes.

Q. And for that kind of cheese, for that kind of commodity type, non-NASS cheddar cheese, is that priced off the CME?

A. Yes.

Q. And that also is a national industry norm?

A. Yes, I believe so.

Q. When you offer pepper Jack, for example, for sale, you are competing with somebody else who uses a similar pricing technique off of the CME?

A. I believe so.

Q. And for such commodity type cheeses, Foremost, as an isolated producer, is not able to pass on costs in its bid price and be successful in selling unless all pepper Jack cheese manufacturers raise their prices for the same reasons?

A. That's true. And also, if all buyers of pepper Jack believe that their competitors' -- their competitors' prices are increasing.

Q. And pepper Jack cheese, is that one of the cheeses for which competition comes out of non-Federally regulated milk areas such as Idaho, California?

A. I can't speak to that personally. I know that there is emerging competition in the Upper Midwest.

Q. You were asked some questions about pre- and post-Federal order reform by both Mr. Yale and Mr. Rosenbaum.

Pre-reform, would it be correct to say that a plant which in isolation had increased costs for producing a commodity product, that that plant could not effectively increase its commodity sales price just because nobody else has incurred those costs?

In other words, if just you had higher employment costs and others didn't, could you effectively pass that on in a competitive environment pre-Federal order reform?

A. No.

Q. However, pre-Federal order reform, if cheese operations collectively experienced an increased cost, that kind of increased cost would be passed on to the buyer and retained by the manufacturer to cover those costs?

A. I would say yes.

Q. And the function of the make allowance surveys is to determine collective costs and cost changes?

A. Yes.

Q. That's why we are here?

A. Yes.

Q. It is not recover your cost, it is not to recover Agri-Mark's cost, it is to account for collective cost increases?

A. Yes.

Q. Energy being very predominant one of those costs?

A. Yes.

Q. You describe some of Foremost's activities in the locations where Foremost has members. Foremost also sells milk to other handlers for Class I and II use, is that correct?

A. Yes, we do.

Q. In addition to operating its own Class I plants?

A. Yes.

Q. And you indicated that the Upper Midwest milk going to fluid distributing plants is priced by the CMPC?

A. It is priced by Central Milk Producers Cooperative in old Order 30, the

Upper Midwest Marketing Agency and old Order 68, the Iowa Milk Marketing Agency in old Order 79 and the Mideast Milk Marketing Agency in Michigan.

Q. So there are multiple collective bargaining agencies consisting of multiple cooperatives that get together and set prices, premiums included for Class I and II products?

A. Correct.

Q. And the revenues from those activities contribute to the bottom line of checks that you send to dairy farmers, correct?

A. Yes.

Q. When you talked about assigning profits or losses to your producers or allocating losses to producers in their checks and indicated that you have not yet had losses, that is significantly a function of revenue from your noncommodity cheddar, butter and powder activities, correct?

A. That's true at times.

Q. And by noncommodity cheddar activities, I'm including those specialty cheeses that are not subject to the same competitive restraints as commodity cheddar.

A. Correct.

MR. VETNE: That's all I have

THE JUDGE: Very well. It is a little after 10.

Excuse me. Mr. Yale.

MR. YALE: Just one quick follow-up to Mr. Vetne

THE JUDGE: Very well.

EXAMINATION

BY MR. YALE:

Q. Mr. Vetne asked questions about, you know, selling prices and dealing with margins and the like, you know, the selling of your cheeses. Those are sold -- CME, we talked about CME plus or minus the basis, right?

A. Yes.

Q. And when you go out to negotiate, and let's say that you are getting pressure, either from within the Upper Midwest on your pepper Jack or from either or California, if you -- and I just use this as an example, that your pepper is CME plus a dime, that you might find yourself being pressured to bring that down to the CMI plus 9 cents. I mean, isn't that how it operates?

A. Yes.

Q. Or if you've got a little extra leverage, you might push it to 10-1/2 cents, if you can push it that way, and that's the negotiation that -- it's on a basis that you negotiate, right?

A. Correct.

Q. Now, on the NASS on the cheddar, you do the same thing. When you are selling cheddar cheese, you sell it CME plus or minus a basis, right?

A. Correct.

Q. But the difference is that the NASS includes the basis, doesn't it, of all the plans that reported? It's all averaged in?

A. Ultimately, yes.

Q. Right. Thank you

THE JUDGE: Very well, Mr. Gulden.

EXAMINATION

BY MR. GULDEN:

Q. Neil Gulden, Associated Milk Producers.

Mr. Weis, regardless of all this talk of extra value on the products, there are times, are there not, when the Federal order minimum blend price is higher than returns that can be realized from your operations?

A. Yes.

Q. And do you ever pay producers more than you can afford to pay to meet competition just, just -- just because they are required to -- they, your competition, are required to pay minimum order prices?

A. On occasion, yes.

MR. GULDEN: That's all I have.

THE JUDGE: Very well. It is a little after 10:00. Let's take our 15-minute morning recess at this time. Let's be back at 20 after.

[Whereupon, the hearing recessed at 10:07 a.m. and reconvened at 10:21 a.m.]

THE JUDGE: Sorry, Mr. Weis. There is one more question, apparently. Mr. Weis, you are still under oath.

EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore.

Just one question, Joe, with respect to your comments on page 6 about how energy costs might be incorporated in a decision here.

Would you agree if the energy costs are adopted in an interim decision without an adjuster, it would have the effect of retaining that level of energy costs in the make allowance whether it goes up or down?

A. Yes.

Q. And if it were, in essence, locked in at a certain level and, energy costs being volatile as they have been and are, if they would happen to go down during the period of the interim order, producers, in essence, would not have the benefit of that decline in cost, would they?

A. Through the regulated pricing system, that's correct.

MR. BESHORE: That's all. Thanks.

THE JUDGE: Very well. Are there other questions of Mr. Weis at this time?

Mr. Weis, you may step down.

Exhibit 44 is now entered into the record.

[Whereupon, Exhibit No. 44 was received in evidence.]

THE JUDGE: Mr. Rosenbaum.

MR. ROSENBAUM: Steve Rosenbaum, National Cheese Institute. The next witness will be Mr. Jim Box.

THE JUDGE: Mr. Rosenbaum, I don't have his statement.

MR. ROSENBAUM: Your Honor, he is not going to have a statement to hand out. He just has testimony to provide

THE JUDGE: Very well.

Whereupon,

JAMES BOX,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated and spell your name for the hearing reporter.

THE WITNESS: My name is James Box. The last name is spelled B-O-X.

EXAMINATION

BY MR. ROSENBAUM:

Q. Box, I know that you have some

testimony to provide, although not a written testimony to hand out, so could you please proceed to that.

A. Yes, sir.

Q. Rich Dairy Products, RDP, is a privately-owned company dealing in dairy products for a wide spectrum of handlers throughout dairy industry. RDP begin operation in 1969. RDP is also an active participant in the Chicago Mercantile Exchange for dairy products traded on that venue.

We physically take title to all dairy products we buy and sell, including but not limited to cream, butter, nonfat dry milk powder, whole milk powder, skim condensed, anhydrous milk fat, milk, cream blends, milk and stabilizers.

Since we are engaged in the dairy industry's trading of various products, we appreciate this opportunity to appear and make our public statement for the record of this hearing.

RDP does not on rate any processing facilities.

My name is James R. Box. I'm a milk marketing specialist employed by Rich Dairy Products, Inc. I have held that position since July of 2005.

Prior to that I worked with USDA in Washington and in the Chicago Market Administrator's Office, dairy cooperatives and processors. I have in the industry since 1968 and have appeared at numerous hearings over the span of my career. I represent RDP at this hearing.

RDP supports the adoption of Proposal 1 as listed in the Notice of Hearing. Costs of operations for all producers have risen since the adoption of formulas using components were introduced when the orders were reformed beginning in 2000.

Several witnesses prior who are directly associated with the production function have submitted data regarding costs. While the costs may vary from processor to processor, they all have generally -- have increases in cost they must pay when producing their products.

Mandatory uniform accountability among processors under the Federal milk order system necessitates that the make allowances be updated. Failure to do so will result in reduced capacity for market-clearing functions for milk that's surplus to fluid users.

Finally, RDP supports the consideration that the Department undertake this issue with urgency and that this hearing is held on an emergency basis.

RDP, therefore, supports the concept that the Department move directly to an emergency final decision without going through the normal step of a recommended decision. The industry is in general agreement that the need exists for remedy and the faster one can be implemented, the better the industry will be. There is no reason to follow customary procedure in this case.

RDP expresses our thanks to the Department for the opportunity to express our view on make allowancing, and with the petitioners and the supporters, we ask the Secretary for a speedy decision.

This concludes my testimony

THE JUDGE: Questions of this witness? Mr. Schad.

EXAMINATION

BY MR. SCHAD:

Q. Good morning, Mr. Box.

A. Good morning.

Q. Dennis Schad from Land O'Lakes. Just one question.

Rich Dairy Products, are you -- you

testified that they are engaged in the buying and selling of cream?

A. Yes, sir.

Q. Can you give us some idea how -- the extent in some volume number that you are comfortable with that Rich Diary on an annual basis trades that commodity?

A. I would not think that to be germane, the fact that we -- we do handle a lot of cream.

Q. Okay. Could you share with us your terms of pricing for buying and selling cream?

A. It varies among the people that we are dealing with. Generally, though, it is based on the CME plus a multiple.

Q. Thank you very much.

THE JUDGE: Other questions of this witness?

Very well, Mr. Box, you may step down. Thank you.

MR. ROSENBAUM: Steve Rosenbaum, National Cheese Institute. Our next witness will be Mr. John Davis.

THE JUDGE: Mr. Davis's statement will marked as Exhibit 45, Mr. Rosenbaum.

[Whereupon, Exhibit No. 45 was marked for identification by the judge.]

Whereupon,

JOHN DAVIS,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated and spell your last name for the hearing reporter.

THE WITNESS: Hello. My name is John Davis, D-A-V-I-S.

STATEMENT FOR THE RECORD OF JOHN DAVIS

I'm the General Manager of Davisco Foods International. We are a $600 million company based in Southern Minnesota with cheesemaking facilities in Southern

Minnesota, Eastern South Dakota and Southern Idaho. We currently process approximately 10 million pounds of milk into 1 million pounds of cheese per day. We make cheddar, mozzarella, and varieties of hard Italian cheeses that are sold throughout the U.S. We are currently operating in regulated milk marketing areas in the Midwest and have in the past managed regulated milk in Idaho

THE JUDGE: [Gesturing.]

THE WITNESS: Slow down? You sound like my mother.

We support Proposal 1 in the hearing notice. In addition, we wholeheartedly support the testimony of the National Cheese Institute.

Due to the nature of how our raw material, milk, is priced within the Federal orders, we are completely at the mercy of the regulated milk pricing formulas currently in place. At the heart of those regulated milk pricing formulas are the make allowances that ultimately generate the Class III price, under which regulated cheesemakers must operate. With or without the ever-increasing costs inherent in producing cheese today, the regulated pricing system must develop a technique to quickly react to changes in the various cost inputs that cheesemakers must deal with on a daily basis. We as cheesemakers can't possibly be expected to absorb a multitude of cost increases, all the while being responsible for a milk price that is well above what we can get out of the marketplace, net of the costs of producing that pound of cheese.

Cheesemakers, including Davisco, have been forced to absorb all of the increased costs of producing cheese. From 1998 to 2004 our packaging costs have increased 15 percent per pound of cheese produced, our direct labor costs have increased 25 percent per man hour, our indirect labor costs, which would include health care and benefits, have increased 92 percent. To put the health care number in perspective our cost per employee for health care in 1998 was $2,800 dollars; in 2004 it was $5,400. This number would be even greater, save for the fact that we increased our employee numbers by 33 percent in the same time period which helped us mitigate some of the increases due to our size enabling us to receive more competitive economics from the health care community. Our electrical costs have increased by 14 percent per kilowatt hour from 1998 to 2004. Our costs for natural gas from 1998 to 2004 have increased 149 percent on a per therm basis. None of these cost increases include the effect on all parts of our business of the events of 2005. The effects on our costs of the events of 2005 as it relates to the energy markets have only caused the formula-based pricing to further cause hardship on our ability to survive in this energy- and labor-intensive business.

Thanks again for your time. I can't stress enough the need to quickly modify these cost structures that ultimately determine the formula pricing in order to allow the innovative folks in this industry to concentrate on producing and marketing our products. We can't possibly be expected to survive and further invest in this energy- and labor-intensive industry, all the while being economically tied down by cost structures not even remotely connected to reality.

Thanks.

MR. ROSENBAUM: Your Honor, at this point I would move Exhibit 45 into evidence

THE JUDGE: So admitted.

[Whereupon, Exhibit No. 45 was received in evidence.]

MR. ROSENBAUM: And Mr. Davis is available for cross-examination

THE JUDGE: Questions of Mr. Davis? Very well, Mr. Davis, you may step down. Thank you.

THE WITNESS: Thank you

THE JUDGE: Mr. Vetne.

MR. VETNE: Mr. Galarneau.

THE JUDGE: His statement will be marked as Exhibit 46.

[Whereupon, Exhibit No. 46 was marked for identification by the judge.]

Whereupon,

CLAYTON GALARNEAU,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please give us your name and spell your last name for the hearing reporter.

THE WITNESS: My name is Clayton Galarneau. That's G-A-L-A-R-N-E-A-U.

STATEMENT FOR THE RECORD OF CLAYTON GALARNEAU

I am the Director of Manufactured Product Sales and Operations for Michigan Milk Producers Association (MMPA). I have been with MMPA for 20 years and I am currently responsible for the operations of two manufacturing plants located in Ovid and Constantine, Michigan. MMPA is a member-owned and operated milk marketing cooperative headquartered in Novi, Michigan. MMPA has about 2,400 members supplying over 3.3 billion pounds of milk per year from about 1,865 farms located in Michigan, Wisconsin, Indiana and Ohio. Approximately one-third of the milk marketed by MMPA is processed within our own two facilities.

MMPA's two manufacturing plants produce a variety of bulk dairy products including cream, condensed skim milk, Grade A nonfat dry milk and Grade AA bulk butter. MMPA's manufacturing plants have participated in the USDA Cooperative Service survey of costs at cooperative manufacturing plants for several years, including September 30 year-end data for the 1998 and 2004 surveys. The data from the surveys from 1998 were combined with the results of a similar survey of California instate manufacturers and used as the basis for determining the make allowances for Class III and Class IV product formulas that have been in place since 2000.

Our manufacturing costs have increased dramatically since those cost surveys were completed for 1998 and our profit margins have suffered considerably. The attached analysis summarizes the manufacturing cost increases that our plants have experienced for butter and powder from 1998 to 2004. Although our accounting department has not completed the cost analysis beyond 2004, we have been able to assemble the cost per pound information for electricity and natural gas costs (fuel costs) for 2005 and for the first fiscal quarter 2006. These fuel costs are also included on the attached schedule.

From the baseline cost per pound figures that were established in 1998, our total powder manufacturing costs per pound were 54 percent higher in 2004. The increase in powder cost for one year amounted to $2.1 million of additional manufacturing costs that we were not able to recover from the marketplace. During the same period, our butter production costs per pound increased 14.3 percent and reduced margins by nearly $207,000. In 2005, our fuel costs for powder and butter production increased 11.6 percent and 13.6 percent respectively, adding an additional $174,000 of non-recoverable costs in these figures. In the first quarter of our fiscal 2006, the fuel costs for butter and powder increased 20.7 percent and 6.2 percent respectively, depleting our bottom line by another $112,000.

Our gas costs for our manufacturing operations in 2005 were nearly $2.7 million. If gas costs continue as anticipated by recent futures market activity, we expect our gas costs are likely to increase by nearly $1.3 million for 2006. For our size organization, that will represent a significant hit to our bottom line and unfortunately the dairy pricing mechanisms do not allow for us to recover these costs. Any increases we have been able to tack on to our butter and powder prices are reported to NASS and then serve to increase the raw material cost for the milk used to make butter and powder.

In the petition for this hearing, Agri-Mark provided several examples of the necessity to adjust the make allowances for

Class III and IV product pricing formulas. MMPA has two plants that together process over 1 billion pounds of milk per year and we have considerable experience in the production of nonfat dry milk and butter. We agree that the make allowances should be adjusted to take into consideration the increased costs manufacturers are experiencing. Due to the significant impact these increased costs have inflicted upon our industry, we believe it is imperative that the allowances are adjusted on an emergency basis in order to provide needed relief as soon as possible. We anticipate our plants will be experiencing maximum powder production and very high levels of butter output during this coming spring flush. MMPA has a major responsibility for balancing the milk supply in the Great Lakes area and the outlook for this spring will likely bring unavoidable losses to the butter and powder operations of our facilities.

We are aware that the National Milk Producers Federation has testimony recommending changes to the make allowance formulas for Class III and IV milk prices. We support their recommendations and agree with the concept of indexing the fuel costs and adjusting the make allowances on a periodic basis to account for positive and negative changes in the fuel costs.

Thank you for considering our comments.

THE JUDGE: Do you have a table that is attached to your statement? In other words, would you explain just generally what that is.

THE WITNESS: Yes, sir.

In the first column -- I don't have any numbers there, but those would be our base figures that were supplied for the RBCS survey taken in 1998. So from those base costs I have in the next column the 2004 increases on a percentage basis.

So our manufacturing cost per pound increase for powder on the first row, from 1998 to 2004, increased 54 percent with a manufacturing cost variance of $2.1 million.

The fuel increase from 1998 to 2004 for powder increased 49 percent, and the dollar value was $359,189.

The next row identifies our percentage of capacity utilization in our plant for powder. In 1998 we were at 30 percent utilization. In 2004 we went to 22 percent; in 2005, 24. And the first quarter of '06, it -- we are on a fiscal year basis, so that would be October, November and December. It would be 37 percent utilization.

And then we have similar figures for butter below that. From the base in 1998, our butter manufacturing costs per pound has increased 14.3 percent with a cost variance of $206,714.

Our fuel increase from the base on butter production was 71.5 percent for '04 and, for 2005, another 13.6 increase beyond that. And in the first quarter of '06, we have experienced an additional 6.2 percent increase beyond the '05 number.

And the corresponding cost variances shown below that of $109,000 from the base period 1998 to 2004, an additional $35,953 for '05, and the first quarter another almost $7,000.

And, again, for butter we identified at capacity utilized butter production, capacity going 10 percent in 1998, 8 percent in '04, 8 percent in '05, and 12 percent in the first quarter.

And then the bottom line summarizes the combined cost.

THE JUDGE: Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Going back to that table, Clay, the -- and powder, for example, under fuel per pound increase, 2004 is a percentage increase from the 1998 base, correct?

A. That is correct.

Q. 2005 of 11.6 percent is an increase from what it was in 2004?

A. That is correct.

Q. That's not an increase from the 1998 base period?

A. No.

Q. And then, so for the 2005 column, 2004 is the effective base?

A. That is correct.

Q. And the dollar's also the same?

A. That is correct.

Q. And the same thing is true for the 2006 column, 2005 for that column is the effective base?

A. That is correct.

Q. The fuel cost for the first quarter of 2006, is that a cost that you have already contracted for or is that a projected base on current prices?

A. Well, those are actual numbers for 2006 because our first quarter is October, November, December.

Q. There we go.

A. We are in a fiscal year.

Q. Okay. So the capacity of utilization is actual, not projected? All of these are actual, not projected?

A. On this table, that's correct.

Q. Thank you

THE JUDGE: Exhibit 46 will be admitted into the record at this time.

[Whereupon, Exhibit No. 46 was received in evidence.]

THE JUDGE: Questions of this witness? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Ben Yale on behalf of Select, Continental and the other organizations that we have previously named. Good morning.

A. Good morning.

Q. I'd like to look to this table that you have in our report. And it shows a significant reduction in the utilization of the plant. Is that not one of the major contributors to your higher cost in operation?

A. Well, I don't think it is significant for butter in a 1 or 2 percent change. The powder costs per unit have gone up, though, for powder.

Q. Now, these two plants are -- function almost exclusively as balancing plants, right?

A. The butter powder portion of the operation, but we produce, like I said, lots of cream and condensed, and that would be considered balancing.

Q. But that's not included in these costs?

A. No.

Q. Just the butter and the powder?

A. Right. And we have identified these costs using the formulation or the instructions provided by Charlie Ling for the RBCS study and then carried that same formulation or accumulation of data forward for each proceeding period.

Q. And do you report your powder and butter sales to NASS?

A. That is correct.

Q. Do you make any specialty products of butter, any kind of specialty butters at all?

A. We make salted and unsalted.

Q. That's good. No tomato and basil, pepper butter?

A. No, sir, not at this time.

Q. Does MMPA contract with other marketers in that region to do balancing for them?

A. We have some arrangements with other marketers to provide balancing services.

Q. And do these arrangements provide for those marketers to pay a percentage of the operational cost regardless of the volume that they supply to the plant?

A. I do not believe that to be so. That is not my area of responsibility, but I'm not aware of any types of contracts following that manner.

Q. Does Michigan participate in any marketing agency in common?

A. Yes, we do.

Q. And which one or ones do you participate in?

A. Michigan has a Class I superpool we call the PEC.

Q. Is that the only one you participate

in?

A. That's the only one that I -- I guess I can't answer that. It is not my area.

Q. Are you familiar at all with the terms of the PEC?

A. Just vaguely.

Q. Is there any allocation of value to the balancing plant out of the PEC?

A. Again, that's not my area. I came here to discuss Class III and IV pricing mechanisms.

Q. Do you know what the relative pay price of MMPA is to its members in the field?

A. I'm generally aware of those types of figures, but I couldn't offer you any specific, like what we paid last month examples.

Q. Can you testify whether you are at or above the reported blend or PPD?

A. We are generally above.

Q. And as a cooperative, there are

distributions of profits and losses to producers every year, is that correct? I mean, whatever it is gets distributed?

A. That is right. We are a -- we are a cooperative --

Q. All right.

A. -- Capper-Volstead, and we distribute our earnings back to our members.

Q. And in the fiscal year ended in 2005, have they made any decision whether there would be any distributions to producers?

A. Yes, we did.

Q. And there were earnings?

A. Yes, there were. Fortunately, we sell things other than butter powder at our plants.

Q. I understand. But that brings up another line of questions.

Does MMPA do an analysis of -- there are multiple ways to balance a milk supply, you would agree?

A. That is correct.

Q. Do you ever look at alternate ways to do that, including not operating plants but just take the risk of the spot market from time to time?

A. Yes, we do.

Q. And what are the -- are the economics still better to maintain this plant?

A. It generally becomes the avenue of least amount of loss.

Q. The operation of this powder plant, that is part of your larger overall marketing strategy for MMPA, is it not?

A. That is correct.

Q. Because you supply bottling plants in that region?

A. Yes, we do.

Q. You have your own condensed operation that you have to balance to a degree, right?

A. That is correct.

Q. And there are some cheese and other

manufacturing plants that you supply milk to, right?

A. That is correct.

Q. Are you aware of the prices at which products are sold to the other manufacturing plants that MMPA has --

A. Not specifically.

Q. Do you know whether they are the regular long-term contracts? Are they at class or above?

A. They would be above class on a long-term basis. But are we talking about historical information or speculative?

Q. No, currently. I mean, are they purchasing milk from other or selling milk to other manufacturing facilities?

A. Yes, we do. And currently, I -- that's not my area. I'm not in charge of milk sales, I'm in charge of product sales.

Q. Sometimes the best answer is, I don't have the knowledge.

But going back to this question that this is part of a larger marketing strategy, you sell milk to bottlers and cheese plants for condensing, and the purpose of this is to provide balancing functions to those sales, right?

A. Yes.

Q. And you tend to sell your products, if the market will allow it, at prices higher than the class price in part to cover that cost of servicing those markets, right?

A. That would be our goal.

Q. It is always a goal of a cooperative, right?

A. That is correct.

Q. And part of the cost of servicing those markets include -- you know, you have got field service and transportation and coordination and sales and all those things, right?

A. Yes, we do.

Q. And you also have the balancing, right?

A. Yes, we do.

Q. And the decision of whether or not to operate the balancing plants with or without losses is part of the overall strategy of marketing the milk of its members, right?

A. Yes, it would be.

Q. And at the end of the day, what is important to the producers in your market isn't necessarily the profit or loss of an individual plant or plant but what they receive in their mailbox price, right?

A. Well, one leads to the other.

Q. One does lead to the other, in part, and it is all part of that plan?

A. Yes, it is.

Q. And at the present level, you are at or above the stated PPD or blend price for the market?

A. For our pay price.

Q. For your pay price?
A. Yes.
MR. YALE: I have no other questions, Your Honor
THE JUDGE: Other questions? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Clay, I just have a couple more on the table. You indicated there are two plants --
A. That is correct.
Q. -- included in this?
And both plants are used to make products other than commodity butter and commodity powder?
A. Yes.
Q. Could you identify what the butter products are?
A. Condensed skim milk, cream, instant nonfat dry milk, sweetened condensed whole

milk, skim milk, condensed whole milk and some specialty powders, but very insignificant amounts.

Q. The products that you listed just now, those are products that are not included in the table?

A. No, these are just the costs for butter and powder.

Q. For butter and commodity nonfat dry milk --

A. That is correct.

Q. -- and commodity butter?

And do those plants produce those other products year-round?

A. Yes.

Q. So when you are not producing commodity powder, your employees are engaged in producing the other products that you listed?

A. That is correct.

Q. And the bottom line under powder, for example, percent of capacity utilized, is that a percentage of the total powder that you might produce if the plant were dedicated, all its evaporators were producing powder? Or is that some leftover after -- with the other activities that you are using the evaporators for?

A. That's the percent of machine capacity.

Q. The percentage of machine capacity. So if you were to go a hundred percent powder, you would not be evaporating for other purposes?

A. Probably not, because then you have other limitations like receiving capacity.

Q. So one should not infer by your percentage of capacity utilized that, for example, in 1998, 70 percent of the evaporator capacity was idle. It was, in fact, being used for your powder purposes?

A. That is correct. And that's exactly

the way that Charlie -- the study works for all of us. It is machine capacity.

Q. All right. Thank you

THE JUDGE: Mr. Schad.

EXAMINATION

BY MR. SCHAD:

Q. Good morning, Clay.

A. Good morning.

Q. Dennis Schad, Land O'Lakes. I see from your numbers you are also employed in a balancing capability. I have a couple questions about that.

Your costs represent the costs incurred by a person, an entity that balances the market and has seasonal ups and downs, is that correct?

A. Seasonal, weekly and monthly.

Q. One portion of balancing that may not have been addressed in any of the prior testimony is an inventory risk inherent in balancing. Do you experience that risk?

A. Absolutely.

Q. Would you elaborate?

A. A very good example would be the Christmas holidays. We produce lots of butter and powder for two or three weeks. And quite often, the milk prices during that holiday period are higher than what the products will return in a few weeks after the holidays.

Q. Because the milk is there, you are providing the balancing that the market needs? You are building inventories, paying a competitive if not just a class price. And your return, when you finally sell the product, is less than what you sold the product?

A. That happens.

Q. Second question is that I see that you are a butter-powder plant. Do you -- and you also sell cream. Do you buy and sell cream?

A. Yes, we do.
Q. Could you tell me the general terms what those transactions --
A. Generally, cream is bought and sold at the multiple of the butter market.
Q. And in your purchases of cream, is that for your butter operations?
A. Generally.
Q. Thank you
THE JUDGE: Mr. Beshore.

EXAMINATION

BY MR. BESHORE:
Q. Marvin Beshore.
Mr. Galarneau, I hope I don't cover territory that Mr. Vetne did, but I want to inquire a little bit about the uses at your plants other than for butter and powder.
Are they -- what class -- when you are marketing cream, what class of use is it?
A. Generally, Class II or Class IV.
Q. Now, when you are selling it for

Class II, there are no issues relating to make allowances or any of those factors, correct?

A. You mean does the buyer ask us what the class is?

Q. No, what I mean is the Class II price is not based on a make allowance in the way that Class III and IV are, are they?

A. You mean in the sales price of cream?

Q. Yes.

A. It is not part of the pricing discussion.

Q. Class II price under the Federal order is not formulated on the basis of make allowances in the way that Classes III and IV are, correct?

A. I believe they are. You take the Class III price plus 70 cents is the Class II price.

Q. With the advanced price factor?

A. Right.

Q. Which -- okay.

When you market condensed from the plant, what is class is that sold at?

A. We sell Classes II, III and IV.

Q. Now, the billion pounds that you are processing per year at the two plants, roughly what portion of that is used for butter and powder, if you care to share that?

A. It varies. From 1998, about 27 percent of our butterfat went into butter. 2004, 17-1/2 percent of our fat went into butter. 2005, 16.3 percent went to butter. And the first quarter of '06, 23.4 percent of our fat has gone to butter.

Q. How about skim solids on the powder side?

A. On the powder side? In 1998, that was 38.6 percent of our solids. In 2004, it was 22.2 percent of our skim solids. In 2005, it was 22.2 percent as well. 2006, the first quarter, is 33.9 percent.

Q. Thank you.
Now, what portion of your class -- of your butter and powder is reported to NASS or some products that are reportable to NASS?
A. It would be most of it, almost all of it.
Q. What portion of your sales of cream are condensed for Class II is reported to NASS, if any?
A. We report those numbers as well to NASS, but they are not published as the butter and powder numbers.
Q. Are you sure you report them to NASS or --
A. AMS.
Q. -- "Dairy Market News"?
A. Well, we report to "Dairy Market News," but AMS also collects numbers.
Q. On price ranges for sales?
A. Yes, they do.
Q. But there is no NASS price series on

sales of those products --

A. Not that I'm aware.

Q. In any event, there is no NASS series that goes into the Class II price in the Federal order system? The NASS series for sales of cream are condensed for Class II?

A. Yes.

Q. Yes, that is correct, what I said, right?

A. I believe that's what you asked me.

Q. Okay. I just want to make sure that I understood your answer and that that was clear.

Okay. Now, what are we looking at this spring? We are talking about emergency and the need for prompt relief in this hearing. What are you projecting for your plants in terms of the milk supply that you are going to have this spring?

A. We are expecting a lot of milk, much more than we have seen in the past. We expect to be operating our plants at full capacity and producing probably all the powder machine capacity on both -- on the powder and significantly higher numbers on butter.

Q. And without emergency relief at the current make allowances?

A. That is correct.

Q. Okay. Thank you

THE JUDGE: Other questions?

Ms. Deskins.

EXAMINATION

BY MS. DESKINS:

Q. I'm Sharlene Deskins with the USDA Office of General Counsel.

In your proposal, you -- well, in your statement you put down that you are aware that the National Milk Producers Federation is going to make a proposal and you agree with it?

A. Yes.

Q. Can you tell what your understanding is of what would be in that proposal and what you are agreeing with?

A. That it would be similar to the Agri-Mark proposal for increasing the make allowances based on the summaries of the surveys done by the Charlie Ling group as well as California. And that also would include an indexing to the fuel price so that, on a periodic basis, we could see up or down changes to that make allowance based on the changes in natural gas and electricity.

Q. That's all the questions I have. Thank you

THE JUDGE: Other questions?

Very well, it looks like you may step down.

THE WITNESS: Thank you.

MR. VETNE: Dr. Burleson of the Northwest Dairy Association and West Farm Foods.

Whereupon,

BRIAN SCOTT BURLESON,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please tell us your name and spell your last name for the hearing reporter.

THE WITNESS: My name is Brian Scott Burleson, B-U-R-L-E-S-O-N.

STATEMENT FOR THE RECORD OF BRIAN BURLESON

I'm the Director of Manufacturing for the Ingredients Division of West Farm Foods. My business address is 635 Elliott Avenue West, Seattle, Washington.

West Farm Foods conducts all processing and marketing operations for Northwest Dairy Association, a dairy cooperative with about 640 members, including 520 in the Pacific Northwest Federal Milk Marketing Order. The Ingredients Division includes five plants, including four nonfat dry milk plants and one cheese/whey plant.

I have worked in the Ingredients Division of West Farm Foods for the last 19 years. In my current role as Director of the Ingredients Division, I am responsible for plant operations in four nonfat dry milk (NFDM) drying facilities, and one cheese/whey drying operation. My duties include equipment design, plant/equipment operation, product quality, process modifications, purchasing of new equipment, and commissioning of new equipment. Prior to my current position, I was manager of our cheese and whey plant in Sunnyside, Washington. Before that, I was involved in the construction and initial startup of our NFDM processing facility in Jerome, Idaho, and was plant manager after its opening in 2002. During my career at West Farm Foods, my responsibilities have included dryer/evaporator operator, supervisor, whey plant manager, NFDM plant manager and cheese/whey plant manager. During my career with West Farm Foods I have worked in four different processing facilities. I was involved in evaporation and drying activities in our Chehalis, Washington facility, which dries both nonfat dry milk and why. I have played a key role in the design and initial startup of our Sunnyside, Washington facility that originally manufactured NFDM, but later was converted to a cheese/whey operation.

The purpose of my presentation today is to provide information on the processing differences between NFDM and whey powder. I hope to clarify the process differences associated with the manufacture of these two different products and the related differences in costs.

In preparation for this hearing, I was asked to review the testimony presented by C. K. Venkatachalam ("Venkat") in May 2000

FMMO Class III Hearing, a copy of which is attached to my testimony. My purpose in reviewing the attached was to determine if the assumptions remain valid today. Based upon my review, I believe that the assumptions remain valid and accurate for the kind of system that was described in Venkat's testimony. This whey manufacturing process remains in use in many manufacturing operations today.

However, systems that incorporate a reverse osmosis (RO) step to reduce the amount of water removed through the evaporator are becoming more prevalent. Therefore, I will present an update to Venkat's original analysis using the simple average of the energy costs from the Rural Cooperative Business Service plant cost survey. Additionally, I will describe the whey processing systems that incorporate reverse osmosis and compare costs for those systems compared to nonfat dry milk.

It is important to mention that while several plants are incorporating the use of reverse osmosis for water removal from the whey stream, the total amount of water needing to be removed remains the same. About 55 percent more water is removed per pound of whey powder when compared to one pound of NFDM powder.

In that traditional system outlined by Venkat, energy costs required to produce whey powder are higher than the energy costs required to produce NFDM by 1.12 cents per pound. The following assumptions are used to calculate the energy costs associated with producing whey powder and nonfat dry milk:

Dilute whey and skim contain an average of total solids of 6 percent and 9 percent respectively.

Assuming no losses, product yields at 97 percent total solids would be 6.19 pounds whey and 9.28 pounds NFDM per 100 pounds of dilute feed; steam costs of $7.99 per 1,000 pounds; electricity costs of 5.8 cents per kilowatt hour; 8 pounds of water removal per pound of steam.

Additional power consumption for whey: 200 horsepower for separators and clarifiers; 90 horsepower for crystalizers; 150 horsepower for additional pumps. For total installed, additional horsepower of 440. Assuming that operated at 75 percent capacity, consumption at 75 percent capacity will be 247 kilowatt hours.

MR. VETNE: If I might interrupt.

THE JUDGE: Mr. Vetne, the statement has been marked as 47 and the associated materials as 48.

MR. VETNE: Thank you.

[Whereupon, Exhibits No. 47 and 48 were marked for identification by the judge.]

THE WITNESS: Table one in Exhibit 48, our attachment to this testimony, "Energy Cost Differences for Whey and NFDM Drying, Based on Venkat Testimony, May 2000 FMMO Class III Hearing," demonstrates the updated differences in costs to dry whey and nonfat dry milk, based on the whey and nonfat dry process outlined by Venkat in his May 2000 testimony.

The calculations of the additional energy cost to produce finished whey relative to NFDM and the above table can be summarized as follows:

Evaporator steam .538 cents per pound; refrigeration for crystalizers .188 cents per pound; dryer gas is .100 per pound; and additional power is .294 cents per pound for a total of 1.120 cents per pound.

The additional equipment costs associated with producing equivalent volumes of dry whey were documented by Venkat and have increased over the last five years. However, I was unable to secure updated quotes in preparation for this hearing and am therefore using the quotes as of Venkat's testimony. He concluded that the additional cost of capital in a whey powder operation is 1.1 cents per pound of whey powder and annual depreciation for the additional equipment is approximately .685 cents per pound of whey powder.

Therefore, the incremental whey energy and equipment costs associated with producing whey powder as compared to producing NFDM is 2.905 cents.

A breakdown of that would be energy, 1.120 cents per pound of whey powder; capital, 1.100 cents per pound of whey powder; depreciation is .685 cents per pound of whey powder for a total of 2.905 cents per pound.

Whey Processing Using Reverse Osmosis.

Previously, I had made reference to reverse osmosis becoming more prevalent in the whey processing systems. That being said, I feel it is very important to better explain what a reverse osmosis system is comprised of and a brief explanation of how reverse osmosis systems operate.

Development and History.

The concentration of whey by reverse osmosis has been used in the dairy industry since the late 1970s. Its primary use has been to pre-concentrate the liquid whey prior to evaporation. This pre-concentration step allows more whey to be processed without expanding the capacity of the evaporator.

Process Description.

The basic principle of this process is to concentrate the solids in sweet whey for use as food grade whey. The process is described as follows:

The process begins by making sure the

sweet whey is fine saved and has a fat level of no higher than .007 percent. This will ensure the smooth operation of the membrane system. The whey at this point will have a solids content between 6 and 6.5 percent and a pH of 5.8 to 6.1.

The whey is then pasteurized and typically cooled to 70 degrees and processed on a reverse osmosis system. The membrane system is designed as a multi-stage continuous production plant capable of processing whey up to 20 hours per day. The whey is fed into the system at a predetermined feed rate. It is then fed into a system balance tank, and then passes through a series of pumps capable of generating up to 600 pounds of pressure. The whey then enters the membrane in each stage where a separation of the water and the whey takes place. The water passes through the membrane and is called a permeate. The minerals, lactose, protein and fat are rejected by the membrane and are called the concentrate. In a process such as that used by West Farm Foods, we concentrate the whey 14 percent total solids.

The whey concentrate can now be fed to an evaporator or another membrane system for further processing.

Following production, the system is configured for CIP (clean-in-place) and a series of chemical steps are done to remove the soil from the membrane surface so that production can resume for another 20 hours of operation.

Below is an example of a reverse osmosis process flow diagram.

While reverse osmosis is an important element in the production of whey powder, it is by no means the only processing difference when compared to NFDM production. Chart 1 in Exhibit 48, our attachment to this testimony, "Comparison of Process Flow Steps to Dry Whey Powder Versus NFDM Powder," outlines the difference in process flow between nonfat dry milk and whey when reverse osmosis technology is used.

I will now walk you through the differences in the process based on the testimony attached.

This process chart outlines the difference in the manufacturing process for whey and nonfat dry milk in our West Farm Foods plants.

Go through the Chart 1. Go through the whey flow. Whey would come from storage. The whey stream would then go through a clarifier, would then go through a separator. Whey cream would be taken off. The skimmed whey would go through a pasteurizer, would then go through a reverse osmosis system. It is then pasteurized again, go to the evaporator, go to crystallizer tanks. From there it would go to a two-stage dryer. From there it would go to packaging.

A review of the process for NFDM, the whole milk would come from storage, would be preheated, would then go through a separator. The skim would then go through a pasteurizer to an evaporator to the dryer and then to pack.

As far as some basic equipment differences between the two processes, the whey powder process flow incorporates the use of clarifiers. It has an extra pasteurizer. It has the reverse osmosis system, the crystallizer tanks and a two-stage dryer.

Our operations analyst team worked with our engineers to calculate the comparative energy costs for whey and nonfat dry milk processing. Table 2 in Exhibit 48, our attachment to this testimony, "Energy Cost Differences for Whey and NFDM Drying," outlines the differences in drying costs for both whey and nonfat dry milk.

I will use this Utility Cost Analysis to explain the utility consumption differences between the production of NFDM and whey powder. Once again, I will remind you of the major distinction between the two products -- the throughput. Both product streams run at 185,000 pounds per hour. However, the whey stream starts at 6 percent total solids, compared to 9 percent for the skim milk. This means that the production volume we use to determine our per-unit costs is 11,433 pounds dry whey versus 17,165 pounds nonfat dry milk. In other words, the nonfat finished product volume is 50 percent greater than the whey volume.

In the whey processing, we introduce the RO system prior to the evaporator. This process will remove a significant amount of the water at a relatively low cost. In total, we use around 250 horsepower for the process, netting a cost of $11.15 per hour, or one-tenth cent per pound finished product. The RO system will yield us a whey product of about 14 percent total solids range. The assumption for electric cost is 5.8 cents per kilowatt hour.

After the RO, it would go to the evaporator. It costs about the same $78 per hour to run the evaporator for both whey and NFDM. The only significant difference is throughput. This adds an additional two-tenths of a cent per pound onto the whey processing cost. We use a cost assumption of $.799 cents per therm ($7.99 per MMBTU). One might ask why the evaporation costs are the same for both whey and NFDM. This is associated with the use of steam for both the flash cooler and the hot well, used when processing whey, but not used when processing NFDM. We also see a reduction in the efficiencies of evaporators when operating on whey, due to an increased rate of fouling associated with calcium precipitation.

Whey has to be crystallized before it is sent to the dryer. This adds an additional interface, but adds only one-hundredth cent cost per pound of whey.

Drying costs are a straightforward calculation, based on water removal. We utilize an additional 2,000 BTUs to remove the extra 4,500 pounds of water from the skim milk. However, the volume of finished product is again the key factor leaving the drying of the whey a half-cent per pound higher than the NFDM, even though the NFDM drying cost is higher on a per-hour basis.

For the rest of the equipment in the plant, the cost per pound is relatively the same, or slightly higher for whey powder.

Since we use the RO to remove water, this will reduce utility requirements as demonstrated above. The trade-off is higher annual maintenance and membrane replacements. The membrane costs run slightly more than a third of a cent per year. This brings the total cost difference per pound to 1.2 cents.

On a per-pound basis, in summary, we use around 31 kwh per hour when drying whey compared to 2,840 required in drying skim. We actually use less total MMBTUs when drying whey (40.5 MMBTUs compared to 55.5 MMBTUs).

We have also completed an analysis of equipment cost differences associated with processing of whey powder using reverse osmosis technology versus NFDM drying costs. Table 3 in our Exhibit 48 outlines the additional equipment costs when drying whey.

Additional equipment costs, including RO filter replacement, add about 1.86 cents to the processing cost to dry whey.

I have prepared a summary of the

information put together by Venkat in 2000, Venkat's information using 2004 utility rates, and the whey cost analysis completed by West Farm Foods. Table 4 in our Exhibit 48 to this testimony, "Comparison of Cost to Dry Whey vs. NFDM," shows the difference in whey and nonfat dry milk drying costs between Venkat's original testimony, his testimony updated with 2004 energy costs, and the West Farm Foods cost estimates using reverse osmosis technology, also based on 2004 energy costs.

Venkat's original whey processing estimates showed a whey drying cost difference of 2.559 cents over nonfat dry milk. When updated to 2004 energy costs, that difference grows by almost half a cent to 2.905 cents. The whey drying system used by West Farm Foods substitutes somewhat lower capital costs, energy costs, and depreciation for the cost of membrane replacement. Based on this whey drying system, we calculate the 2.71 cent cost difference between whey and nonfat dry milk.

In summary, it appears that regardless of the process method used, the lower solids level of diluted whey compared to nonfat dry milk results in significantly higher costs for whey removal. These additional costs must be considered when determining manufacturing allowance for whey.

EXAMINATION

BY MR. VETNE:

Q. Mr. Burleson, you have also as indicated attached something marked Exhibit 1 to your testimony. That is the 2000 testimony of Venkat upon which you built in providing your testimony, correct?

A. Yes.

Q. And in Exhibit 48, if you will turn to the last page, Tables 3 and 4, is there a correction that you need to make in your data on Table 4?

A. Yes, the column that's titled, CK 2005.

Q. That's the column identified as Source right under the words Table 4?

A. Yes.

Q. Okay.

A. That should be titled, CK 2004.

Q. Instead of 2005?

A. Yes.

Q. And there is a reference to a footnote?

A. Yes, the Footnote 1 should also be changed to CK 2004, adjusted for 2004 RBCS energy rates.

Q. Okay. In providing this cost information both for whey and nonfat dry milk and making energy cost assumptions, you have included no adjustment for the increased cost of energy between 2004, on average, and January of 2006 energy costs?

A. That is correct.

Q. Thank you. The witness is available

THE JUDGE: Very well. Questions of this witness? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Benjamin F. Yale on behalf Select Milk producers and others. Good morning.

A. Good morning.

Q. First of all, I want to thank you. I think I understand this. So now I have got questions based on my understanding.

First of all, just some scopes, Mr. Burleson. Will anybody else from West Farm Foods or NDA be testifying at the hearing, do you know?

A. Yes.

Q. And I would take it that your testimony is strictly limited to this processing cost of making the whey?

A. Yes.

Q. So I don't get to ask you questions about producer prices, right?

A. No.

Q. Okay. Is it my understanding that West Farms uses the RO method to prepare and condense the whey prior to the drying exclusively or do you dry some entirely as well?

A. Can you repeat that?

Q. Well, you have a process that includes the RO in front of the dryer, right?

A. In front of the evaporator.

Q. I'm sorry, the evaporator. Do you sometimes not use the RO and go straight to the evaporator?

A. It would be a very rare occurrence to operate that way.

Q. So your design and your plant is with the idea in mind that the RO is a critical and ordinary part of the process?

A. Yes.

Q. Now, you relied upon, in your testimony, Venkat's testimony from five years ago. Were you present here during his testimony?

A. No.

Q. My first -- well, let's go back. Maybe I can deal with it with a simpler question. Let's look at your Exhibit 48 and Table 4. Can we go to the WFF -- I'm glad that's not WWF -- but WFF, RO 2005 and, in some respects, ignore what is to the left and be able to say if the record or if there is evidence to support that the drying cost of nonfat dry milk was X, that the process, at least used at West Farms, would be X plus this 2.7151? Would that be a fair use of that information?

A. Can you explain that a different way for me?

Q. Sure. As I understand your testimony, that one way at arriving at the cost of dried whey, to process dried whey, is to take the cost to process nonfat dry milk because it fundamentally is a liquid milk byproduct with solids in it that all you are doing is removing the water by either reverse osmosis, evaporator or a dryer, or a combination thereof, to yield a powder at approximately 97 percent dry matter; that both of those have the same goal in mind, to take in slurry or whatever you want to call it and end up with a dry product, right? Is that correct?

A. Yes.

Q. And as I understand your testimony, that although they are, in a sense, fundamentally the same thing, there are several differences. The first difference is the fact that, with dried whey, you start with a higher moisture content or lower solids, however you want to look at it, as compared to the skim, right?

A. Correct.
Q. So there is a function between the energy cost and the amount of water you need to remove from the product?
A. Right.
Q. So the more water you have to remove, the higher the energy cost?
A. Yes.
Q. See, I told you you had made it so I could understand.
Now, my question is, as I understand your testimony, is that you have computed what that extra cost would be. And there are some other things. You have to crystallize in the dried whey. I think, because of the RO, you have to do some cooling that isn't part of the nonfat dry milk, right? There are some other costs associated in the steps. They are not identical steps, but there are some extra costs.
And you have computed the difference

in cost between what it cost to dry nonfat dry milk to 97 percent dry matter versus the cost to dry the same volume -- to produce the same volume of 97 percent dried whey. Am I correct on that?

A. The same starting volume, not the same finished.

Q. The same starting volume?

A. Yes.

Q. So this price that is shown here on Table 4, what is that? What is that 2.71? Is that 2 cents or is that $2? What is that price?

A. That's 2.7151 cents per pound of the base cost to dry whey versus NFDM.

Q. All right. And just -- I'm not saying that that is the price, but just so I can do the math, let's say it is determined that the cost to dry nonfat dry milk is 10 cents a pound, okay? So based on your testimony, you would say that it would then

cost 12.71 cents plus to produce dried whey?
A. Based on my testimony, I was asked to go through energy costs, and that's what my primary focus was on, was what equipment, capital and energy costs were associated with the difference.
Q. I think we are saying the same thing. And let me back up. The idea is -- let me back up. You are showing the difference between nonfat dry milk and dried whey, right?
A. Yes.
Q. What is the -- what is the base for the nonfat dry milk in your analysis? What number do we add that to? What number is nonfat dry milk?
A. The comparison that I have done shows the difference in energy, capital costs and depreciation costs associated between -- between -- the difference between drying whey powder and nonfat dry milk.

Q. So if the energy, depreciation, capital and other costs associated with drying nonfat dry milk is 10 cents, your analysis is suggesting, then, to -- using that as a basis, to make dry whey is 2.715 cents more?

A. Yes.

Q. Okay. That's how I intended to use it. I just wanted to make sure I was doing it right. Okay.

Now, the decision to go to RO in this pre-evap state is not unique to dry whey, is it, in the dairy industry?

A. As far as are there other applications? Yes.

Q. What are some of those other applications which RO is now being used instead of the evaporator or in conjunction with the supplement evaporator?

A. I have experienced with whole milk, ROM, skim milk, ROM.

Q. Also used for, like, condensed milk and evaporated milk?

A. With whole milk and with skim, you would get condensed milk, depending on what level you took --

Q. But, I mean, there are even products that, called evapped milk, that in many cases are ROs rather than evap?

A. Yes, I have experienced that, but there are additional steps other than just the RO.

Q. Right. RO doesn't caramelize the milk, does it? Okay.

Are you saying in your testimony -- well, okay, let me go back. I want to get to this point.

One could, as part of an analysis in terms of arriving at a dried whey cost, on Table 4, could ignore the first two columns and only rely upon the analysis that you did in the last column, right?

I don't need to know what is in the CK 2000 or the CK 2004 to understand what the WFF(RO) 2005 is, do I?

A. I feel that it is relevant information.

Q. I understand it is relevant. But, I mean, I could just look at this and have an understanding of one way of calculating that extra cost, right?

A. Yes.

Q. Now, you made an adjustment for the 2004. This 2005 data reflects 2005 energy costs or not? That's also 2004?

A. As noted in the footnote, it reflects the same energy rates used in CK 2004.

Q. So it really is an RO 2004 number as well?

A. [The witness nodded.]

Q. Okay. Are the costs that Venkat talked about in 2000, are those -- I guess because you don't use that method, you wouldn't know if those are exactly your costs or not?

A. That is correct.

Q. Do you know if West Farms reports the sale of whey to NASS, dried whey?

A. Those type of questions you will need to save for Mr. McBride when he gets up here.

Q. Okay. Very good.

MR. YALE: I have nothing else, Your Honor. Thank you

THE JUDGE: You are welcome. Other questions?

Ms. Deskins.

EXAMINATION

BY MS. DESKINS:

Q. Sharlene Deskins, USDA Office of General Counsel. I just wanted to clarify what you have in Exhibit 48. The information you have in here, you have updated the Venkat data with data from your own plant?

A. No, the Venkat data was updated with

just the different energy usage rates, the 2004 rates from Mr. Ling's study.

Q. Okay.

And then, for Chart 1, did you prepare the chart yourself, Exhibit 48?

A. Yes.

MS. DESKINS: That's all the questions I have. Thank you

THE JUDGE: Other questions?

Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Just to clarify, in updating the Venkat information which was employed in 2000 to the more recent process, you didn't just update the energy, you additionally incorporated your own procedure of RO-ing the whey?

A. Yes, that is correct.

Q. And that is one means of conserving the evaporation energy costs?

A. Yes.

Q. Which comes at some corresponding additional expense for the RO equipment but, presumably, the total is less expensive than evaporating from the start?

A. Presumably.

Q. Thank you

THE JUDGE: Other questions?

Very well, Mr. Burleson, you may step down.

Mr. Vetne, it is about quarter till. In other words, do you think we could get another statement in, at least, and save the cross?

MR. VETNE: I think so. Craig Alexander from O-AT-KA has testimony that's segues nicely from Scott's testimony. I would ask him to follow.

THE JUDGE: Very well.

Whereupon,

CRAIG S. ALEXANDER,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated.

Is there a statement, Mr. Vetne?

MR. VETNE: Yes.

THE WITNESS: My name is Craig --

THE JUDGE: I'm sorry, we need the statement.

THE WITNESS: I'm sorry.

THE JUDGE: The statement has been marked as Exhibit 49.

[Whereupon, Exhibit No. 49 was marked for identification by the judge.]

THE JUDGE: Please tell us your name and spell your last name hearing reporter.

THE WITNESS: My name is Craig S. Alexander. The last name is spelled A-L-E-X-A-N-D-E-R.

STATEMENT FOR THE RECORD OF CRAIG ALEXANDER

I am testifying today on behalf of O-AT-KA Milk Products Cooperative, Inc.

(O-AT-KA). I am the Manager of Dairy Ingredient Sales and Regulatory Affairs. The business address is Cedar and Ellicott Streets, Batavia, New York 14021. I received a Bachelor of Science degree in Economics and Political Science from SUNY Albany and then a Master of Science degree in Agricultural Economics from Cornell University in 1985. In the past 20 years I have worked for Upstate Farms Cooperative, Dairy Institute of California, Cornell University and O-AT-KA in a variety of capacities involved with dairy economics, market analysis, regulatory impact of State and Federal orders, and bulk milk and dairy commodity sales. I have testified at numerous State and Federal order hearings.

First let me say that we appreciate USDA calling this hearing to consider emergency changes to the outdated make allowances in the Class III and IV price formulas. An expedited decision from this hearing is critical to our cooperative owners. As we head into the spring months facing increased milk production and balancing needs, the unrecoverable processing costs that are being discussed at this hearing will likely worsen.

O-AT-KA is owned by three producer-owned cooperatives: Upstate Farms Cooperative, Inc., Niagara Milk Cooperative, Inc. and Dairy Farmers of America. In 2005, O-AT-KA processed 577 million pounds of milk. We employ about 300 in plant and office personnel. O-AT-KA manufactures a full line of canned evaporated milk products, a variety of long shelf life formulated specialty beverages in cans and glass bottles. We also process bulk fluid cream and skim condensed and last year produced 16.5 million pounds of butter and 16.4 million pounds of nonfat dry milk.

In the late 1950s, O-AT-KA was formed

as a joint venture of dairy cooperatives to balance milk supplies in the Western New York area. Although over time additional product lines have been added at O-AT-KA, the mission of handling the swings in milk production and changes in demand from other non-Class IV uses on a daily, season and yearly basis has not changed. For example, we see milk volumes range from 80 percent from midweek lows to the weekend highs. We experience 50 percent variation between fall low months to spring flush months. In producing nonfat dry milk, the extremes are even greater as we produced just 433,000 pounds last November compared with over 2 million pounds last May. In the last five years we have had 30 percent swings from low to high in total annual milk volumes.

It is critical to the producers in New York now more than ever that there is a viable balancing plant in Western New York.

The November 2005 Northeast Market Administrator's Bulletin describes the loss of plant capacity due to 12 plant closings since January 2004. Five of the plants were manufacturing plants that provided balancing capacity to the market. As described by Mr. Wellington, this is probably understated as other manufacturing plants have closed or substantially reduced production. And although the other plant closings were fluid distributing plants, whose volume may have stayed in the region, the reduction in milk storing silo capacity has impacted milk balancing. Reduction in plant capacity makes a viable balancing plant structure that'S much more critical in the Northeast.

O-AT-KA has supported the use of product formulas as a necessary means to determine the benchmark minimum market value of milk used to produce butter and nonfat dry milk for Class IV uses and cheese for Class

III uses. A necessary aspect of these Class III and Class IV formulas is the use of processing or "make" allowances. If these make allowances aren't kept up to date, the producers who have to shoulder the responsibility for balancing the market, investing in plants that make cheese, nonfat dry milk and butter, are not compensated fairly as compared to other producers in the market. Increasing product selling prices, if possible, is no solution as these increases are captured by the NASS surveys and fed back into pricing formulas with no cost recovery to the producers and balancing plants. Mr. Wellington already described the example of how this occurred with Dairy America energy surcharges, and as Dairy American members, we can testify that we too felt the impact of this pricing trap. While the producer uniform prices have benefitted from increased Class IV prices in this case, the net return to our producers has suffered as compared to their neighbors that do not own balancing plants. In essence, we are indeed trapped into outdated fixed make allowances that need immediate updating.

O-AT-KA's Increased Costs.

Currently O-AT-KA, and the producers that own O-AT-KA, are suffering the increased costs of processing dairy commodities while operating under a fixed make allowance that is providing less and less recovery of costs.

The O-AT-KA plant is very complicated with quite different product lines housed in the same plant. This obviously makes cost allocation difficult. For internal business reasons we contracted with Compton and Associates to analyze and allocate costs of producing the various products in our plant. This study was completed during 2005 using 2004 data.

Total costs for nonfat dry milk

amounted to $.2118 per pound for 2004. The cost factors are somewhat comparable to the CDFA methodology. For example, the total costs include factors for general and administrative costs, but do not include a return on investment. Adding the CDFA factor for ROI would bring this total to $.2218 per pound. This cost far exceeds the current make allowance of $.14 per pound make allowance for nonfat dry milk in the Class IV formula. This $.0818 per pound difference, multiplied by the 16.4 million pounds of nonfat dry milk that O-AT-KA produced last year, represents just under $1.34 million in unrecoverable make allowance shortfalls to O-AT-KA and more importantly to O-AT-KA's producer owners.

The Compton study showed a total cost of $.1427 per pound for bulk butter in 2004. Adding the CDFA factor for ROI brings the total to $.1497 per pound. Based on these costs, our processing costs for butter are $.0347 per pound above the current make allowance of $.114 per pound. On the 16.5 million pounds of butter produced in 2005, this difference between the current make allowance and our costs represents a deficit of $572,550. This is a conservative number as we have short-term transportation and outside warehousing costs that we did not include.

The combined total of unrecovered make allowance costs for both nonfat dry milk and butter is $1.9 million for 2005. We expect 2006 may be as bad or worse for the cooperatives and their producers owning O-AT-KA. O-AT-KA Supports Proposal No. 1.

Specifically, O-AT-KA supports the application of the CDFA and RBCS data as detailed in Mr. Wellington's testimony. We feel this is a conservative yet representative approach to the data. The survey data shows that both California and Federal order plants have had increased costs over the years since AMA first used the data for setting make allowances. We support use of the combined data as discussed by Mr. Wellington and want to underscore that, in general, our costs are farther out of line on nonfat dry milk than on butter. As a first step we support moving the make allowance on nonfat dry milk from $.14 per pound to $.1867 per pound. The Agri-Mark proposal uses the medium cost group of nonfat dry milk plants in the California survey and the weighted average for the RBCS data. The medium group for California is more representative of similar plants in Federal orders and, after all, it is Federal order pricing we are working to determine.

In general, we feel that while make allowances should not overcompensate plants, a weighted average means that half of the milk will not have costs covered. If the largest California butter-powder plants are included in determining make allowances, the average costs will be pulled down and many balancing plants purchasing Federal order milk, including our own, will continue to bear the burden of an insufficient make allowance. We ask that the Department keep in mind that cost inefficiencies of the balancing plants are a function of the swings of milk production and changes in demand from other uses. Dr. Ling, in his response to questioning, stated that it is the butter-powder plants that are doing relatively more of the balancing. These will have higher than average costs compared to large plants producing the same commodities in heavy manufacturing areas such as California with less variation in supply.

In January 2005, the Department published a final decision from the Northeast

Pooling Provisions hearing. The decision rejected a proposal for market-wide payments for balancing and states in part:

"The Class III/IV pricing formulae adopted in the Class III/IV Interim Decision (65 FR 767732, published December 7, 2002) included a factor to offset the cost of balancing performed by butter-powder manufacturing plants. Official notice is hereby taken of the Class III/IV Final Decision (67 FR 67906, published November 7, 2002). The Class III/IV Final Decision that adopted product price formulas for all Federal milk marketing orders, including the Northeast order, gave specific recognition to costs associated with balancing in the make allowance factor in setting the Class III and Class IV milk price (pages 4951-4952).

The 2002 Interim Decision, referred to above, provides for a "factor" or "specific recognition" to costs associated with balancing in the make allowance only through the selection of certain groups of California plants for combining with the RBCS data. Mr. Schad discussed in great detail how the Department's choice of California plant groups, and the resulting combined California and RBCS averages, resulted in a relatively lower make allowance for nonfat dry milk make than for butter. It is like the story of a man and his accountant crossing a river. The accountant had audited the river depth and said it was okay to walk across, the average depth was 5 feet. The man crossed and was fine until he got to the middle, which was 10 feet deep. He then drowned. We respectively submit that we are the ones in the middle of the river now. The Department rejected a targeted market balancing payment in the Northeast pooling hearing by saying it was already in the make allowance. The Department must therefore carefully use the California and RBCS data to give proper weighting and recognition to the nonfat dry milk plants that balance. It should not include the largest California plants that do not have comparable size, cost structures and balancing inefficiencies.

We also support Agri-Mark's proposal to change the butter make allowance to $.1515 per pound from the current $.115 per pound. This increase is actually less than what the data might suggest based on how the Department calculated make allowances last time. However, we feel that the butter make allowance requires less of an increase right now as compared to nonfat dry milk.

2004 Survey Data Should be Updated to Reflect 2005 Energy Costs.

O-AT-KA also agrees with the Agri-Mark proposal that the immediate update of make allowances should include an adjustment for energy cost changes in 2005.

We feel that this makes sense given the uncertainty of when another hearing may be called -- this time for a full-blown make allowance review. We believe another hearing is important for this review but we understand that data is still being collected by Cornell and a wider hearing with more issues for consideration will take more time to implement.

The increase of utility costs during 2005 was dramatic, particularly in the last part of the year. Our gas prices had doubled at their peak and still greatly exceed prices at this time last year. We have calculated that our average rates for 2005 for gas were up 34 percent ($7.40 per DTH in 2004 compared to $9.90 per DTH in 2005) and electricity was up 17 percent.

We support Agri-Mark's proposed increase of $.0098 per pound for nonfat dry milk and $.0028 per pound for butter. We believe this is a fair representation of cost increases for the interim until other proposals can be implemented or hearings called. The National Milk Producers Federation will be detailing a proposal for indexed changes to make allowances to reflect energy costs on a monthly basis. O-AT-KA supports the indexing concept as a way to keep make allowances in line with volatile costs associated with energy price changes, both up and down.

Emergency Conditions Exist.

Each month O-AT-KA and its cooperative owners are incurring thousands of dollars of unrecovered make allowance costs associated with producing butter and nonfat dry milk. We have found that increased milk in our market and decreased alternatives for handling milk are placing increased pressure to make these commodities. We see milk volumes continuing to increase this winter, and already available capacity is being stretched to the limit. We are extremely concerned about our ability to process milk while sustaining increased losses. We believe it is critical for USDA to act as quickly as possible, foregoing the normal recommended decision procedures and move to immediate implementation of changes on an interim basis.

If left to run its course, unchanged make allowances will undercut the very ability of the Federal order program to preserve minimum pricing for milk. Minimum class pricing will be undermined, disorderly conditions will increase as uneconomic milk movements and alternative sales under class will be sought out to avoid processing losses or simply because plants have closed and there is no home.

As a producer-owned cooperative we are concerned about producer income and the impact of increasing make allowances. However, studies such as the one by the Department and prepared for this hearing have not taken into account the costs of outdated make allowances to producers such as ours that have already occurred. The studies have also not taken into account the costs over time as inadequate make allowances force plant closings, reduce outlets, lower premiums, increase hauling costs and therefore lower returns to all producers. As discussed earlier, this scenario is not theoretical, it is already happening in the Northeast.

Again, we thank the Department for holding this hearing and we ask for a decision and implementation as soon as possible. Thank you

THE JUDGE: We will withhold examination of the witness until after the lunch recess.

I'll ask that you come back at 1:30.
[Whereupon, the hearing recessed at 12:01 p.m. and reconvened at 1:28 p.m.]
****
AFTERNOON SESSION
THE JUDGE: We are back on the record.
Let's see. I don't see Mr. Harner. Is Mr. Harner going to offer any redirect of this witness?
MR. VETNE: He is getting extra copies.
MR. BESHORE: He went to get extra copies.
THE JUDGE: All right. Well, while we are waiting for Mr. Harner, is there cross of this witness?
Mr. Yale.
MR. YALE: I'm afraid if I don't quickly respond, they may just take him off the stage. Yes.

THE JUDGE: I have been known do that.

EXAMINATION

BY MR. YALE:

Q. Good afternoon. I want to talk a moment first here about O-AT-KA's products. Does O-AT-KA produce any cheese?

A. No.

Q. Does it produce any nonfat dry milk?

A. Yes.

Q. Is part of its other processing to make other products or is it made as a balancing function? How is --

A. It is made as a balancing function. We use some in internal use, but the vast majority is sold through Dairy America.

Q. Do you report to NASS any of that powder?

A. It is reported, and on butter as well.

Q. So your plant, you do the

butter-powder at that particular plant?
A. Yes.
Q. Do you do anything else at that plant?
A. It is in my statement, basically, that we produce canned evaporated milk, we produce various formulated beverages, and we produce bulk cream, skim condensed and butter and powder.
Q. O-AT-KA is also known for its use of membrane technology in making products?
A. We have a UF unit.
Q. Do you have an RO unit?
A. We do for water, to filter water.
Q. For your evaporated milk you do not use any RO process?
A. No.
Q. Have you looked at using RO for evaporating?
A. No. Not to my knowledge, no. Now, all the time the technical folks are

reviewing other ways to do things, so they could very well be looking at it, but not to my knowledge.

Q. And you don't also -- I take it, then, that you don't use RO make nonfat dry milk?

A. That is correct.

Q. And what percent of the -- approximately, of the products that you manufacture, is this nonfat dry milk or butter? What percentage of your sales does that account for?

A. On a milk usage basis, are you talking about?

Q. Yes.

A. Something like 30, 35 percent of the milk that comes in as solids is sold as nonfat dry milk.

Q. Do you purchase milk from nonmembers?

A. Occasionally.

Q. Nothing on a long-term basis?

A. Nothing on a long-term basis and very little overall. That represents a very small proportion of our overall --

Q. Do you sell any milk, raw milk on a regular basis?

A. Not on a regular basis. Again, very sporadically, very rarely.

Q. This is all used internally one way or another?

A. Yes.

Q. Now, your plant is located in Western New York?

A. Batavia, New York.

Q. Batavia. That's right.

A. Roughly between Rochester and Buffalo.

Q. Do you -- you are not involved with any of the milk in the Southwest, are you, at that plant?

A. I'm not sure what you mean by --

Q. You don't purchase milk or balance milk off the Southwest?

A. No.

Q. Now, I think the record or the reports just recently indicated that you have expanded your operations by acquiring another company?

A. We purchased a food service operations at Diehl, which was another canned evaporated milk manufacturer. We did not buy any of the assets.

Q. And you are going to be supplying -- are you going to operate the plant in Defiance, Ohio, or are you --

A. No, we're not going to operate it because it's -- we purchased none of the assets.

Q. So you are going to be supplying your customers out of your plants?

A. Correct.

Q. And this consolidation is going to

provide efficiencies in your ability to supply those customers, right?

A. Modestly. We feel we can do a good job for those customers.

Q. And the consolidation in ever larger plants in the evap is consistent with what you see in other dairy manufacturing plants as well, right?

A. In some ways, we have only been able to kind of keep our volumes kind of flat because the evaporated milk market has been shrinking. So it's been a matter of consolidation in a flatter, shrinking overall market.

MR. YALE: I don't have any other questions.

THE JUDGE: Other questions of Mr. Alexander? Ms. Deskins.

EXAMINATION

BY MS. DESKINS:

Q. Good afternoon, Mr. Alexander. My

name is Sharlene Deskins, and I'm an attorney with USDA. In your statement, you said that O-AT-KA is owned by three producer-owned cooperatives?

A. Correct.

Q. Is O-AT-KA, then, a superco-op or is it a company or --

A. It's a co-op of cooperatives. So we are Capper-Volstead, a Capper-Volstead cooperative. All the equity is owned by producer cooperatives, and we return proceeds back to those member cooperatives based on patronage.

Q. One of the cooperatives you list as owned by O-AT-KA is Upstate Farms Cooperative?

A. Correct.

Q. Do you know approximately how many members that cooperative would have?

A. It's a little under 300, I think.

Q. Are all of them dairy farmers?

A. Yes.
Q. The next one you had listed was Niagara Milk Cooperative?
A. Yes.
Q. Do you know approximately how many members they would have?
A. I think they are under 200.
Q. And would all of them be dairy producers?
A. Yes.
Q. And the third one is Dairy Farmers of America?
A. Uh-huh.
Q. Do you know approximately how many members they would have?
A. A lot. I don't know. I think over 20,000.
Q. Are all of them dairy farmers?
A. As far as I know.
Q. And the other in your statement, you said you support a proposal of the National

Milk Producers Federation?

A. Right.

Q. That proposal hasn't been put in the record. Can you tell us what your understanding is of that proposal?

A. As far as I know, they are looking to try to adjust make allowances for energy costs on a monthly basis.

So I think they -- and I would defer to Dr. Cryan when he comes on, but I think they are looking at some type of published energy price going back in time, then updating that with an index and adjusting the make allowance each month for changes in that index to basically reflect changes in energy costs in the make allowances, both up and down.

Q. And that's your understanding of what the proposal will be?

A. Yes.

MS. DESKINS: I don't have any other

questions.

THE JUDGE: Very well. Other questions of this witness?

Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore. Just one question, Craig.

On your first page of your statement, Exhibit 49, you refer to heading into the spring months of this year. Can you just elaborate a bit about what your expectations are for spring months of this year at O-AT-KA, and particularly with respect to the request for prompt action by the Secretary?

A. Well, already we are seeing increased milk volumes coming into the plant, and I think that's reflecting overall in the milk shed. A couple things. One is the decline in plant capacity that we talked about and Mr. Wellington explained and, also, increases in production on the farm and farm expansion, more milk per cow, etc.

And so, those volumes are increasing and we are seeing, perhaps, even an earlier spring flush than normal. And frankly, we expect that to kind of continue on through the spring.

Q. Do you expect O-AT-KA to be running at or near capacity this spring?

A. Yes.

THE JUDGE: Other questions of this witness?

MR. Alexander, thank you. It appears that you may step down.

Mr. Vetne, is it my understanding you are going to yield to Mr. Yale at this time?

MR. YALE: We have got some producers.

MR. VETNE: Oh, heavens yes.

MR. HARNER: Excuse me, did that Exhibit 49 get put into evidence? I was out for a moment.

THE JUDGE: It was not, but at this time we'll admit the exhibits through 49 if they have been not been done so specifically.

[Whereupon, Exhibit No. 49 was received in evidence.]

THE JUDGE: Mr. Yale, it appears that Mr. Vetne is yielding the floor to you at this time.

MR. YALE: And I appreciate that courtesy. We are going to call to the stand Mr. Klaas Talsma.

THE JUDGE: Very well. Mr. Talsma.

MR. YALE: And he has a short statement, no copies, then it's going to be a Q&A.

Whereupon,

KLAAS TALSMA,

having been first sworn by the judge, was examined and testified under oath as follows.

THE JUDGE: Please be seated and, if you would, spell your name for the hearing reporter.

THE WITNESS: My name is Klaas Talsma, K-L-A-A-S, T-A-L-S-M-A. My address is 7469 County Rt. 209 in Hico, H-I-C-O, Texas. The zip is 76457.

EXAMINATION

BY MR. YALE:

Q. Mr. Talsma, what is your occupation?

A. I'm a dairy farmer.

Q. How long have you been a dairy farmer?

A. For 20 years.

Q. Where are your -- how many dairies do you operate?

A. At this moment, I operate two dairies, and my daughters operate one dairy of which I'm managing.

Q. And where are those dairies located?

A. Two of the dairies are located in

Hico, and the third dairy is located in Hartley, Texas, which is in the northwest corner of Texas, close to Dalhart.

Q. And in your role as a dairy farmer, have you served on any boards or commissions?

A. Yes, I have served on several boards and commissions. I have been a member of the Farm Bureau. I have served on their board. I have served on local organizations. I have served on the boards of milk producers, including Select Milk Producers.

Q. Are you currently a member of the board of Select Milk Producers?

A. Yes, sir.

Q. And are you here speaking on their behalf?

A. Yes, sir.

Q. Are there any other organizations that have indicated that they support the testimony that you are about to give?

A. Yes. In our area, we work -- Select

works at several other co-ops, and two of those co-ops, Lone Star Milk Producers and Zia Milk Producers, are also supportive of our testimony.

Q. Now, you have a statement that you have prepared. Are you prepared to read that now?

A. Yes.

STATEMENT FOR THE RECORD OF KLAAS TELSMA

I'm a dairy farmer from Hico, Texas. I have been milking cows since I was four years old. As you might have noticed by my accent, I'm a native from the Netherlands. My wife and I came to Texas in 1985. After working for several other dairy farmers, we started our own dairy. During the years, we have marketed our milk to Mid-American Dairymen. We marketed one year independently to a Class I plant in Alabama. After that, we formed Elite Milk Producers with several other producers in the central Texas area. And three, four years ago, we merged with Select Milk Producers, of which I'm a member today. And I have served on the boards of each of these cooperatives. Thank you to allow me to testify against increasing the make allowance. Rising the make allowance will result in lower Class I and Class III prices, which in turn will create lower mailbox prices to dairy farmers. Dairy farmers have experienced escalating production costs because of increased fuel costs. Fertilizer cost have more than doubled in the last year. Transportation costs have increased. Electric bills also have increased enormously. Dairy producers will have to work more efficiently to make up for these increased production costs. I do believe processors should do the same. Their burden should not be put on already overloaded producers.

Select Milk Producers just finished

construction on a $230 million cheese plant. This is a joint venture with other cooperatives as well as an independent. Increasing the make allowance would make life easier for our plant managers since the profit is almost a guaranteed. However, I believe it to be better for these managers to be always on their toes how to improve their operation. Since an increased make allowance will result in lower milk prices, this in turn will increase the MILC payments. These increased payments in turn will cost the government and, therefore, the tax pay dearly. I appreciate that I can testify here, and I sure hope that the make allowance will not be increased at a cost to dairy producers as well as taxpayers.

BY MR. YALE:

Q. Mr. Talsma, you just made a comment about that it will result in increased milk payments. Is that M-I-L-K or M-I-L-C?

A. M-I-L-C.

Q. You are talking about a government payment to producers, not a payment that producers receive by selling the milk?

A. Correct.

Q. You mentioned but I forgot to follow up the other support of Select by Zia and Lone Star. Approximately what percent of the Southwest milk marketing area is supplied by those three organizations?

A. I believe it probably is -- it is close to 40 percent, maybe even a little bit more than that.

Q. You indicate today that you are a member of Select Milk Producers. What -- and you have been members of other co-ops. But what stands in your mind as special about Select Milk?

A. Well, what I like about Select and where we continuously work on, is we look at ways to improve the milk prices to producers.

That is our goal, to return the highest price to the producers. And we do that by making sure that we optimize our efficiencies for hauling, find local plants or create our -- or build local plants so that we can return the highest price to the producers. We also work on getting premiums through the marketing of quality milk. Our producers are working hard on getting quality milk. So we are looking at ways that we, as producers, can work together to benefit.

Q. When you talk about efficient marketings, what are the some of things that Select and that market do to increase market efficiencies?

A. Well, I mentioned hauling before. And at this moment, we are working on creating a hauling agency along with the other cooperatives so we can maximize efficiencies, so we have no redundancy in trucks going up and down the road. And this is -- what we did is together, we own all the milk trailers. And then we started a logistics route office so all the milk is hauled efficiently. We share all the costs. And we believe this can make a savings of 10 to maybe 30 cents a hundredweight.

Q. What else do you do in the way of shipping requirements that you have to maintain efficiency?

A. Another thing we started several years ago, that we built some small RO plants. Texas is in a market that is long on milk. We have more milk than plants. So we ship a lot of milk long distances. By making RO and ultrafiltration plants, we could reduce our hauling and sell milk to cheese plants in the Midwest. And that was a great benefit to dairy producers.

And on top of that, our RO plants also allow for some specialty products. So we have been able to get a little bit in the market so we can get a return to our producers.

Q. And also, in the area of shipping, do you have any requirements at the farm level in the hauling in terms of shipping milk to maintain efficiency?

A. Yes, sir. We had problems in the past with high shrink numbers. And what we have started doing several years ago, that every farm has a scale. The milk is weighed on the farm, and that is the amount of milk the farmer ships to the processor. And that's -- so there is no shrink, and the processors will validate these numbers from time to time and it will be adjusted either way. So we always keep a real close eye on that so there is no shrink.

Q. And also, in terms of the loads, do you have any requirement in terms of how full the loads need to be?

A. Yes, sir. Every load is full,

52,000 pounds.

Q. And the importance of that is what? What happens if you put in only 50,000 pounds?

A. Well, I talked about efficiencies, but that is a 4 percent loss in efficiency.

Q. And this is kind of the mind-set that the producers in that area have, that they are looking for every one of those, is that right?

A. Yes, sir.

Q. You indicated that you wanted to -- that there was a need to look and bring in some new manufacturing and plants in your marketing area. And what did Select do to do that --

A. Well --

Q. -- and others, I mean, in the market?

A. -- in our agency we worked together. But in the last year or so, we saw and still see an increase in production in our area because a lot of dairies are coming from California, relocating. So we are looking at making -- to facilitate that growth.

What we have done in the past is looking for people that want to do our companies, that want to do a joint venture. We found a company that is very aggressively looking at low-cost projections and creating efficient plants. And as I mentioned before, we just finished building a $230 million plant. We are looking at building another plant in the next three to four years because we do need a home for that milk.

Q. Now, in terms --

A. And when we did that, we looked at the location of the plant and we said, where are we going to put this plant? We looked at the milk supply in that area, and then we did a computer analysis and looked at hauling costs. And we found a spot that was very beneficial to put a plant, so that's where we built the plant. It also had a good location to the railroad system. So we can market and ship the cheese in an efficient way.

Q. And you talk about advantageous with location. What was -- the concern was that if you were located too far from the milk supply, there would be added cost?

A. Yes, sir.

Q. And do you recall what the analysis was, about every 10 miles what that cost would be?

A. I'm sorry, but I cannot recall that at this moment.

Q. Okay. When the -- and the board of directors of Select, of which you are part of, was involved in directing this effort with Select and the other co-ops to find this partner, right?

A. Yes.

Q. Did you give management, as a board member, any directive in terms of what you expected in any relationship with the manufacture of milk in that market?

A. As far as pricing?

Q. Yes.

A. Yes, we have a long-term contract with them, and it's based on the Class III price. And we had our relation to that, that that's what our -- the price we expect to receive, and we signed off on it. So that's what it's based on for the foreseeable future.

Q. During the periods of time in which Select was looking at various plants, was it reported back to the board in terms of what plants would be able to purchase milk for under the current make allowances?

A. Can you explain that?

Q. You know, the buyer -- the person who you've entered into the agreement now is

not the first one that Select dealt with?
A. No. We worked with several different companies.
Q. Right.
A. And this company, you know, they could guarantee the price. They were willing to go with this. And also, like I said, they guaranteed a price and they looked like they would be able to fulfill their contract.
Q. And --
A. A very good track record.
Q. Right. And purchase it at the current Class III prices?
A. Yes.
Q. Now, you say it's a long-term contract. Is that contract subject to modification if the Federal order were to change its pricing rules?
A. No, sir. No, that would cost us as producers.
Q. I want to talk about some other

plants in that area. In the report that's been submitted as an exhibit in this record is a plant in Lovington, New Mexico. Do you know anything about that plant?

A. Well, yes. As I mentioned before, as an agency with co-op -- joint cooperatives, we evaluate these plants, how they perform. This plant has been a persistent non-performer and has been losing lots of money, every year. Last year was in the millions. Some of the reasons are that the technology is a little bit outdated, but their yields are very low. I believe that the normal plant has 10 pounds per cheese per hundred pounds or better. This plant was several pounds below that. And, of course, those numbers will result in huge losses.

Q. What is being done to correct that?

A. At this moment we are renovating the whole plant, and we hope in the foreseeable future to make this a profitable plant with new technology. The labor costs were also sky high, and we are looking at making it more efficient.

Q. When you say we, who is we?

A. We, as -- well, Select is working, as I said before, with other cooperatives. And that is Select and Lone Star and Zia, the Greater Southwest Agency.

Q. And who else is -- there's another co-op, a major co-op?

A. And BFA.

Q. And BFA?

A. Right.

Q. So the agency's response was not to come to the Department and ask for a change in rules. You took it on as producers to fix the problem yourself?

A. That's what we believe needs to happen, yes.

Q. And based upon your understanding of what is going on at Lovington, would you consider that as a benchmark to consider what make allowances ought to be for other plants in the country?

A. Absolutely not. If I may use a comparison, that is like using a 20-pound average on a herd as a cost of production for milk product, for milk.

Q. For a dairy farm?

A. For a dairy farm, yes, where the average is about 60 pounds.

Q. Now, one of the things as -- oh, there is another plant in the Southwest that's mentioned.

It's called the Winnsboro plant, and it is -- do you know anything about that plant?

A. Yes. They built that plant when I -- I was there in Winnsboro. So, of course, I know about it. That plant is -- our agency, the Greater Southwest Agency uses that as a balancing plant. It's a fairly well-run operation. The only problem with it is, to use that, I believe -- it is used, like I mentioned, as a balancing plant, so it is not running a hundred percent efficiently all the time. And so, there is an increased overhead per pound of milk because it is not a hundred percent of the time full.

Q. And the cost of operating that plant, is that -- how is that covered? Do you know anything about -- I mean, what is the purpose -- what is it balancing? What market is it balancing?

A. It is balancing our market as well as the Southeast market. It is based in the Southeast Agency.

Q. Now, you indicate that -- you testified that you are a dairy farmer and the like. Have you, from time to time, gotten involved in other co-ops or other business ventures with other producers for the purposes of supplying feed or things?

A. Oh, yes. At this moment, I'm a member of Alliance Feed Bank. And what we do is we buy silage from farmers, and then we sell it back to ourselves and also to other dairy farmers. In the past we were running, also, a grain mill. We bought the thing, and we were hoping to make it work. And we ran it for several years, but the mill was a little bit not efficient enough. And at that time, there were no make allowances for grain mills, so we had to shut her down.

Q. Now, Mr. Talsma, do you know what the purpose of the hearing is today that's going on today?

A. Yes.

Q. And what is the purpose of this hearing?

A. To my understanding, it is to increase the make allowance on manufactured milk.

Q. And what is your understanding of

the impact of that change in those make allowances?

A. The impact to me?

Q. Yes. Well, first of all in general, and then --

A. Oh, well, in general, I do believe that it will lower our milk prices substantially, especially for a few years after the program is in effect.

Q. In what range?

A. I heard numbers from anywhere from 25 to 50 cents.

Q. Per hundredweight?

A. Per hundredweight.

Q. What is the impact of a 25- or 50-cent per hundreds weight on your farm?

A. It is enormous. If you want to look at -- you know, on all our farms combined, we milk close to 6,000 cows. And at 25 cents, it would probably approximate 3 to $400,000 a year. And that, on top of --

also, as I mentioned before, we have escalating fuel prices, hauling prices. And I would say those costs are close to a dollar a hundredweight compared to four years ago.

So if you add the 25 cents to that, I do believe that it creates a tremendous burden on dairy farmers.

Q. The increase in energy prices, how does that impact you on the farm?

A. As I mentioned before, our fuel costs are up, our diesel costs. Our fertilizer costs are up. It's like 250 percent up from a couple years ago. Fertilizer, we use extensively.

Q. And this is fertilizer to grow feed for the dairy?

A. Yes, sir. You know, for silage and hay. Our transportation costs from the dairy farm to the plant has risen tremendously, our feed costs. We have to transport the milk and buy the feed. You know, we import most of the hay from Kansas, Colorado. And our costs of the raw product has gone up 10 to 15 percent just because of the hauling costs. And then our electric bill, just as the testimonies this morning, they have increased tremendously.

Q. And what are some of the ways in which electricity is used on the dairy farm?

A. Well, on our farms, the electric pump runs -- the electric bill runs all the time. The vacuum pumps run 24 hours a day. It's a fairly substantial amount.

Q. Do you use it for any cropping?

A. No. Our irrigation is done by -- with natural gas. And, you know, I can relate to the people this morning that were testifying that -- our irrigation costs have more than doubled because of increased gas prices.

Q. So how do you, as a dairy farmer, respond to these increased costs?

A. Well, I wish we'd get a higher support price, but that's not there. So what we do is we try to work harder and make it more efficient. And, you know, it takes time. It's just -- we try to maximize our production, minimize our cost, and continuously to work on that.

Q. Do you participate in any efforts with other dairy farmers to look at their costs as compared to yours as part of a study to --

A. Yes, we do that. We do that continuously on our farm. I have some friends that have similar-sized farms, and once in a while we get together and we talk about different cost structures, what we have on our dairies. And as well, our CPAs, they provide an overview of how we compare to others. And if one of our costs is a little bit out of line, we look at, you know, where we are going wrong and how we can fix the problem.

Q. Do you use those discussions to determine whether to come and seek additional money from the government to cover those costs?

A. Well, you know, as I said before, I'm a native of the Netherlands. And, you know, that is a somewhat socialistic country the way government takes care of everybody. And I like America to where everybody takes charge of their own, free enterprise. And I do believe that the markets eventually will take care of the problems.

Q. As part of your operation, do you use the futures market for milk or cheese or anything to -- as part of your pricing?

A. Yes, sir.

Q. How do you do that? I mean, in which ways, in general? You don't need to get specific, but what are some of the tools that you have used in the last year?

A. Well, what I do is just -- you know, you are looking at the cost of production, and you look at a little bit of expectancy with that, the market. And when I think the future markets look good, you know, I just have my milk. And I have done that from time to time. At this moment, I have a few positions out.

Q. Now, one of those -- one of the proposals that has been somewhat discussed, not completely, but is the concept of a month-to-month indexing of energy cost that would change the make allowances from month to month. How do you see that impacting your use of the futures?

A. It will make it more tricky. If you look at the -- I'm going to back to natural gas. I believe last week natural gas was trading around $8, and about a month before it was trading at 14-1/2. So that would create tremendous swing in futures prices.

Q. And what about milk future prices?
A. Well, you know, milk future prices would be related to that, also, and that would make it more complex.
Q. And you say you have some positions now. How far out are those positions?
A. Up to July of this year.
Q. So an emergency decision by the Department that changed the Class III price prior to that, would that have an impact on your future positions?
A. Probably. In this case, it might be beneficial, though, because it's going to lower the milk price, and since I'm already low --
Q. There is -- what is Select's position in terms of viewing -- I mean, there's been testimony that they need to fix things and there may be some changes in the price. Does Select have a position as to what ought to be done in terms of these

formulas?

A. You know, Select believes that we should leave the formulas the way they are and absolutely not change.

Q. If there is a change, how should that change be approached?

A. They should be looking at the whole picture and just not at the make allowance, but the whole milk pricing.

Q. What do you understand the role of the Federal milk order system to be?

A. To my understanding, the Federal milk orders were formed to protect the producers, to guarantee them a decent return for their milk. And the way I see what is on the table today is that this is not to protect the producers but to protect the processors.

Q. Do you see that this could change the view that the board of Select might have towards the Federal order system if this change were to take effect?

A. Yes, it might. We may look at that and say, you know, if this is the direction that they want to go, we may look at things differently and how to proceed and how to work without an order.

Q. I want to go back and make sure we understand the -- if there is a change in these make allowances that reduces the relevant prices of, say, Class III and Class IV, would -- if these make allowances are changed and the prices per milk are changed in the Southwest, is Select or the other members of that agency, are they going to be able to recover those costs through any other means, through negotiating higher prices?

A. I don't think so because we have a contract set for a long time. No, it would be a loss to us as producers in the Southwest.

MR. YALE: One moment, please. Your

Honor, I have no more questions and make him available for cross-examination.

THE JUDGE: Very well. Mr. Rosenbaum.

EXAMINATION

BY MR. ROSENBAUM

Q. Good afternoon, Mr. Talsma. I'm Steve Rosenbaum with the National Cheese Institute.

When is it that you signed these long-term contracts?

A. Before we started construction, before we did the -- when we started making our plans, we signed those contracts.

Q. Give me an approximate time.

A. Probably about three years ago.

Q. So about 2004?

A. Yes, I would say end of 2003, beginning of 2004.

Q. Now, were you aware at the time that you signed those contracts that the Class III price as set by the Federal government was based in part on a make allowance for cheese?

A. Absolutely so.

Q. Did you know that that make allowance for cheese had, as of that point in time, the end of 2003-2004, changed three times in the last three years?

A. To my understanding, that -- we changed from NW to different pricing.

Q. Did you -- were you aware that when the make allowance had first been set as of January 1, 2000, when the Federal government, USDA, issued its final rule for order reform, that it changed again January 1, 2001, when USDA issued a tentative decision following the last round of hearings, and it changed again on April 1, 2003, when USDA put into effect its final decision which modified, in some respects, the make allowance that had been adopted in the tentative decision? Were you aware of that at the time you signed this long-term contract?

A. Yes, sir.

Q. Were you also aware at that time that the philosophy that had been adopted by USDA in setting make allowances, as expressed in its November 7, 2002, decision which led to the final rule that came into effect April 1, 2003, that its philosophy was, "The make allowances incorporated in the component price formulas under the Federal milk orders should cover the cost of most of the processing plants that receive milk pooled under the order"? Did you know that was their philosophy?

A. Well, that may be their philosophy. It might not be the right philosophy.

Q. Well, were you aware that that was their philosophy in terms of how they were going to approach make allowances at the time that you signed these long-term contracts?

THE JUDGE: Isn't that the same

question you just asked?

THE WITNESS: I just answered that question.

BY MR. ROSENBAUM:

Q. I think my question was, were you aware of that?

A. And I answered that.

Q. If you answered that, I didn't hear it.

A. I said I wondered if that was the right philosophy.

Q. Right, but my question is, you wondered at the time whether that was the right philosophy?

A. No, at this time.

Q. Right, but my question --

A. I said yes, I --

THE JUDGE: He answered.

BY MR. ROSENBAUM:

Q. All right. And did you know at the time that the make allowance was based in part on surveys that were conducted by the California Department of Food and Agriculture?

A. Yes, sir.

Q. Did you know that those surveys are updated by CDFA on an annual basis?

A. Yes, sir.

Q. How long are these long-term contracts?

A. I cannot -- that's confidential.

Q. I see. That's all I have. Thank you.

THE JUDGE: Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Good afternoon, sir. My name is Marvin Beshore.

I don't think you were here -- well, were you here at the start of the hearing?

A. No, I came this morning.

Q. Okay. Well, for your information, I

represent the eight dairy cooperatives in the northeastern part of the United States called the Association of Dairy Cooperatives in the Northeast. When you moved to the United States from the Netherlands, how many years ago was that?

A. It was 21 years.

Q. What part of the country did you move to?

A. Texas.

Q. Have you resided in Texas the entire time?

A. Yes. Previous to that I worked in California, also, on farms, but that was an exchange program from my school.

Q. Have you ever been on a dairy farm in the northeastern United States?

A. No, sir.

Q. Can you tell us a little bit more about Select Milk Producers? How many members does Select Milk Producers have?

A. We have approximately 80 members.
Q. Eighty members. And how many -- what is your monthly volume of milk production for those 80 members?
A. The average dairy farm has probably about 2,000 cows.
Q. Average dairy farm is about 2,000 cows?
A. Yes.
Q. So that's 80 farms, what, 160,000 cows?
A. Uh-huh.
Q. Do you know what the average -- the average production per day per cow, you indicated, was?
A. About 65, 70 pounds.
Q. Sixty-five, 70 pounds?
A. Somewhere in that range.
Q. So if we did the arithmetic, we could come close to Select's monthly milk marketings?

A. Yes.
Q. Now, you indicated that Select is an owner, one of the owners of a new cheese plant that's just come online --
A. Yes.
Q. -- in the Southwest, correct?
A. Yes.
Q. And prior to that, did Select own any milk manufacturing plants?
A. Yes. We have some smaller RO plants and UF plants.
Q. Other the RO and UF plants, are there any butter --
A. No butter.
Q. Now, you have made some comments about the Lovington plant?
A. Yes, sir.
Q. From -- you don't -- you are not an owner of the Lovington plant?
A. Yes, sir, we are.
Q. You are? Select?

A. Select is an owner of that plant, also, because it's in the agency.
Q. It is part of the Greater Southwest Agency?
A. Yes, sir.
Q. What information -- is it your testimony that the yields at that plant, cheese yield at that plant are subpar?
A. Absolutely.
Q. What are those yields?
A. Again, it's confidential information that I'm -- but it is way below 10 pounds of cheese per hundred pounds of milk. It is way below that.
Q. You are certain of that?
A. I'm a hundred percent sure of that, yes, but more than 10 percent.
Q. More than 10 percent?
A. Yes.
Q. And do you have knowledge that you are prepared to testify under oath about the

cost of making cheese at Lovington?
A. I do know that that plant operates at large losses the last few years.
Q. Is it a balancing plant in the Southwest?
A. It is not a balancing plant. As I mentioned before, we are long on milk and we need every pound of milk to find a home close by. Otherwise, we have transportation costs that amount to 30 to 40 percent of our milk check. So to ship the milk back to Wisconsin, it is bad. It costs a lot of money. So we want that plant to operate all the time at a hundred percent capacity. And we have the milk sitting there, but it -- it was inadequate, and it was broke down half the time. It was broke down a lot.
Q. It's being modernized, you said?
A. It is being modernized.
Q. You talked about shrink. If I understood your testimony correctly, you're

selling milk on the weight of the milk on the tanker at the farm, correct?

A. Yes, sir.

Q. So that when you deliver that to the plant, they pay for those volumes of milk, correct?

A. Yes, sir.

Q. And the test of that milk?

A. Yes.

Q. Have you ever heard the expression, farm weights and test?

A. Yes, sir.

Q. Okay. That's how you are selling milk, correct?

A. Yes.

Q. And when you talk about a shrink issue, what you mean is -- I take it you are saying that, because the plant has to pay for your weights at the farm, shrink is not an issue as far as you are concerned as a farmer?

A. No, from a processor point of view, also, because the weights are being analyzed -- if I see a load of milk, they analyze the weight of that milk and that doesn't correspond with the pounds of milk they received in the plant, there is going to be an adjustment be made. In other words, the scales need to be within a certain amount. Otherwise, the milk is not going to be accepted from our scales since the scales are not correct.

Q. So the plant double-checks the calibration of the scales on the farm?

A. So they don't have no shrink. That is the plant's responsibility to check that.

Q. Okay. Are you -- with respect to the Winnsboro plant, I take it it's your testimony that that's a balancing plant for the Southeastern markets?

A. Yes, sir. And since the Southwest Agency works together with the Southeast

Agency, both agencies use that plant as a balancing plant. And as you may know, production swings are usually in the south with the summer production and summer slumps and spring flush.

Q. What are your swings in production?

A. In the neighborhood of 30 percent.

Q. On your farms?

A. Yes, on my farms. Well, like I mentioned before, we have two different farms. And the farm in the northwest corner of Texas, the weather is a lot more stable there, so the swings are very minimal.

Q. Where is your other farm?

A. The other farm is in central Texas, and the swings are pretty high. I would say 30 percent is a very realistic number.

Q. Where is the third family farm?

A. Right next door to us.

Q. In central Texas?

A. Central Texas, yes. My two

daughters are owners of that place.

Q. I'm a little confused with respect to your testimony about government costs. In what respect are you -- are you contending that these proposals are going to raise costs to the government?

A. Yes, sir.

Q. In what manner?

A. Because a lower Class III price will result also in a lower Class I price, which will increase the MILC payments to dairy farmers.

Q. You're strictly talking about the MILC payments?

A. Yes, sir.

Q. Of course, if Class I prices are lowered, it wouldn't have any effect on MILC payments, correct?

A. Maybe.

Q. Basically --

A. No, MILC payments, you are correct.

That would be the case.

Q. Now, I think that's all the questions I have. Thank you.

THE JUDGE: Other questions? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Good afternoon, Mr. Talsma. Thank you for coming.

Is the -- one of the other co-ops you mentioned -- now, you merged with Select. Zia is still a separate cooperative?

A. Zia is a separate co-op as well as Lone Star Milk Producers.

Q. And how do cow numbers per member of Zia compare with those of Select?

A. Probably fairly identical.

Q. About 2,000 cows on average?

A. Yes, I would say so.

Q. You have 6,000 cows --

A. Yes, sir.

Q. -- on your farms?

A. More or less.

Q. Are you a member as one producer for all 6,000 cows?

A. No, three producers.

Q. Three producers. So your family is -- you are the average?

A. Yes.

Q. The long-term supply contract that you signed two years ago or so, that was for the plant that is being constructed?

A. That has been constructed.

Q. Has been constructed. And has that started receiving milk yet?

A. Yes, sir.

Q. And it is the case, is it not, that the profits from the operation of that plant will flow back to Select and BFA and members?

A. Some of the profits.

Q. Uh-huh. And then from the co-ops back to you in some form other than your monthly milk check?

A. Correct.

Q. So if the Class III price goes down, presumably the amount that you would get in that type of payment would be greater than it would be if there was no change?

A. No, it would be smaller because we would have to share that with the investors, with other parties.

Q. If the profitability of the plant is higher on a per-unit basis, you would get less money?

A. Yes, because I, as the producer, will already -- let's use an example. Let's say the Class III, because of this rule, goes down 40 cents. I'm just using a number.

Q. Yes.

A. Okay. So the plant profitability should go up 40 cents. Of that, I would have to share a large margin with our other partners.

Q. And that's true for everybody.
A. So I only get maybe -- let's say it's 50/50. I only get 20 cents more while I lose 40 cents. I don't think that --
Q. You are adding the loss to your farm compared --
A. Oh, no, no.
Q. -- to the gain? No?
A. I do believe cooperatives have to work for their producers, and that's what Select tries to do. If Select would be in favor of this ruling -- and again, use that 40 cents difference. Let's say this ruling, this proposal would lower our Class III prices by 40 cents, okay. That would mean that I would receive 40 cents less for my milk, assuming that all my milk goes in Class III. Okay. At that moment, the plant would make 40 cents more, correct? You agree with that?
Q. If the cheese price stays the same.

A. Okay. So I think what your motivation and what you are trying to tell me is it doesn't matter because you are going to get 40 cents, anyhow. But I don't because I have to share the profits of the plant with other investors.

Q. My --

A. And so, I lose. And let's say that number is 15 percent. I lose 20 cents. And in my opinion, it should be the plant's responsibility to look at ways how they can be as profitable as they can be. They do share the same problems like every cheese plant in the nation. Every cheese plant in the nation does have the higher costs because of the increased costs.

Q. So we --

A. And so, why would I as a producer have to pay for that, because it's a fair competition here in the United States. There is no advantage from one plant to another plant.

Q. I believe, Mr. Talsma, that you misunderstood my question. Let me make sure that you do understand it.

My question to you is, to the extent that the plant is more profitable, your share of that profit, your -- not your share, the dollars that you get from that profit will be greater than if the plant is less profitable?

A. That is correct. The more profitable the plant is, the more we like it, after they pay the highest return possible to me for the raw product.

Q. Did I understand correctly that you moved from east Texas to west Texas or east Texas to central Texas?

A. Yes. If you want to know my story, we came here and worked for other dairymen and worked on small farms, and then we started -- my wife and I had a savings of twenty thousand. We started with 40 cows.

We rented a small dairy. And after a few years, we bought a property in central Texas, and we have been there now for 16 years.

And then, four or five years ago, we started a dairy in west Texas.

Q. You indicated, also, that you follow dairy activities in California. You are aware of the California pricing system?

A. Not very aware.

Q. You are aware that they have a different make allowance?

A. I know a little bit about it, but I'm not very knowledgeable about it.

Q. Are you aware that in 2003, as they do periodically, they had a hearing to adjust their Class IV(B) price, Class IV prices make allowances?

A. Not very aware. I can't recall it.

Q. Do you know whether those that negotiated contracts for you were aware of that?

A. Excuse me. Can you repeat the question?

Q. Do you know whether those that negotiated your long-term Class III --

A. I'm sure they were.

Q. If the Secretary were hypothetically to determine tomorrow that the Federal order system no longer serves to effectuate the Act and the Federal orders go away, is there not a clause in your contract that would provide you with income or would you give milk away? Is there not a contingency for some change in regulation?

A. I cannot answer that question. That's confidential.

Q. You know the contract, and you refer to one part of it, but you won't give us the details?

A. I cannot give you the details.

Q. You are familiar, however, because you were in the system at the time, you are

familiar with the former NW pricing system?
A. Somewhat.
Q. Somewhat. You are aware that the NW price resulted in a Class III price that reflected the marketplace, the competitive value of milk, correct?
A. Yes.
Q. And you also indicated that, as a general matter, you are in favor of the marketplace being the solution to problems rather than government?
A. Yes, sir.
Q. Okay. And you have heard -- have you heard testimony here that manufacturers have attempted a marketplace response by passing on their increased costs to buyers of manufactured dairy products?
A. I have not been here the entire hearings.
Q. Let me represent to you that there has been prior testimony that dairy product

manufacturers, manufacturers of commodity products, have testified that they attempted, as marketplace people do, to pass on their increased costs to their buyers in order to recover their increased costs.

But as a result of the way the current system works, government regulations stood in the way of their recovering those costs from the marketplace.

Would that representation to you -- let me ask you this question. Is it your position that, in at least this area, the government should stand in the way of marketplace response?

A. Well, what I think I hear from you is that since -- since the government is standing in the way of passing down to the consumer, they should not stand in the way of passing down to the producer. Is that your question?

Q. No. My question to you is, assume

-- assume with me that the government has stood in the way of passing on these costs, and the intent is to pass on the cost to the buyer so that the processor may retain, and the government formula works in the way it does.

Is it your position that the government should stay in the way of that and have it instead be borne by producers?

A. No. My position is that we should have a free market and the government should not stand in the way of these things. And like I mentioned before, they should not pass if off to the producer.

Q. Would you feel you would be better off if, in marketing your milk, if there were no Federal orders?

A. At this moment I do believe that the Federal market orders do have a place. But as I mentioned before, times are changing, and there may be a time that we may relook at changing the Federal order system.

Q. Does your milk go mostly to non-Class I milk buyers?

A. Our milk goes to about -- and this is very roughly -- 40 percent Class I, 40 percent Class III, and 10 percent IV and 10 percent II.

Q. In response to my question, were you referring to the Talsma family farms or to the Select cooperatives?

A. That is the same.

Q. It's the same. The long-term supply with the new joint venture plant, does that long-term call for a hundred percent of your milk going to that plant?

A. A hundred percent of my milk?

Q. A hundred percent of Select's milk or your milk.

A. No, no, no, no. That is just -- as I mentioned before, in our agency about 60 percent of the milk is from BFA and about 40 percent is from Lone Star and Zia and Select. And I assume that the percentage of the milk going to the cheese plant is probably also 60/40.

Q. Is that a function of the contract between the plant and --

A. No, no. And I probably should restate that. I think the milk that will go in that plant is just milk that is closest located to that plant. And my assumption is that it is pretty evenly distributed among those.

Q. Is your central Texas milk part of that group that's closest to the plant?

A. No, my central Texas milk is about 500 miles away from that plant, 400 miles.

Q. So you don't expect your milk will go there?

A. No, sir. My milk goes to Class I plants in the Dallas-Ft. Worth and Houston area as well as San Antonio.

Q. If any one of the cooperatives that are co-owners of that plant increase milk production substantially in relation to the others or disproportionately in relation to the others, do you have an understanding of whether that co-op would correspondingly send more of their milk to the cheese plant or not?

A. No, that doesn't have no effect.

Q. It has no effect? So it is a supply based on percentage ownership at the time of acquisition and building?

A. Somewhat to that extent, yes.

Q. Do you expect that Select will continue to concentrate and sell part of its milk supply to cheese plants to the north of Texas and New Mexico?

A. I don't understand the question.

Q. You have indicated that you sell on occasion to Wisconsin, for example, and haul --

A. Yes.
Q. And that includes RO milk?
A. And UF as well.
Q. UF milk?
A. Yes, and that -- we did that in the past, and we should now. But that was -- at that time, we didn't have no Class III plants or balancing plants available.
Q. You no longer have to do that?
A. Well, not to the extent that we were before. We still -- the ramping up of production in Texas and New Mexico is very, very high. We are looking at a 10 to 20 percent growth every year right now.
Q. You indicated, also, that Select participates with the Southwest Agency and the Southeast Agency?
A. Yes, sir.
Q. And that is in supplying and balancing the Class I needs of plants in those two regions?

A. Yes, sir.

Q. And those two agencies negotiate or announce premiums for those services, correct?

A. Yes, sir.

Q. And they negotiate prices for spot needs of Class I handlers?

A. Yes, sir.

Q. And attempt to recover increased costs from the buyers whenever possible?

A. Correct.

Q. And Select, as well as the other cooperatives, share in the revenue of that process?

A. Correct.

Q. That's all I have. Thank you.

THE JUDGE: Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. I've got a couple of questions, Mr. Talsma. Is there a benchmark yield for cheddar cheese that you, as a co-op board member, would presently require of your plant managers?

A. We want it to be efficient. I mean, that's getting into technical stuff that I am --

Q. I'm only asking you because you testified on direct --

A. Well, I know, but -- you know, as a board member, I know that that plant where you are referring to was not performing up to par. And our benchmark yields, to be honest, I cannot answer that question exactly what it is. I think there is something like that, but I cannot answer that. The only thing I can say, that plant was performing way under par.

Q. Now, with respect to the long-term milk sale contract for cheese production, if I understood your questions, your answers to Mr. Vetne, if there are profits at the plant,

plant owners get a portion of the profits?
A. The plant owners will share the profits, and there is -- the plant owners are cooperatives as well as individual investors or outside, you know, non-cooperative. It's a joint venture between cooperatives and non-cooperatives.
Q. So the private side is who the cooperatives are sharing --
A. Correct.
Q. What happens if there are losses at the plant?
A. We share them evenly.
Q. Between -- among private investment and the cooperative investment?
A. Yes.
Q. So if the regulations -- is it -- does the contract require the plant to pay the producers on a monthly -- let me finish my question first, please -- pay producers on a monthly basis the minimum regulated

price irrespective of its ability to make a profit at that purchase price?

A. Like I said before, I cannot answer that question. But we do have a contract in relation to the Class III price, and that is a set price.

Q. Oh, it is in relation to the Class III price?

A. Yes.

Q. Not the Class III price?

A. Well --

Q. Is that correct?

A. -- it is the -- the Class III price is also in relation to -- I cannot answer that more specifically than I did.

MR. BESHORE: Okay. Now, at that point, I'm going to just make this simple motion that the direct testimony on that point be stricken unless he is willing to provide the particulars.

MR. YALE: Well, Your Honor, we'll

join that, but we'll strike all the other testimony given today because they can't give it, either. He's given what he can, and the rules provide that he can view that -- the Department can view --

THE JUDGE: I think the claim of confidentiality has been extended many times to many people in this room and elsewhere. So in other words, I'm not going to force the witness to answer nor am I going to strike his testimony.

Are there other questions of this witness?

Ms. Deskins.

EXAMINATION

BY MS. DESKINS

Q. Good afternoon, Mr. Talsma. I'm Sharlene Deskins with USDA Office of General Counsel.

You mentioned that there were three cooperatives, you were involved with Select

Milk Producers, Lone Star Milk Producers and Zia?

A. No, ma'am, I'm not involved with those three, but those three are supporting our testimony.

Q. Okay. Just in terms of Lone Star Milk Producers, where are they located?

A. I think they are located out of Texas, but they do have producers in the entire south and southeast. And I -- they have a lot of producers in Texas, some in Oklahoma, some in Kansas, I believe in Louisiana and Mississippi as well.

Q. Do you know approximately how many members they would have?

A. Several hundred.

Q. And you said another one? Zia?

A. Zia, yes.

Q. Can you spell that one?

A. I believe it's Z-I-A.

Q. Do you know where their producers

are locate?

A. Mostly in New Mexico and west Texas.

Q. Are for both Lone Star Milk Producers and Zia, are all their members milk producers?

A. Yes, ma'am.

Q. And you have spoken to the board of directors, and they support your testimony?

A. Yes, ma'am.

Q. I don't have any other questions. Thank you.

THE JUDGE: Other questions.

Yes, sir, Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. There was a question by Mr. Vetne that dealt with -- I think you talked about the theoretical Class III and how you reduce 40 cents and the plant would get the 40 and stuff. But in your market, there are other classes as well, right?

A. Yes, sir.

Q. So if there was a reduction of, in your example, I think it was 40 cents, and that was translated also in the Classes I, II and IV, how would that be recovered?

A. Well, that's a good question. I don't think there is a recovery there. And if you really look at it, assuming that we increase the make allowance and that would increase it, 40 percent of our milk goes into Class III. And so, and if 40 percent of that milk comes back to a dairy producer through the co-op, so we have 40 percent of 40 percent, that's only 60 percent in reality that comes back to those dairy producers. So we lose 84 percent of that value to somebody else.

MR. YALE: I have no other questions.

THE JUDGE: Other cross? Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. I just have one.
A. Promise?
Q. I promise. I was waiting for the government to ask it. The Federal government has a benchmark for farms, for what they call small businesses of $750,000 gross per year. To your knowledge, are any of the members of Select or Zia in the category of small business by that definition?
A. Yes, sir.
Q. How many?
A. I don't know exactly. I know my sister and brother in law, they are operating a dairy, and they don't see that much. My daughters operate a dairy, and they don't --
Q. They are members of Select?
A. Yes.
Q. Their gross from dairy farming is less than seven fifty?
A. Yes, sir.
Q. Gross revenue, not income?

A. Yes.

Q. Okay.

THE JUDGE: Other questions?

Thank you, Mr. Talsma.

Mr. Yale, it is about a quarter of. Do you think we should break at this time or do you think -- how long would Mr. Weaver's testimony take?

MR. YALE: Well, we have got a page-and-a-half statement that we wrote and --

THE JUDGE: We could probably get his statement in before --

MR. MILTNER: And then I would have a few questions after the break. That might be a little more efficient.

THE JUDGE: Very well. Let's take Mr. Weaver at this -- yes, sir.

MR. ROSENBAUM: I have one witness who has a 6 p.m. flight tonight, if we could accommodate him.

THE JUDGE: I have your witness. I also one other producer besides Mr. Weaver. Let's see. The other -- Mr. Pittman, you said you would be here tomorrow or through noon tomorrow?

MR. PITTMAN: Yes.

THE JUDGE: And there was also an individual from Family Dairy Association. You have to leave today as well?

MEMBER OF THE AUDIENCE: I have an early flight tomorrow morning.

THE JUDGE: So you need to be on today?

MEMBER OF THE AUDIENCE: Yes.

MS. DESKINS: And I have one witness. It will only take five minutes.

Whereupon,

LEON WEAVER,

having been first sworn by the judge, was examined and testified under oath as follows.

THE JUDGE: Please tell me your name

and, if you would, spell your name for the hearing reporter.

THE WITNESS: My name is Leon Weaver, L-E-O-N, W-E-A-V-E-R.

EXAMINATION

BY MR. YALE:

Q. Dr. Weaver, do you have a written statement you want to read into the record?

A. I do.

STATEMENT FOR THE RECORD OF LEON WEAVER

my name is Leon Weaver. I own and operate Bridgewater Dairy in Montpelier, Ohio. That's in extreme northwest Ohio. Bridgewater Dairy is a family-owned dairy with my wife, Nancy, who happens to be a CPA, and our son, Chris, who is a dairy management person. The three of us together manage 3,900 cows and farm approximately 2,400 acres. We are a member of a milk marketing cooperative called Continental Dairy Products, Incorporated. Continental

Dairy Products, Incorporated, is a co-op comprised of approximately 21 large producers in Indiana, Michigan and Ohio. Herd sizes would be similar to those we heard described in the previous testimony. Even though Continental's members are among the largest dairy producers in the nation, our interest in this hearing is no different from other dairy producers, regardless of size.

Increases in make allowances will negatively effect all dairy farmers in the form of decreased receipts for the milk we market. I've worked my entire life in the dairy industry. After I got a doctor of veterinary medicine degree from the University of Pennsylvania, I entered veterinary practice in Southern California, specializing in dairy cow health and reproduction programs. And later, after about a decade there, I joined the faculty of the University of California School of

Veterinary Medicine's Teaching Research Center in Tulare, California, where I participated in instruction of veterinary and graduate students and conducted clinical research in dairy cattle. In 1998, our family moved from central California to northwest Ohio and established Bridgewater Dairy. We purchased raw land, so to speak, where there were no animal facilities and constructed new facilities to accommodate and milk our cows.

As I mentioned earlier, Bridgewater Dairy is a family farm. In fact, it was a fulfillment of a lifelong dream of my wife and I, who grew up on small livestock farms in southeastern Pennsylvania. Bridgewater Dairy also has represented a very substantial capital investment; as you can imagine, large amounts of debt; and considerable exposure to the unpredictable risk from weather, disease and markets. As a formerly tenured faculty member of a major university, I can tell you that the risk profile is quite a bit different here than it was there.

I'm appearing as a dairy producer and a member of Continental Dairy Products to voice our opposition to the proposal to increase the make allowance for the manufacture of dairy products. We oppose an increase in the make allowance for four reasons. First, I don't think there is any dispute that it will decrease the pay price to producers. Having been around the university and research for quite a while, I have the greatest respect for people that are good with numbers, statisticians, economists and modelers. I can also say that I've been coauthor of some research papers where modeling is involved, and I assure you, at least on the veterinary and biological side of things, getting a model that accurately predicts what is going to happen in a very multidimensional, multifactorial world is a very challenging thing.

And one of the reservations that I have, certainly, in discussing this with you today is whether a dynamic model that predicts supply and demand and the effects of supply and demand is as robust as it really needs to be. When there are market forces in place independent of the make allowance, this discussion we are having today, that are surely going to drive the pay price of milk to be down in excess of a dollar hundred, I believe that that market force is the driving determinant of the demand and the supply of milk. And maybe there are people and maybe there are techniques that can model the incremental effect of 8 or 10 or 25 or 50 cents further reduction in milk.

But as they say in Missouri -- and I'm not from Missouri -- show me. What my dairy clients used to always tell me when I was a veterinarian and trying to get them to invest in some new technology or product, they would always ask me this really difficult question. They'd say, At the end of the day, Doc, the thing you would want know buy costs another $2 per cow per year, and how* can I be sure that it's just another check I have to write for $2 per cow per year?

And what I'm really getting at is, I'm not too secure that a dynamic model is really predicting what I'm going to experience on the farm. But perhaps it is, and that's fine. So the first reason, again, was that it is going to lower our price. And a second is that, as was mentioned before, we have very significant increase in our own operating cost, energy and fertilizer, which is to some degree the same thing, but labor costs, health care costs, all the same items that have already been mentioned. And we are having to absorb those. A major cost for dairies in every locale is huge investments, capital investments in managing environmental issues such as surface water, odors and the like. The third reason we oppose the increase, as also has been mentioned before, is that we feel as producers that we are forced and required to respond to these changing cost structures by focusing first on efficiencies and, secondly, just kind of sucking it up, really, and seeing if we can survive the tough times.

Farming by its very nature, and dairy is no exception, is an activity that has periods of profitability, periods of treading water and, yes, periods of operating at a loss. And we all become a lot better managers during those periods when we are operating at a loss or at zero profitability. And we are opposed, I am certainly opposed to creating a dampener of those marketing forces that discourage an increase in efficiencies.

And finally, it seems like the most predominant reason for the need for the make allowance relates to energy and so on. And I have a concern that if we were to implement an adjustment to the make allowance now, we have already run past the energy cost runup, and we are already looking forward as producers to probably significant reduction in our milk price; that we could end up in kind of a double hit where the make allowance is increased to offset energy prices that have, perhaps, already peaked. No one knows, certainly.

But we as producers would then take this 20- or 25- or 40-cent hit right when our -- when market forces are already driving our prices to very low levels. So a key message of my testimony is that we don't think a partial budgeting approach where one just looks at the cost of an average of a whole bunch of plants is an appropriate approach to determine a -- to make a determination of what that make allowance should be.

As has already been discussed, there are many different efficiencies that can be captured in plants, and we think the owners of those plants should enjoy the rewards and the penalties of not capturing those efficiencies. As a side note, we are also concerned about the emergency nature of making such a decision. We as producers certainly have been experiencing all of the same cost increases, or many of the same cost increases, that processors are, and should -- as a result of these hearings, should the make allowance now be increased before, or even in the absence of, any consideration of the total milk marketing issue and the efficiencies and other issues apart from this partial budgeting examination of costs, during that period from the increase of the make allowance till some further, larger review would be initiated or implemented, producers would be bearing the full brunt actually twice, first at their own cost level and then, secondly, through the reduction in their milk price from the increased make allowance.

Any observer of the U.S. dairy industry over the last several decades can recognize that in periods of low milk prices, there is an acceleration of the demise or the reduction in herds in the United States. Herds that are not well managed or are in the wrong locale, or where there isn't another generation to take things on or they don't have a good milk market, during the good times they will roll along, and then, during the bad times, they will say, boy, this is too much stress or it's not profitable enough, or I'm not getting a return on my investment, and those herds are liquidated. And so, that's part of the normal business cycle.

But part of the reason, I believe, that this whole milk marketing order system is in place is to prevent or to modulate severe exacerbations of those cycles so that we don't end up overshooting and have a period of such low, low prices and such low profitability that in fact more herds and more cows exit the industry than the long-term supply of milk requires. I think we have a situation here, a little bit of a perfect storm analogy, where no matter what decision is made about this make allowance right now, we have had two years that dairying could be profitable, in 2004 and 2005, and producers had done what they always do: they produced more milk, and the increase in supply. We heard that testimony just an hour or so ago. Supplies are increasing, and there is a concern about where all that milk is going to go. That will drive milk prices down to below the break-even point for many, many producers. And if we subtract another 25 or 50 cents from the price those producers receive, there are going to be many more herds and cows exiting the system.

And I think we merely exacerbate the market swings by decreasing the milk price even more to producers during a time when milk prices will be decreasing a great deal just due to normal market forces.

What might a dairyman do who is not able to have cash flow? Take a typical 500-cow dairy. A 500-cow dairy is -- I shouldn't say typical. Let's just say -- as an example, let's choose the 500-cow dairy. Some are much -- 500 is typical, by the way, if you look at -- there's a lot of ways to look at it. There is nothing aberrant about a 500-cow dairy any more than it's aberrant to talk about a hundred-cow dairy or a 2,000-cow dairy.

But a 500-cow dairy typically has as a labor force several milkers that milk the cows and an individual who does what we call the outside work. He feeds the cows. He provides animal care. He sees that the cows get bred and that type of thing. And then there is usually an owner who kind of fills in for him and looks after the general business management and so forth. From my years of observing dairies in quite a few locales, what I observe happens during periods of financial distress, the two things that most commonly happen is that the farmer owner-operator says, well, I just can't have as many people around here. I've still got to keep my milkers to milk the cows. I can't do anything about my feed prices, or very little. And hopefully, he's run all the other efficiencies he possibly can out of this operation. So he decides to lay off that outside guy and start working himself. So here you have this family who is financially stressed, they can't pay their bills. The bankers are calling him. Creditors are calling him. And now the response to that is to work harder and longer hours, have the wife who might have a job off the farm contribute more to raising the calves and doing other things. And you get into this downward spiral of human distress that is just a prelude to management failures. And those dairies often exit the business, sometimes with divorces and worse.

So I'm concerned that raising the make allowance now may bring a lot of human suffering to small-, medium- and large-scale farmers that's unnecessary because it will drive more herds and more cows out of our industry when the demand for milk in the long term requires it. Some other producers will say, well, I'm not going to go down that road. Instead, I'm just not going to replace my cull cows. I'll just sell them when they come to the end of their useful life, and I won't replace them. By my calculations, a make allowance adjustment in the order that's being discussed here on a 500-cow dairy could involve easily a reduction of 50 to 70 cows in herd size in one year.

What happens then? First of all, just like your plants that aren't full, his plant's not full. He is not efficient. Now he is less profitable. Secondly, his banker was looking to those cows as collateral. His banker isn't going to let that happen. He says, I have loaned you operating funds based on the number of cows in your barn, and you will have those cows in your barn. So at that point, the person has no choice other than to tap other assets, should he have any; start selling off real estate, liquidating other assets to keep his barn full. That's one choice. The second choice is to sell out. And the third choice would be, if the first two aren't available to him, is to file Chapter 11 bankruptcy or Chapter 11 or Chapter 15. Those are the two most common things that happen.

So fundamentally, we have a problem -- you know, in the long haul we have a problem with supply and demand. And fundamentally, when supply is too big and demand can't be modified too much, then the supply has to be adjusted. And I really don't think the make allowance is a very market-efficient tool to send those messages back to producers.

If a large percentage of cheese is produced by producer-owned cooperatives, what better signal to producers that making cheese is not profitable and let it come to the bottom line of the co-op statement then have the co-op with their farmer members sit there and the members discuss what the optimum thing they should be doing with their milk is and how much milk they should be producing. That's a true market signal. Rather than send the market signal to the co-op, say, hey, you know, you can kind of keep your co-op going, and everything looks good on paper so we'll just take 30 or 40 cents away from the producers, and have quite a number of producers go out of business.

I appreciate the opportunity to come before you this afternoon and present the reasons for our opposition to an increase in the make allowance.

We urge -- Continental Dairy Products and I, as a producer, urge that no increase be made at this time and that any increase be considered only after a review of the entire array of operational factors affecting processing profitability.

We do not believe that examination of the cost side of processing across the whole variety of plants alone will result in a correct conclusion.

Thank you.

THE JUDGE: Very well. It is almost 5 after 3:00. We'll be back at 3:20. We'll take 15 minutes now.

[Whereupon, the hearing recessed at 3:04 p.m. and reconvened at 3:21 p.m.]

THE JUDGE: Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Mr. Weaver, I just have one follow-up question with your prepared statement. And that is, you indicate that if the Department is to look at pricing, they need to look at, you know, other factors. What are some of those other factors that you were referring to?

A. Well, in the broadest sense, it

would be -- it would all fall under the category, I guess, of plant efficiency. And that could be broken down into some things like cheese yields that were mentioned, labor efficiency, even energy efficiency, modernization of plants.

I guess at the bottom line -- and I'm certainly not an expert on processing, but it would seem to me that a make allowance should be set so that efficient and modern and many plants could make a profit.

But I think we've long abandoned the concept at the producer level that the support price should be such that most producers could make a profit. And so, if we tried to set the make allowance so that highly efficient, well-managed, modernized plants could make a profit, then we create the competitive environment that we need that's good for everyone in our industry.

And so, again, it goes back to just

simple nuts and bolts of running a plant efficiently, running it 24 hours a day and running it in a way that you get yields and markets and so on.

Q. Now, I want to change topics. You also talk about things that were done at the farm, and you -- I kind of want to mix two things, talking about changes that needed to be made at the farm to be more efficient. You also talked about the stewardship of the land and the water and the air that dairymen are so interested in.

Are there areas in which farmers are finding themselves, as part of their drive for efficiency, are kind of combining, taking care of both of those at the same time in terms of their manure handling and the like?

A. Yes, there is certainly a national -- on a national level. That plays out typically through state regulatory agencies, but there's -- and through just concerned citizens. There are tremendous forces out in the countryside to ensure that dairy producers, if they are not now, become good stewards of both the land and the water and the air.

And I think at first blush many smaller producers thought, well, that's just a big producer problem. But in fact, producers large and small are facing all those issues of adopting conservation and air quality and water quality management practices that increase their costs for which they get no compensation but which would just become a normal cost of operating a dairy to meet societal and standards as promulgated through regulations and, indeed, litigation.

For example, on our dairy, we are halfway through what will be a $3 million investment to process our manure, make it more transportable and to segregate the phosphorous into the solids and put in an anaerobic digester that will reduce the odors and the emissions from the facility.

We are just about the third or -- well, actually, the fifth or six Continental producer to make those investments. And that's an inexorable, marching force throughout our industry. And those costs -- there is nowhere in our milk check that we'll be compensated for those. We just have to become efficient and keep on going.

Q. Now, five years ago -- well, really, going on six years ago when the hearing was set for these particular make allowances, were the same forces involved in terms of demands on the farms to make those investments as they are today, or has that changed?

A. The germs or the seeds, the underlying factors were there, but the fleshing out of what the details are and what needs to be done, the involvement of the technology is kind of on an expedited or --

Q. So a prototypical dairy being built today would be having to address different capital demands of what, five years ago, we had?

A. Actually, in two ways. One, as you suggest, by the increased capital investments, simply to get a permit.

I just went through a second permitting process for these renovations that I mentioned a moment ago, and the engineering cost just for the renovations of my dairy were roughly three times what they were seven, eight years ago for the original establishment of my dairy. That's just the engineering costs alone.

The other way that -- the other component of that is the construction costs are not, just in our industry but all over -- I mean, it costs 50 to 60 percent more to build the same dairy now as it did eight years ago.

Q. I want to turn to another topic. You had mentioned a 500-cow dairy and also the impact on small farms and stuff. And in rural Ohio where you live and in nearby Indiana and Michigan, you are aware of, are you not, of other small dairy farms and those in that vicinity?

A. I am.

Q. Can you -- have you ever been able to make an observation of whether you see, within those farms, that there is a reinvestment in new capital and new facilities and the like or not? Or do you have an observation in that regard?

A. It would be correct to say that the vast majority of those farms are not investing capital in modernization. They are, in effect, in their terminal generation. That's not a good choice of words, but when that dairy producer tires of the enterprise he is in or retires, his children are probably gone from the farm, and that will be the last generation of the farm. There are exceptions which typically involve building new facilities at another location.

Q. And is part of that the fact that there just isn't enough money at the dairy and at that level to have the money to reinvest or --

A. That is correct.

MR. YALE: I have no other questions.

THE JUDGE: Examination of this witness?

Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Good afternoon, Dr. Weaver. What county are you from in Pennsylvania?

A. Lancaster County.

Q. Tell us little more about Continental. Does it have 39 members? Is --

A. Twenty-one.

Q. Twenty-one?

A. We have 21 members, and we do about -- I think we produce about a billion pounds a year.

Q. A billion pounds a year. Has Continental invested in any butter-powder balancing plants?

A. No.

Q. Do you own any manufacturing plants?

A. No.

Q. Thank you.

THE JUDGE: Other cross? Mr. Rower.

EXAMINATION

BY MR. ROWER:

Q. Mr. Weaver, I'm Jack Rower, AMS Dairy Programs.

You referred to the dynamic forecasting model in your testimony. Were you referring to some specific model?

A. Yes, to the models that I believe

were published in the Federal Register or alluded in the Federal Register that were forecasting the all-milk price and included the --

Q. The preliminary analysis --

A. Yes.

Q. -- that appears in the hearing notice?

A. Yes, that is correct.

Q. Thank you very much.

THE JUDGE: Other questions?

Very well, Dr. Weaver, you may step down.

Mr. Yale, do you want to call Mr. Summer at this time?

MR. YALE: Yes, we have, Your Honor, Mike Sumners testifying, and I believe he has his own written statement.

MR. ROSENBAUM: Your Honor, I would mention that I do have my one witness who has to catch an airplane.

THE JUDGE: Yes, sir. I haven't forgotten you.

Whereupon,

MICHAEL SUMNERS,

having been first sworn by the judge, was examined and testified under oath as follows.

THE JUDGE: Please be seated, tell us your name, and spell your name for the hearing reporter.

THE WITNESS: My name is Michael Sumners. M-I-C-H-A-E-L, S-U-M-N-E-R-S.

EXAMINATION

BY MR. YALE:

Q. Mr. Sumners, you are a dairy farmer?

A. Yes.

Q. And you are located where?

A. Paris, Tennessee.

Q. And that is approximately where? For those of us that haven't been to Paris, Tennessee, can you give us some nearby cities or --

A. [Pause.]
Q. Within 200 miles.
A. Well, I'm about a 120 miles from Memphis; about 120 miles from Nashville; about 80 miles from Jackson; about 80 miles from Paducah, just west of the Tennessee River in the northernmost county of Tennessee, Henry County.
Q. Do you have a written statement?
A. Yes, I do.
Q. Do you want to present that, please?

STATEMENT FOR THE RECORD OF MICHAEL SUMNERS

A. As I said, my name is Michael Sumners. I'm an independent dairy producer from Paris, Tennessee. I sell milk produced -- my milk production on my operation goes to Dean Foods, Incorporated.

And after listening to this Federal order, I would sort of like to ask the question, will the real Federal order please stand up. Before we can resolve problems, it needs to be clear what the Federal order is all about.

Two weeks ago, I was at a hearing considering transportation credits to ease the pain that producers were shouldering because of doing the milk supply. Now we are at a hearing to lower the blend price for all pool producers.

The economic model that USDA says that over time affects the increase make allowance will have a minimum effect on all milk products because milk supplies will decrease. Decreases in supplies will not be equally distributed over the nation. In the Southeast, we have been losing producers more rapidly over other areas of the country. Transportation credits have been instituted to import milk from other areas of the country at the expense of producers in the Southeast.

If other rules or marketing

regulations stay the same, an increase to the make allowance means that dairy producers in the Southeast are going to receive less and the consumers are going to pay more as milk has to be brought in from other regions to supply the fluid needs of the Southeast that local producers will no longer supply.

Another problem with changing allowances, changing make allowances, emergency hearings, for that matter, having energy factors changing make allowances, is the effect it will have on producers, manufacturers and end users, which is a futures market.

In the futures market, you have people assuming risk so others might reduce risk. A make allowance is a moving target. It is not going to be good for risk management. Those that are trying to reduce risk are going to have to pay more, and it will be a detriment to those that are assuming risks from entering the market.

There are other ways manufacturing plants can manage rather than changing make allowances. Energy costs can be added. Co-ops owning balancing plants are allowed to reblend and charge balancing costs to whomever they are balancing. The effects of changing the make allowance nationally will not treat all Federal orders the same. Until regional impacts in the full pricing formula can be addressed, it is best for the dairy producers to leave the make allowances alone.

Class prices are an obligation to the milk supply, not necessarily the farmer's milk price. It's a fine line between correct make allowances and the Class I sales subsidizing the milk supply for manufacturing. And I thank you for your time.

MR. YALE: I have no other questions. He's available for cross.

THE JUDGE: Very well. Questions? Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Mr. Sumners, can you tell us where you ship your milk?

A. It either goes to a plant in Murray, Kentucky, or sometimes it goes to Nashville, to Country Light or Purity Dairy.

Q. And the plant is Murray, Kentucky, is a distributing plant for your order, is that correct?

A. I think it is a distributing plant by association.

Q. You mean like a distributing plant unit or something of that sort?

A. Well, the definition is getting kind of complicated, but I don't it's a pool plant just standing alone. But because of other plants, it is considered a pool plant.

Q. And the plants in -- the other

plants where your milk goes sometimes --

A. They would be distributing pool plants, yes.

Q. And I take it your testimony is that you are opposed to any reduction in the minimum prices that these plants would have pay?

A. I'm opposed to changing the make allowance.

Q. Are you in favor of reductions in prices that your plants you are selling to have to pay?

A. If legitimate market forces dictate that and they pay less, I'm fine with that.

Q. Now I meant under the order. I'm sorry. I didn't mean to confuse you there. I meant, are you in favor of reducing the minimum order price that the plants you supply have?

A. Yes, I -- you are talking about changing the Class I differentials?

Q. Changing the minimum Class I price that those plant haves to pay. You are not supporting that, are you, lowering it? Or maybe I'm not yet --

A. No, what I support, I want people to be held accountable to the milk supply, now. And manufacturers should be held accountable just as the fluid plant is held accountable. And one way of doing is having a make allowance that doesn't give room for plants just to make cheese because they can. If there is not a market, they should be wondering why they are doing it. And if they are doing it to balance somebody else, they should be charging those that they are balancing, not just making cheese because they make a profit.

Q. So you are opposed to reducing -- by increasing the make allowance, you are opposed to reducing the minimum Class III and Class IV price, correct?

A. If you put it that narrowly, yes.
Q. Isn't that what increasing --
A. If you had a hearing based on yields and a lot of other factors and how it affected each order, then -- and it came out that we need to change them, I wouldn't object to that. But this narrow focus on changing the make allowance solely on a little bit of information, I am opposed to that.
Q. Have you heard anything that suggests the plants you are selling to should have a lower price for Class I milk?
A. No, I haven't heard anybody say that.
Q. Thank you.
THE JUDGE: Other questions?
Thank you, Mr. Sumners. You may step down.
THE WITNESS: Thank you.
THE JUDGE: Mr. Rosenbaum.

MR. ROSENBAUM: Yes, Your Honor.

Whereupon,

GREG DRYER,

having been first sworn by the judge, was examined and testified under oath as follows.

THE JUDGE: Please be seated, tell us your name and spell your last name for the hearing reporter.

THE WITNESS: First of all, thanks for accommodating me and my travel plans. I appreciate that.

My name is Greg Dryer, D-R-Y-E-R. I am Executive Vice President of Administration and Services for Saputo Cheese USA, Inc. And my responsibilities in that position, among other things, include milk procurement for all of the company's U.S. manufacturing facilities.

MR. ROSENBAUM: Mr. Dryer, before you go on, let me mark your testimony as an exhibit.

THE JUDGE: It's been marked as Exhibit 50.

[Whereupon, Exhibit No. 50 was marked for identification by the judge.]

STATEMENT FOR THE RECORD OF GREG DRYER

THE WITNESS: I serve on the Board of Directors of the National Cheese Institute, the American Dairy Products Institute and the Dairy Institute of California. And I'm a member of the Wisconsin Cheesemakers Association, the Institute of Food Technologists, and the American and Wisconsin Institutes of CPAs. The University of Wisconsin - Milwaukee awarded my undergraduate degree 1974.

My involvement in the dairy industry began as an auditor and consultant for dairy and dairy-related companies. I have been directly employed in the dairy industry for the past 25 years. For a majority of that time I have had bottom-line responsibility for entities of various sizes and structures from local and family-owned to international and publicly traded. Prior to joining Saputo I was President of Avonmore Cheese, Inc., of Monroe, Wisconsin.

Our company, Saputo, has 15 manufacturing facilities across the United States employing approximately 2,000 people.

We buy from three to four billion pounds of milk annually, primarily from farmer-owned cooperative organizations. With the exception of the two plants we operate in California, the vast majority of milk we buy is regulated by the Federal order system and extends at least to some degree to all classes of milk.

We are here to support the proposed change in Federal milk marketing order regulations to update the make allowances used in all FMMO minimum class price formulas with the most recently available cost data.

We have reviewed and support the testimony of Dr. Robert Yonkers, representing the International Dairy Foods Association (IDFA) and the National Cheese Institute (NCI), one of the many organizations of which we are members.

Before I begin, I would like to thank USDA for the opportunity to express our concerns and to stress the emergency nature of the NCI petition and the need for an expedited decision.

1. Emergency Marketing Conditions

We have a number of concerns relating to FMMO minimum class price formulas, not the least of which is our inability to derive returns from our whey byproducts commensurate with those anticipated by the Class III "other solids" component factor. While this issue is specifically excluded from the subject matter of this particular hearing, it is pertinent to the emergency nature of the petition. Dramatic increases in manufacturing costs, when coupled with the aforementioned concern among others, have placed most cheese manufacturers in an untenable position for an extend period of time. Clearly it was not the intent of Congress or USDA to create a system which would threaten the economic viability of cheese manufacturers who serve as an important outlet for farm milk. Unfortunately, that is in fact where the industry finds itself today. In our opinion, the term "emergency" appropriately describes the gravity of the current U.S. cheese manufacturing environment.

2. Make Allowances

Saputo is a producer of an extensive array of cheeses in the United States, but not cheddar. Therefore, I am unable to testify as to its cost. I can, however, relate some information relative to our costs which may assist in understanding the magnitude of our problem. I reviewed the eight cheese plants we have operated on a somewhat consistent basis from the year ended March 31st, 2000 -- which, by the way, is the best year of information I had available to me -- through the nine months ended December 31st, 2005. Over that period, electricity costs for those plants have risen by 96 percent or approximately 14 cents per hundredweight of milk. Natural gas costs have increased 125 percent or approximately $.12 per hundredweight of milk. Resin-based plastic packaging costs have increased in excess of 150 percent. Transportation, fuel, chemicals, employee health care-related benefit costs have all escalated significantly. Virtually all of our major cost categories have incurred large increases during this period. Cheddar manufacturers are trapped in a system where attempts to raise prices simply result in higher milk costs. Efforts to recover cost increases from the market for other commodity-type cheeses have been difficult if not impossible, because the competitive environment is influenced by operators in non-USDA regulated areas or cooperatives not limited by Federal milk pricing regulations. We support the proposal to update make allowances with the most recently available industry cost data from both the California Department of Food and Agriculture and the USDA Rural Business Cooperative Service. These costs should be reviewed to insure they are all inclusive and comparable.

Your Honor, am I allowed to interject something that is not in my written testimony?

THE JUDGE: As long as it is labeled as an insert and so forth, then you can -- in other words, the hearing reporter is able to follow you in a reasonable fashion.

THE WITNESS: I was not privy to the details of the Rural Business Cooperative cost information until I arrived here. And upon looking at it, I have several concerns, especially with related to the cost factor for dried whey. We operate a plant in Whitehall, Pennsylvania, the plant we acquired in March of 2002, and we produced about 25 million pounds of dried whey in that plant.

And I reviewed cost accounting information of that plant over the last three and three-quarter years and noted that our costs have averaged about 20 cent per pound of dry whey in that plant. And those costs do not include a factor for depreciation or return on capital investment or marketing expense. So those costs are more in line with those reported in the California survey than they are the Rural Business Cooperative survey.

That plant, unfortunately, is scheduled for closure, is in the process of being closed, eliminating 125 jobs. And in my opinion, that relates in part to some of the economic difficulties the industry is facing.

Now back to my original testimony.

3. Urgency

The increasing incidence of recent cheese business failures and plant closures substantiates the necessity of prompt action on the part of USDA. The Department is authorized to omit a "recommended decision" under these conditions. We appeal to the USDA to move as expeditiously as possible to the issue of a final decision and a final rule. It is important to recognize that even a complete implementation of proposals under consideration here will not alone be sufficient to return manufacturers to an acceptable degree of profitability. Costs have continued to climb subsequent to the cost survey data under consideration, and other factors intrinsic to the current system will continue to confront the industry with enormous challenges. Nonetheless, the decision rendered here may be an important first step on the road to recovery.

Thank you again for the opportunity to register our opinion. We wholeheartedly support the detailed testimony and proposal submitted by the National Cheese Institute on behalf of our industry.

MR. ROSENBAUM: Your Honor, at this point I would ask that Exhibit 50 be admitted into evidence

THE JUDGE: So admitted.

MR. ROSENBAUM: Your Honor, Mr. Dryer is available for cross-examination

THE JUDGE: Mr. Yale.

EXAMINATION

BY MR. YALE:

Q, Benjamin Yale on behalf of Select Milk and Continental Dairy Products and the other parties named earlier. Good afternoon.

A. Good afternoon.

Q. Mr. Dryer, what types of cheeses are produced by Saputo?

A. Quite a wide variety. Quite a bit of volume in the Italian cheese arena, mozzarella, provolone, Parmesan, Romano, ricotta. We also make quite a bit of blue cheese and Swiss cheese and string cheese, a variety of Swiss-type cheese called Lorraine. Just quite a large number of different cheeses.

Q I take it by that list you are not into cheddar?

A. We make no cheddar.

Q. And no American style?

A. No American style.

Q. Any other Euro style cheeses besides

the Italian and other three or --

A. When you say Euro style, Swiss?

Q. Yes. Any others? Any brie?

A. No, no brie.

Q. Now, your plants, are they located in areas that are subject to Federal order regulation?

A. Yes, all but two. Those are California plants.

Q. And the other plants are located all in the east or --

A. No, we are really almost coast to coast. We have a plant in Pennsylvania, a plant in Maryland, a plant in Vermont. We have eight plants in Wisconsin, South Dakota, Indiana.

Q. And do you buy your milk from cooperatives or do you have your own independent supply of milk?

A. We were buying all of our milk from cooperatives, and then about a year ago we acquired a small plant in Wisconsin that had direct ship producers, and we maintained that farm base. So we have a small number of direct-produced milk.

Q. But you are not expanding that program to your other plants?

A. No, we are not.

Q. And the pricing that you pay for that milk, do you pay at least the announced Class III price for the milk?

A. Yes. That's -- I can't think of any case where we don't pay more than that.

Q. And that's outside of California?

A. California.

Q. Right, and all the other orders.

And your comment about in the middle of page 3, where you say cheddar manufacturers are trapped in a system where attempts to raise prices simply result in higher milk costs, you are speaking there, not from the experience of operating Saputo, but as a member of the board of NCIA?

A. I'm just speaking from my limited knowledge of how the system works, so that if you are in the NASS survey, you are reporting your price milk cost.

Q. And the expectation that you would have is, if this proposal were adopted, that the cost of milk for your plants relative to the cheese price would be reduced?

A. That is correct.

MR. YALE: I have no other questions

THE JUDGE: Other questions of this witness?

Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Mr. Dryer, I'm John Vetne. I represent Agri-Mark.

The whey plant that's imminently going to close in Pennsylvania, it is currently operating, however?

A. Only as a cheese and whey operation. Only the whey dryer is continuing to operate.

Q. The whey dryer is coming out of the cheese?

A. Right, attached by a pipe.

Q. But the cheese plant will continue to make cheese?

A. No, no the cheese plant has already ceased operation.

Q. The cheese plant?

A. Yes.

Q. So the plant was drying whey from other --

A. It is receiving whey from our Maryland plant.

Q. From where?

A. Maryland, from near Hagerstown.

Q. From Maryland? One of Saputo's plants?

A. Right.

Q. Does it receive whey from others?

A. No.

Q. Is the plant in Maryland still going to operate?

A. Yes.

Q. And how will the plant in Maryland after this dispose of its waste?

A. Well, we are investigating the best options. We have several alternatives in selling the whey.

Q. The alternatives all involve selling the whey?

A. Yes.

Q. Do you condense it before you sell it?

A. We RO it.

Q. And then sell it in concentrated form?

A. Right.

Q. Are you familiar with the price you received from whey that is sold from a cheese plant?

A. You mean this particular cheese plant?

Q. Generally. Saputo sells --

A. We sell whey in a myriad of configurations.

Q. I'm talking about just whey that comes out of the cheese plant.

A. I couldn't really answer that.

Q. In Wisconsin, you operate a number of cheese plants?

A. Yes.

Q. And you don't produce whey at all in those cheese plants or you don't dry whey?

A. We have a drying plant in Fondulac, Wisconsin. We don't dry whey, we dry WPC there at times.

Q. Do you produce a whey powder or other dried whey type product at your cheese plants in Wisconsin?

A. We produce all liquid products in our cheese plants. The only drying plant we have is Fondulac.

Q. So the pattern of your cheese plants, then, with the whey byproduct, is to concentrate or condense the whey that comes out of cheesemaking and ship it to Fondulac?

A. That is correct. Or sell it in liquid form.

Q. Or sell it to some --

A. In liquid form, or some of it is utilized for the manufacture of our cottage cheese.

Q. You said some of it is used in the manufacture of cottage cheese?

A. Correct.

Q. Cottage cheese is a cheese that uses whey as one of its ingredients?

A. Correct.

Q. The drying plant in Fondulac produces both nonfat dry milk as well as whey powder?

A. No, we don't do any nonfat dry milk

there anymore. We produce other products there, USDA products and animal feed products.

Q. You used to produce nonfat dry milk?

A. We did. Well, it was quite a while ago.

Q. How many of your cheese plants aggregate their whey and send it to Fondulac?

A. It's a little convoluted. We have a plant in Reedsburg, Wisconsin, that ROs whey and ships it to Monroe, Wisconsin, where it is ultra-filtered. Occasionally, the whey from that plant will be dried in Fondulac, for instance. So that would the path of some of the whey.

Q. So it goes from a cheese plant to a UF plant to an RO plant to Fondulac?

A. Well, an RO plant or an evaporator plant to a drying plant, right.

Q. Okay. Thank you. That's all I have

THE JUDGE: Other questions of this

witness? Counsel.

EXAMINATION

BY MR. RASTGOUFARD:

Q. Hi, I'm Babak Rastgoufard. I'm with the Office of General Counsel, USDA.

I just wanted to make sure I understood something you said with respect to your testimony. In regards to the CDFA and the USDA Rural Business Cooperative data, you said that these costs in your testimony, your written testimony, you said these costs should be reviewed to make sure they are all-inclusive and comparable. And then you interjected something with respect to the whey cost.

I wasn't sure if by interjecting something with respect to the whey cost, did you mean to imply that all the other costs in those two studies are all-inclusive and comparable?

A. No, I said that I have -- I don't

have much familiarity with nonfat dry milk and butter costs. With the whey cost, I do have a fair amount of knowledge about, and our costs are more in line with -- the California study has quite a disparity with the Rural Business Cooperative Service study, and we are more in line with the California costs in our own plant.

Q. Thank you

THE JUDGE: Other questions?

Thank you, Mr. Dryer. You may step down.

THE WITNESS: Thank you

THE JUDGE: Unless there is objection, maybe we could hear from the representative from Family Dairy at this time.

Your statement has been marked as Exhibit 51.

[Whereupon, Exhibit No. 51 was marked for identification by the judge.]

Whereupon,

DON DESJARLAIS,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please tell us your name and spell your last name for the hearing reporter.

THE WITNESS: Don Desjarlais. That's spelled D-E-S-J-A-R-L-A-I-S

THE JUDGE: You have a statement which I have marked as Exhibit 51. Are you prepared to read it into the record at this time?

THE WITNESS: Yes, I am

THE JUDGE: Please do so.

STATEMENT FOR THE RECORD OF DON DESJARLAIS

THE WITNESS: My name is Don Desjarlais and I serve as the General Manager of Family Dairies USA, a multi-purpose USDA-qualified cooperative headquartered in Madison, Wisconsin. I appear here today on behalf of the 3,700 family dairy farmer members who own the cooperative.

At the outset, our dairy farmer members want everyone to know, they empathize with the manufacturers who are seeing their operating margins squeezed by accelerating energy costs. Our members fully understand margin squeeze because their own dairy farms' bottom lines are being negatively impacted by the same energy cost increases. The proposed solution to these serious energy price hike problems suggested by the petitioners Agri-Mark, et al., would be to increase manufacturing cost allowances for Class III and IV. Such make allowance adjustments might, indeed, afford manufacturers a cost of production guarantee. Economists agree, however, that such adjustments would lower Class III prices; and we suggest that the money needed for these adjustments would come right out of our producer members' milk checks, thus making the whole proposal a nonstarter.

Our members are particularly sensitive to the negative impact rising energy costs are having on their own operations. Early in 2005 (well before the current Agri-Mark request) our board of directors and management contacted top Federal Order 30 officials about the possibility of requesting a Federal order hearing that could produce a fuel adjustment or energy allowance for producers through the Federal order system. The order officials considered the Family Dairies USA request and informed the board chairman that while they were sympathetic with producer cost problems, there was no authority in the order system to address those concerns. They suggested that perhaps the Secretary of Agriculture, himself, or the Congress would be the better proper venue for redress.

It appears then, the internal Federal order rules do allow consideration of an emergency hearing to address manufacturers' energy cost of production problems, but do not afford the same consideration to producers' concerns.

Since these internal rules do suggest sort of a double standard, our members believe that when the Secretary does issue the proposed rule in this matter, he should use extreme caution to see that the decision does not solve the problem with the manufacturers at the expense of the producers.

In conclusion, we should like to enter into the record the summary paragraphs of a paper written by Professor Ed Jesse and Brian Gould of the University of Wisconsin dated October 2005 concerning this very subject. The title of that paper was -- that's not in here -- Federal Order Price

Formulas and Cheesemaker Margins: A Closer Look. The views expressed reflect exactly those of Family Dairies USA members.

What I would like to do now is I have attached a copy of that summary and conclusions to my testimony, and I would like to read that as part of my testimony.

This analysis --

THE JUDGE: Excuse me.

Mr. Vetne.

MR. VETNE: I'm familiar with that study, and as helpful as it might be, there are two problems. One is that this -- that all we have is the last couple pages of it.

THE WITNESS: I do have a full copy.

MR. VETNE: And the other is that the authors aren't here. If it is going to be received, as things tend to be here, I would just save time and I would just say it's received and we don't have to read the whole thing. But I have a problem with receiving two pages of a document that's from the Internet? Is that right?

THE WITNESS: Yes

THE JUDGE: Mr. Miltner.

MR. MILTNER: Your Honor, I believe that the witness said that the paper was one that he relied upon in drafting his testimony and coming up with a position of his cooperative. And as such, it should be admissible. Of course, he can read into the record anything he wants, and I think the Secretary could afford it whatever weight he so chooses.

THE JUDGE: Well, rather than read it into the record, why don't we just append it to his statement and, in other words, receive it in that form, because he does indicate that it does reflect the views of his members as expressed to him.

I'm just going to have it incorporated as part of your statement, okay?

Examination of this witness?
Mr. Miltner.

EXAMINATION

BY MR. MILTNER:
Q. Ryan Miltner on behalf of Continental and Select. You are going to have to help me the pronunciation of your last name again.
A. It is Desjarlais.
Q. Desjarlais. Okay.
Your 3,700 cooperative members, are the majority of them located in Wisconsin?
A. The majority of them are in Wisconsin, but we do have members in the neighboring states around Wisconsin as well.
Q. So Illinois and Iowa and Minnesota?
A. Michigan.
Q. Upper peninsula of Michigan?
A. Even some out -- I believe some go out into the Dakotas and Idaho, as well, there are a few, I think.

Q. I'll save the Department a question. How many of those members do you imagine have gross farm receipts of less than $750,000 a year?

A. I have no idea.

Q. Do most of them -- are most of those farms farms with less than a hundred cows, let's say?

A. I am very new to this organization, so I don't have a good feeling for the size of the farms. But as we all know, in Wisconsin, a large majority of the farms are below a hundred.

Q. And your farms are typical of those in Wisconsin?

A. Yes, I would say so.

Q. What would an impact of 25 to 50 cents per hundredweight on a milk check mean to your member producers?

A. It would be a big number. I can't give you a good answer on that because, as I said, I have been -- just for the record, I have been with the company since the beginning of January so I'm still learning, you know, some of these things. But 3,700 members at an average, I think it was talked about earlier today about, you know, let's say an average of a hundred cows a herd. If it's a hundred cows at 80 pounds a day, you could figure it out at 25 cents.

Q. Aside from the actual numerical impact, the monetary impact, whatever that number might be, that kind of percentage reduction in receipts for your members is nonetheless significant?

A. It is significant, yes.

Q. And these are indeed family dairy operations?

A. Yes.

Q. I'm sure the judge will let me know if my question here is out of line, but is there anything in these two appended pages that you would want to summarize for us to give us the gist of what you found so important in these two pages to rely upon?

A. Yes. The paper evaluates the margins of cheesemakers today and looks at the formulas that's used in the Federal order, and it cites flaws in the formulas. And I guess we would -- our position would be that, since there are flaws in the formula, including the make allowance, that it should be looking at the whole formula and not just the make allowance.

Q. Is it your understanding that if USDA proceeded to raise the make allowances at this hearing and then consider other problems with the pricing formula at another hearing, that your producers would lose income that could not be recovered in the interim period between those two hearings?

A. That would be true.

Q. Thank you. I don't have any other

questions.

THE JUDGE: Other questions of this witness?

Very well, you may step down. Thank you.

THE WITNESS: Thank you

THE JUDGE: Mr. Vetne.

MR. VETNE: Did we finally get to Daniel McBride?

Whereupon,

DANIEL S. McBRIDE,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated and tell us your name and spell your last name for the hearing reporter.

THE WITNESS: My name is Daniel S. McBride, M-C-B-R-I-D-E

THE JUDGE: Mr. Vetne, this statement has been marked as Exhibit 52.

[Whereupon, Exhibit No. 52 was marked

for identification by the judge.]

THE JUDGE: Mr. McBride, you have a statement here. Are you prepared to read it into the record?

THE WITNESS: Yes, I am

THE JUDGE: Please do so.

STATEMENT FOR THE RECORD OF DANIEL MCBRIDE

THE WITNESS: My name is Daniel S. McBride. I am testifying today on behalf of Northwest Dairy Association, which is usually referred to as NDA. My title is Director of Milk Pricing and Producer Programs for NDA. I'm responsible for coordinating all types of matters pertaining to Federal orders, and have done so since leaving the Market Administrator's Office to join the NDA staff in 1986.

Northwest Dairy Association is a cooperative marketing the milk of approximately 640 dairy farmers in Oregon, Washington, Idaho and California.

Approximately 520 of our producer members are part of the Pacific Northwest Federal Milk Marketing Order No. 124. And approximately 120 producers are located in the unregulated area of Eastern Oregon and Southwest Idaho.

Northwest Dairy Association conducts all processing and marketing operations through a subsidiary known as West Farm Foods. West Farm Foods is a fluid milk processor in the Northwest region. West Farm Foods operates three Class I processing plants in Order 124 (Seattle, Washington; and Portland, and Medford, in Oregon) and one is Boise, Idaho. West Farm Foods operates four dried milk product plants located in Lynden and Chehalis, Washington, and Caldwell and Jerome, Idaho. West Farm Foods also operates a cheese/whey plant in Sunnyside, Washington, and a butter plant in Issaquah, Washington.

NDA would like to thank USDA for their timely response to the hearing request by Agri-Mark and others. We appreciate the opportunity to address the important issues of updating Federal order manufacturing allowances at this hearing.

I am testifying on behalf of NDA in support of Agri-Mark's proposal to update the manufacturing costs surveys used to determine the Federal order Manufacturing Allowances. These cost updates are needed in order to allow Class III and IV manufacturing plants to effectively operate under the current market conditions. Both Agri-Mark and Land O'Lakes have provided a thorough background on how the class prices are determined and have outlined a specific proposal to address these concerns. NDA is in agreement with both of them.

NDA also supports the Agri-Mark proposal because of the simple, logical approach it provides to updating processing costs. No changes are being made to the manufacturing formulas other than the adjustment to change and costs. By completing new surveys, all cost changes are captured, including any improved efficiencies within the plants.

As other supporters of the Agri-Mark proposal have noted, the "circular" impact of NASS price reporting allows manufacturers of nonfat dry milk, fresh cheddar cheese, and whey few, if any, options to increase margins through higher product prices. As described by both the Agri-Mark and Land O'Lakes testimony, the NASS survey collects product price adjustments for energy and includes that information in the published NASS price survey. But since the manufacturing allowances have not been adjusted for the increased cost of such inputs as energy, labor and packaging, processors of these products have been left with the tab for increased production costs. Adjusting manufacturing allowances to reflect more current costs provides a logical way to assure plant margins are not so severely impacted by dramatic short-term or even longer-term changes in production costs.

We find the results of the RBCS and CDFA surveys to be consistent with our own. While NDA provided data on six plants for the 2004 survey, we did not participate in the 1998 survey. There have been fairly significant changes in the product mix in many of our plants since that time and it is difficult to provide direct comparisons. However, we believe our cost increases are in line with the changes noted in the CDFA and RBCS surveys.

NDA agrees that balancing costs need to be considered when determining make costs, particularly in Class IV plants. We believe the proposal details outlined by Agri-Mark and Land O'Lakes help address that need. We also agree with the Land O'Lakes testimony outlining the challenges with balancing, and we support their recommendations. Our results from the 2004 RBCS survey show that our nonfat dry milk processing costs are from 2 to 5 cents higher per pound of nonfat dry milk in plants we use to balance the market, compared to our Class IV plant with the highest capacity utilization rate. And even that plant is far from a hundred percent utilization.

The West Farm Foods Director of Manufacturing for the Ingredients Division, Scott Burleson, provided testimony on the different costs involved in processing whey and nonfat dry milk. I would like to discuss a different aspect of the whey costing issue related to our whey processing costs. When we calculated our whey costs for the RBCS survey of our Sunnyside plant, we did not adjust our costs to reflect the purchase of a significant amount of condensed whey form another cheese manufacturer. Those costs are significant, and we would like to outline them now. In our Sunnyside cheese/whey plant, about 22.5 percent of our processed whey is received as condensed whey from another plant. That whey is condensed off-site to about 20 percent solids and transported to Sunnyside where it is further condensed and dried. Of course, those costs are part of our total whey drying costs, and should have been included in our whey costing. That cost is outlined in the table below.

And I'll talk to the table here. The table outlines the additional whey drying cost on our operation that results from this outside whey source, based on the RBCS average condensing costs, and our known transportation costs. While the plant that condenses this whey is part of the RBCS survey, we do not know their condensing cost, so we are using the average cost of 6.72 cents per pound solids for a proxy in this example. The load rate is based on a cost of $1 per minute while loading. The haul rate is the actual movement cost between the two plants. The additional processing costs on this whey totals 8.75 cents. When the cost incurred on the 22.5 percent of our whey intake is spread across all of the whey processed at our Sunnyside plant, the cost increase equals an additional 1.969 cents per pound of all whey processed.

NDA supports the adjustment of the 2004 survey costs to reflect the 2005 energy costs, and also supports the use of indexed energy costs to adjust manufacturing allowances based on changes in the cost of natural gas and electricity. The National Milk Producers Federation (NMPF) will be providing testimony that outlines an indexing system for fuel costs that will allow manufacturing costs to be adjusted, depending on changes in these costs. We have reviewed the NMPF proposal and support the energy adjusters as a good way to keep manufacturing cost estimates up to date. We believe adopting such a program now will both protect processors from future spikes, and producers from drops in energy costs.

While we support the NMPF proposal on using energy adjusters, we must emphasize that the current plant cost situation requires immediate relief. There are simply no ways at this time to manage the higher energy costs we are now experiencing at our plants. We support the request of Agri-Mark and others for the Secretary to release an interim final decision using the most recent survey data, adjusted for 2005 energy costs, and, if deemed necessary, to provide for a more thorough comment and review period on the energy adjusters proposed by NMPF.

The issue of increasing make allowances is not an easy one for NDA or any farmer-owned cooperative to address. Updating allowances to reflect current costs has significant impacts on producer prices. USDA's analysis shows those net impacts to be significant to producers, but less than the actual change in the regulated milk prices. This issue has been discussed at both the NDA Board of Directors meetings and at our producer meetings for some time. Our board of directors are producers. Our January producer newsletter announced our participation in this specific hearing to our membership. Our membership understands the importance of having make allowances that allow for the cooperative to cover our own costs and protect their huge investment in our manufacturing plants.

NDA supports the adoption of

Agri-Mark's proposal on an emergency basis, without a recommended decision, in order to protect the solvency of the manufacturing base that participates in the Federal order system. The tight world fuel supply/demand situation and other steadily increasing costs have left most industries exposed to higher costs. The "circular" effect of the NASS product price survey provides little, if any, opportunity to address increased cost through product price adjustments. Issuance of a tentative final decision in a timely fashion is necessary to protect the assets of our Federal order manufacturing plants.

Again, NDA would like to thank USDA for their rapid response to industry requests for this hearing. We look forward to a timely decision that addresses the needs of our industry. Thank you

THE JUDGE: Mr. Rosenbaum.

EXAMINATION

BY MR. ROSENBAUM:

Q. Good afternoon, Mr. McBride. Steve Rosenbaum for the National Cheese Institute. I just -- because there are a lot of numbers that have been provided by various witnesses, I want to be clear how some of your testimony fits in.

A. Okay.

Q. And I want to particularly focus on the information you gave on pages 3 and 4 regarding whey costs.

Now, you are aware that Agri-Mark's proposal is one under which the whey costs would be set based upon the nonfat dry milk make allowance plus an adjustment, correct?

A. Yes, that's the proposal.

Q. And you are aware that part of the reason for that proposal was concern by Agri-Mark whether the RBCS study had actually properly captured the true cost to make -- make costs per whey, correct?

A. Yes.

Q. And there is quite a disparity between the survey price that California produced for whey compared to the RBCS survey, correct?

A. Yes.

Q. All right. Now, the information you are providing here on pages 3 and 4 go in part to the question whether some costs have in fact not been captured by the RBCS survey data for dry whey's make cost, is that correct?

A. That is correct.

Q. And if I understand what you are testifying to here, the point is that when you look at a drying operation, some of that whey often has been brought in in condensed form, correct?

A. Yes. And although Dr. Ling surveyed some plants that condense whey and some plants that dry whey, what was missing was the cost incurred if you transport the condensed whey to the dry whey plant, correct?

A. Yes.

Q. And that's what you are capturing for us here, correct?

A. Yes.

Q. And so again, the bottom line is you have calculated that -- that in order to capture that cost -- and that's a real cost you have to incur, correct?

A. Somebody has to incur the transportation cost along with the condensing cost, yes. And when we saw Dr. Ling's survey we were, you know, sort of miffed by the numbers, too. So we started looking at our own numbers and found out, you know, we had missed that portion of the -- of our costs.

Q. I see. So you had missed both the transportation costs and other costs as well, correct?

A. Yes. We didn't -- there was no -- well, I think we did what we were told, but there are additional costs that are, you know, being borne by -- to condense that whey.

Q. All right. And -- okay. And the bottom line is -- what is the bottom line in terms of the increased cost?

A. The increased cost in our survey would have been indicia 1.969 cents per pound of whey at our Sunnyside facility.

Q. Thanks very much

THE JUDGE: Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. Mr. McBride, you responded to Mr. Rosenbaum's question and said you did what you were told. Almost. You did not, however, whether you understood what you were told or not, you did not include in the data provided to Dr. Ling, you did not attribute any condensing costs to the concentrated whey that you received from an outside source?

A. That is correct.

Q. And apparently some of the other plans did. So you did it differently?

A. Okay.

Q. You don't know what the other plants did. At least you did not?

A. We did not.

Q. And Dr. Ling testified that he assumed that you did?

A. Yes.

Q. And the loading and transport costs that you included here are not items that were included in any part of Dr. Ling's testimony where whey is transported from point A to point B?

A. Correct.

Q. But you believe they should be?

A. I think that's part of the cost.

Q. For those plants that do not process

their own whey, they have that cost?

A. Yes.

MR. VETNE: Thank you

THE JUDGE: Mr. Schad.

EXAMINATION

BY MR. SCHAD:

Q. Good afternoon, Dan. Dennis Schad, Land O'Lakes. A couple questions.

Were you in the room when I spoke to the representative from Michigan milk about the concept of inventory risk for entities that balance the market?

A. I believe so, yes.

Q. Would you like to comment on whether Northwest experiences such a phenomenon?

A. Yes, we do. When we get milk, as an example, over the holiday season, our plants get, you know, pretty full, especially our balancing plants, over that three- or four-day period or couple weeks. And when the price does change, then we are impacted additionally, by the way, of trying to sell lower -- sell those products at lower prices than what we had to purchase the milk at.

Q. If indeed that did happen during the reporting period for the Ling survey, would those costs be included in the Ling survey?

A. Those costs?

Q. Those costs that you speak about with the inventory.

A. I'm not sure of the --

Q. Well, for the Ling survey, did you report operating costs?

A. Yes, we did.

Q. And would this selling risk and the cost of business be reported in a paper that would report operating costs?

A. Yes.

Q. Yes?

A. Well, if you could repeat the question.

Q. We are discussing what we are

calling inventory risk. And as you described it, that during periods when your plants are balancing the market, you often buy milk at class prices. But when you sell the milk, when you sell the finished product later, you sell it for a price lower than what should have been the price, given the class prices that you bought the milk for?

A. Yes.

Q. And we define that as a loss. And my question was, would those losses be included on the operating cost survey which would be included on the Ling survey?

A. No.

Q. The next question is, does NDA buy and sell cream?

A. Yes, we do.

Q. Could you tell me the terms of those transactions?

A. I know we are buying, so basically on multipliers.

Q. Other witnesses have described it as a multiple of the butter price?

A. Butter price, yes.

Q. Do you buy cream on the market for your butter, to be used in butter?

A. We do buy some cream.

Q. Thank you

THE JUDGE: Other questions? Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Ben Yale of the Yale Law Office for Select Milk, Continental Dairy Products and the other organizations we have identified. Good afternoon.

A. Good afternoon.

Q. I want to follow up on some of Mr. Schad's questions here. I think maybe that would be a good place to start. We talked about the cream, and cream is bought and sold as a multiplier of the butter price, right?

A. Yes.
Q. And that's the CME price, right?
A. I believe we have got contracts that do -- you know, CME or other market prices.
Q. What are some of those other market prices?
A. They could be based on NASS, also.
Q. And that multiplier is negotiated, is it not?
A. Yes.
Q. And if cream is tight, the multiplier goes up. And if cream is long, the multiplier goes down, right?
A. Yes.
Q. Sometimes pretty close to one if it's really long. It hasn't happened for a while, but it can happen, right?
A. It could.
Q. So if there is a cost or a value to that cream or a cost, it reflects market conditions for cream in that particular

market, right?
A. Yes.
Q. And the terms of the sales of that cream, are they traditionally FOB the selling plant or the buying plant or is that also negotiated?
A. That's negotiated.
Q. And as an operator of a butter plant, the opportunity sometimes exists to sell the cream at a price higher than you can obtain than if you processed the cream into butter yourself, right?
A. At times.
Q. I want to move over to this issue of this inventory risk. And I think the example has been given the end of the year, holidays, plants are closed down, cows continue to produce the milk, and you have -- surplus milk goes into the powder plant, you dry the powder and now you have this inventory of powder, right?

A. Yes.

Q. What happens, then, when you sell that or a month or so later, the inventory price or the value of that product drops, how do you account for that? I think that's kind of the issue, right?

A. Right.

Q. Let's talk about that for a second. First off, in your plants how do you -- I mean, do you do an inventory of first in/first out?

A. I'm not sure what the plants do.

Q. And you are not familiar with the accounting of how they handle it?

A. That is correct.

Q. Now, the assumption in the question is that if you acquire the milk, say, in December, you would pay -- I think it's probably true that if the plant receives the milk in December, you are going to be paying or accounting to the pool at the December

Class IV price, right?
A. Correct.
Q. All right. But there is no obligation for you to sell the powder that particular month, right? I mean, you can sell it in December or you can sell it several months later, right?
A. Correct.
Q. So the assumption is that whenever you do sell it, the price will always be lower than the nonfat dry milk price was for the month of December that set that price? Is that always the case?
A. No.
Q. But it can sometimes -- later on it could be higher, right?
A. Could be, yes.
Q. And in fact one of the theoretical rewards of a butter-powder operation in terms of marketing is that you have the ability to hold the product until the market could

recover, to move it if that opportunity should occur, right?

A. At a cost.

Q. At a cost. Storage, right. There's the cost of money. I understand. And that's all part of the decision of when to sell and when to put it on the market, right?

A. Yes.

Q. Not unlike the farmer who decides when to sell the grain, he's got the cost of storing it and he's got to decide when he's got to move it and when to hold it, right?

A. Yes.

Q. Okay. But you have the ability, if milk is long in June, for example, and maybe powder is long at that time, you do have, I acknowledge, at a cost, to hold until sometime that that market recovers and then move the powder at a higher price than what your Class IV price was calculated, right?

A. If you can hold it. The markets

could be coming down and you still have to have to -- you have contracts to sell the products.

Q. Right. None of it's simple. I mean, there is no guarantee that you are going to take a risk or no guarantee that you're going to have a reward. There's no guarantee you are going to have inventory to sell or hold or anything. It just depends on a lot of factors, right?

A. Yes.

Q. In the decision or in the determination of the profitability of a powder plant, you -- at the end of the year, you -- or your fiscal year or whatever, you look at your total sales, right, that you sold for the year, and you subtract out the cost. And that determines whether you have a profit or loss for the year, right?

A. On that plant.

Q. On that plant. That's pretty

standard P&L accounting for businesses, right?

A. Yes.

Q. So if there is a cost associated with an inventory risk, as Mr. Schad's asked you the question, you would agree that there is also a potential inventory reward if markets go up after you have the product?

A. If the markets go up.

Q. Right. That value, as compared to the price that you paid for the raw milk, will not show up in the business until you do the end of the year and you look at the full accounting after the products are sold and you know what you paid for your product and your labor and all that, the make costs, right?

A. Okay.

Q. Do you agree with that?

A. [The witness nodded.]

Q. Okay.

Now, how can you, if that is based -- that's based on a much longer term thing than a month-to-month situation, right?

A. Yes.

Q. And have you been asked to determine what an inventory risk is for a long term, for a year in your plant?

A. I have not.

Q. Okay. But in the Charlie Ling study -- well, let's go back. You said that at a cost, you could hold that cost. What are those costs?

A. You have cost of storage. You might have some off-site cost of money.

Q. Okay. And are those costs included in the information you reported to Ling?

A. I don't believe so.

Q. Is the income positive or negative over your costs of selling that powder reported to NASS?

A. Yes.

Q. But for the month in which you paid for the milk?

A. The NASS is -- well, during the month, yes.

Q. The month that it was sold, right?

A. Right.

Q. Which isn't necessarily the month in which you acquired the milk?

A. That is correct.

Q. So there could be a difference between the value of the powder that was used to set the price of milk for that particular month from the value of the powder in the month in which it is sold, plus or minus?

A. Yes.

Q. And that is not reflected in the make allowances, right?

A. That difference in the prices?

Q. Right.

A. That is right.

Q. And it is not reflected in the NASS

price for the month in which the milk was purchased?

A. Reflected in the NASS when the product is sold.

Q. While we are talking about the NASS, I want to move to another issue. Do you report sales to NASS, does NDA?

A. Yes, we do.

Q. What products do you report?

A. Butter powder, cheese, whey.

Q. That is a voluntary decision on the part of NDA?

A. Yes, and we -- we have been reporting.

Q. You have indicated that you have discussed this fully with your membership and with your board, which every good co-op should do. I congratulate you on doing that. Do you have a program right now where, on your check, you are doing a reblend, called a Federal make allowance adjustment or make allowance adjustment?

A. We do.

Q. How much is that?

A. Five cents.

Q. And in your presentation to your members that you talked about this upcoming hearing to the board, was there any promise made that if this is adopted, that that reblend would be removed?

A. I don't know if there was a promise.

Q. There was a hope?

A. There was a hope on some parts.

Q. And when there was an explanation to producers, was there an explanation that there would also be a reduction in the price at which milk is sold to other handlers?

A. The issues that we had with producers focused on the -- you know, on the changes in the plants, plant costs.

Q. West Farm has quite a group of plants, bottling and manufacturing?

A. [The witness nodded.]

Q. And does NDA sell milk to any processors other than its West Farm plant?

A. Yes, we do.

Q. Does that include cheese plants or powder plants or butter plants?

A. Cheese plants.

Q. Is that -- are those long-term or regular agreements or are those spot agreements?

A. Both.

Q. Is there a consistent amount, though, on a regular basis?

A. Yes.

Q. And are those contracted above, at or below the Class III price?

A. Some are above, and most are below.

Q. But you sell the milk for them?

A. I'm thinking of our -- the Idaho -- the plant in Idaho where we sell the -- the cheese plants.

Q. Because there is no Class III minimum price in that market?

A. There is no Federal order.

Q. Right.

Now, in the middle of page 2, you indicate this circularity of price, that you report the price, and if you raise the price because of the formula, it automatically in an equal amount increases the cost that the plant has to pay for the milk. Do you recall that?

A. Yes.

Q. I want to talk a moment about cheese, okay. Do you make things other than cheddar cheese?

A. We make a little bit of Monterey Jack.

Q. Another American-style cheese?

A. [The witness nodded.]

Q. Is all of your cheddar what we call the commodity cheddar or is it sold in any

other specialty type cheese?
A. It is all commodity cheese.
Q. Are you familiar with "Dairy Market News"?
A. Yes.
Q. And that it has a report of the cheese markets on a weekly basis?
A. Yes.
Q. And I think we have had admitted as exhibit No. 17 one issue of "Dairy Market News." And in that, it has the -- and I'll report this. If you want to see the exhibit, I'll be happy to do that, although I think we can do it simply -- it reports for the West, for December, an average 40-pound block being sold at $1.72 per pound, and the final NASS commodity prices for cheese for December was $1.3964 per pound. That would suggest, would it not, that there is a significant amount of cheddar sold above the NASS and it is not reflected in the NASS price, would it not?

A. I don't know how that "Dairy Market News," what prices those -- if that's the high or --

Q. Now, you also testified, Mr. McBride, that you think it is important that the manufacturing prices reflect balancing costs. What do you mean by that term, by that expression?

A. Well, we have two plants, the plant in Chehalis and one in Caldwell that basically will -- I'll refer to them as a balancing plant. During the week they will have, you know, very little milk. But on the weekends and holidays, they will be fairly full. So we have to have that capacity available.

Q. To balance the market which that milk is serving, right?

A. Yes.

Q. And that market is primarily the West Coast of Oregon and Washington and in that area, right?

A. Yes.

Q. You would agree, would you not, that the balancing needs -- you mentioned it varied based upon time of year, right?

A. Yes.

Q. And holidays?

A. Yes.

Q. And weekends?

A. Yes.

Q. And sometimes weather?

A. Yes.

Q. So it's a very variable situation, right?

A. Yes.

Q. Now, the seasonality of balancing varies from region of the country to region of the country, does it not?

A. It does.

Q. Both in terms of the timing and the extent, right?

A. Yes.
Q. Now, we all tend to share the same holidays, so we probably have some similarity there. But weather also can be a very local issue, right?
A. It can be.
Q. So you are aware, are you not, that the proposal that's before the Secretary here is to change make allowances that affect manufacturing plants throughout the country, right?
A. Yes.
Q. And if there are other markets that have -- in other regions who are paying their costs through other ways to balance their market, why should they have a reduction in their overall blend price to reflect your cost for balancing in your market?
A. Repeat that again.
Q. If you have producers in one region of the country who have addressed the

balancing of their market and are paying for the balancing of their market under current make allowances and current formulas to their satisfaction, why should they have to incur increased make allowances and therefore reduced producer income that reflects the costs of balancing -- the costs out of your plant in balancing your market?

A. Balancing is -- we are balancing, basically, the Class III and IV prices, I mean the markets, and that's what the -- that's what's going to do the balancing.

Q. Do you see cost of balancing as a factor in all of the manufacturing prices or only in the butter powder?

A. I think in all.

Q. Do you know how many cheese plants are already in the United States?

A. I do not.

Q. Do you how many cheese plants are balancing cheese plants in the United States?

A. I do not.

Q. Is it your understanding that proprietary cheese plants routinely balance the market?

A. I know there are some.

Q. There are some, but do they routinely balance the market?

A. I don't know.

Q. But that's primarily a role that cooperative plants have taken on, haven't they, to balance the market?

A. Yes.

Q. Part of the responsibility that cooperatives have taken in various markets to see that the needs of the markets are handled in an orderly fashion, right, through their plants?

A. Yes.

Q. Do you know what the balancing cost is? You say you have got 2 to 5 cents for the Class IV plants. Do you know what the balancing cost would be added to for the Class III plants?

A. No, we did an analysis -- we did the comparison of our -- of our two balancing plants.

Q. The one that's running full and the one that's not running full?

A. Right.

Q. Do you know if anybody is going to provide that information?

A. I do not know.

Q. Now, in the RBCS study on -- let me back up and start it a different way. Not all cheese plants process their whey, right?

A. Correct.

Q. Some of them dispose of it, land application or however they can lawfully do so, right?

A. Yes.

Q. In the RBCS study, is there a provision for the cost of -- dealing with --

the cost of dealing with whey disposal, is that included in the RBCS study?

A. I don't believe so.

Q. Now, NDA participated in the hearing in 2000, did it not?

A. We did.

Q. Have you done a comparison between the cost of NDA today as part of the study that your presented in 2004 with your cost that existed in 1999 or 2000, at the time of that hearing?

A. We did not.

Q. Now, when the final, final, final decision came down on these make allowances after the hearing in 2000, NDA didn't agree with those numbers, did it, the one that we are working with today? You objected to the numbers that we are working with today at that time, is that right?

A. I remember something like that.

Q. And a lawsuit was filed, was it not,

to try to stop their implementation?

A. I believe so.

Q. And how different are the prices today from the prices that were -- I think that was 2002. Do you know what the differences are?

A. I do not.

MR. YALE: I don't have any other questions. Thank you

THE JUDGE: Other questions? Mr. Schaefer.

EXAMINATION

BY MR. SCHAEFER:

Q. Henry Schaefer, USDA Dairy Programs.

In your testimony, Dan, you indicated that you agree with both Agri-Mark's and the process that Land O'Lakes, Dennis Schad, put in the record for computing the make allowances?

A. Yes.

Q. And then you also included a table

showing a variation in whey processing costs based on the condensing and transportation of whey that has to move between plants to be processed further --

A. Yes.

Q. -- on Table 3?

Did you intend to then add that 1.969 cents to the calculations that Mr. Wellington and Mr. Schad had for dry whey, or did you just include those numbers as an example or an illustration of what those cost differences may be for further consideration?

A. We showed -- the 1.969 is what the increase would have been in the information that we supplied to Dr. Ling's study. And then we also -- then the 8.75 is what we -- we just, you know, estimated what the cost of condensing and -- what the cost of condensing and transportation would be, in this case, on the milk that we -- on the whey that we received.

Q. So you did not intend for that necessarily to be added on to their numbers but more as an example of what you -- that you did not include with Dr. Ling's work? And so, you would agree with the -- an addition of the amount that Mr. Wellington added on to the nonfat dry milk number to arrive at a dry whey cost number?

A. That is correct.

Q. Thank you

THE JUDGE: Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. We will hopefully soon understand the bottom of Table 3 of your testimony. The line showing estimated condensing costs which ends up to be 6.72 cents per pound for whey solids, that 6.72 cents comes from the RBCS average?

A. Yes.

Q. And although you didn't do it, this

is -- this is your proxy for the condensing costs of milk that you received from an outside source?

A. That is correct.

Q. That would be -- are you able to the identify the outside source?

A. Yes, it is the Tillamook plant there in Boardman.

Q. So you receive whey from Tillamook. And they have a condensing cost. And Dr. Ling asked you to include condensing costs for all of the whey solids that you convert to whey powder, correct?

A. Correct.

Q. But this part, which is about a quarter or so of your whey, you forget to include those condensing costs in the data reported to Dr. Ling?

A. That is correct.

Q. So Dr. Ling's calculation of whey understates by whatever percentage your whey product is of the total?

A. Yes.

Q. And additionally, nowhere in Dr. Ling's survey is the cost of loading and transporting condensed whey from a cheese plant to the ultimate whey processing plant?

A. Right.

Q. And you believe that also ought to be included as part of the whey disposal --

A. Well, yes, it is a cost.

Q. Either you do it yourself or you transport it some place else?

A. Yes.

Q. And if whey were being separately processed at the two plants, both plants would do so less efficiently, probably?

A. Correct.

Q. Mr. Yale asked you a question whether you supplied milk to other cheese and powder plants, other manufacturing plants. Your answer was yes. Do you also supply milk to fluid plants that are not part of the NDA system --

A. We do.

Q. -- other fluid customers?

Are you able to estimate what percentage of the NDA milk supply goes to Class I and II plants?

A. About 25 percent.

Q. And Mr. Yale refers to a reblend line item of 5 cents for make allowance. That's applied across the board to all your milk, not just to the producers' milk that is delivered to the manufacturing --

A. That is applied to the producers in the Pacific Northwest.

Q. To the NDA producers in the Pacific Northwest?

A. Yes.

Q. Whether their milk goes to Class I or Class III or IV or whatever?

A. Correct.

Q. If you take -- if you add back the 5 cents, what would that do to your pay price in relation to the statistical blend price?

A. If we added the five, it would then be the -- we would be paying the blend price.

Q. You would be paying the blend?

A. Yes.

Q. Okay. Thank you.

THE JUDGE: Mr. Rastgoufard.

EXAMINATION

BY MR. RASTGOUFARD:

Q. Good afternoon. Babak Rastgoufard, USDA Office of General Counsel.

In your statement you provide or state support for the National Milk Producers Federation proposal, forthcoming proposal. Since there is no proposal yet in the record, can you for the record just state your understanding of that proposal, basically?

A. Basically, to index the energy, electricity and gas.

Q. Based on your understanding of the proposal that you support, does it provide a basis for how such an indexing should be done?

A. Yes. I believe it does, yes.

Q. Are you capable of elaborating on that?

A. No, I'll let them do that.

Q. Thank you

THE JUDGE: Other questions of this witness?

Very well, Mr. McBride you may step down.

I would like to exercise my privilege at this time to declare a 15-minute recess, and then let's see how we should proceed.

[Whereupon the hearing recessed at 5:01 p.m. and reconvened at 5:17 p.m.]

THE JUDGE: Back on the record.

This statement has been marked as 53.

[Whereupon, Exhibit No. 53 was marked

for identification by the reporter.]

MR. ROSENBAUM: Your Honor, Steve Rosenbaum. The next witness is Russ DeKruyf

THE JUDGE: Very well.

Whereupon,

RUSS DeKRUYF,

having been first sworn by the judge, was examined and testified under oath as follows.

MR. ROSENBAUM: Do you have a prepared statement, Mr. DeKruyf?

THE WITNESS: I do

THE JUDGE: Tell us your name and then spell your last name for us, please.

THE WITNESS: My name is Russ DeKruyf. The last name is spelled D-E-K-R-U-Y-F.

MR. ROSENBAUM: And you have a prepared statement. Could you please read it for us?

STATEMENT FOR THE RECORD OF RUSS DEKRUYF

THE WITNESS: Good evening. I'm Russ

DeKruyf representing Glanbia Foods, Inc., based out of Twin Falls, Idaho. I have worked for Glanbia Foods since March of 1996 and have held the position of Milk Procurement Manager since October of 2004.

Glanbia Foods operates two cheese plants in Idaho. Our Twin Falls plant processes 2.5 million pounds of milk per day into 40-pound blocks and our Gooding plant processes 7.5 million pounds of milk per day into 500-pound barrels. Glanbia also operates whey processing facilities at Gooding and in Richfield, Idaho, where a variety of whey, whey protein, lactose and whey mineral products are produced. We are also a member of the National Cheese Institute.

As Idaho has no Federal Milk Marketing Order, all of our milk is is unregulated. Although we are not regulated we still purchase a portion of our milk on a

Class III basis so the proposed changes to Class III and Class IV make allowances are relevant to Glanbia.

We fully support this proposed change to the Class III and Class IV make allowances outlined by the testimony of Dr. Robert Yonkers, and I'm familiar with his testimony. We fully support Proposal 1 as submitted by Agri-Mark.

We have seen significant manufacturing cost increases in our cheese and whey plants in the last few years and a sharp increase in some areas over the last 12 to 18 months. When we look back at cost comparisons between 1999 and 2005 we have some difficulties in comparing cost. We were not the same company we were back in 1999. We have gone through plant expansion, management changes, system upgrades and even a company name change (we were formerly Avonmore West, Inc.). But there are some key cost elements in the production of cheese and whey products that are still required in the manufacturing process today as they were back in 1999. I will outline some of those costs we can use for comparison purposes.

Energy: The size and scale of our plants dictate that we watch our energy costs very closely because we are a significant energy user. Electricity rates in Idaho have increased at our plants 34 percent from 1999 to 2005. A much larger increase was absorbed in natural gas. Natural gas increased a whopping 370 percent from 1999 to 2005. We sell a portion of our cheese on a delivered price basis and therefore need to absorb the price of diesel fuel increases. From 1999 to 2005 our costs for diesel fuel have increased 111 percent.

Labor: Idaho has enjoyed sustained very low unemployment rates over the past several years which translates into more competition and wage inflation for the existing labor pool. Our factory labor rate has increased 44 percent from 1999 to 2005.

Health insurance: As an employee of Glanbia I am thankful for a solid family health insurance plan that is provided to all full-time employees as a benefit. We all know that costs of providing this benefit has increased dramatically and Glanbia's health insurance costs have increased 90 percent from 1999 to 2005 even after making some plan design changes in an attempt to keep these costs under control.

Packaging/Cleaning materials: Plastic liners have increased mostly due to increases in resin prices. 40-pound box liners have increased 11 percent and 500-pound barrel liners have increased 8 percent from 1999 to 2005. Cleaning chemicals used in our production facilities have increased from 7 to 27 percent from 1999 to 2005.

From the examples outlined above, I hope everyone can see that manufacturing costs have increased significantly thereby impacting our cheese margins. Due to the significant increase in costs to operate our cheese plants, the time to implement the make allowance increases to Class III and Class IV milk is long overdue. We support making adjustments in the Class III and Class IV make allowances and would ask that the USDA act quickly to correct the make allowance problem.

MR. ROSENBAUM: Your Honor, at this point I would ask that Exhibit 53 be admitted into evidence

THE JUDGE: So admitted.

[Whereupon, Exhibit No. 53 was received in evidence.]

MR. ROSENBAUM: And the witness is available for cross-examination

THE JUDGE: Questions of this witness?

Very well. You may step down.

[Whereupon, Exhibit No. 54 was marked for identification by the judge.]

Whereupon,

PATRICIA STROUP,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated and tell us your name and spell your last name for us.

THE WITNESS: My name is Patricia Stroup, S-T-R-O-U-P

THE JUDGE: Mr. Rosenbaum, her statement has been marked as No. 54.

EXAMINATION

BY MR. ROSENBAUM:

Q. Do you have a prepared statement for us today, Ms. Stroup?

A. I do.

Q. Could you please read it into the

record.

A. Sure.

STATEMENT FOR THE RECORD OF PATRICIA STROUP

My name is Patricia Stroup. I am the Director of Dairy Policy and Producer Services of Hilmar Cheese Company, Inc., whom I represent today at this hearing. In my role at Hilmar, I am responsible for milk and milk ingredients procurement from individual dairy farms, cooperatives and proprietary handlers. I have been with Hilmar Cheese since 1997. Prior to that, I held positions with Maryland and Virginia Milk Producers Cooperative in Reston, Virginia, and Eastern Milk Producers/Milk Marketing, Inc., in Syracuse, New York, and Cleveland, Ohio, and was a dairy producer --

THE JUDGE: Ms. Stroup, just a little slower.

THE WITNESS: It's getting close to dinnertime -- in Syracuse, New York, and

Cleveland, Ohio, and was a dairy producer, myself, in Pennsylvania. I hold an M.B.A. from Purdue University and an undergraduate degree with a cognate in Dairy Science from Virginia Tech. I developed this testimony in cooperation with Hilmar Cheese Company staff and present it today with authorization from the Chief Executive Officer and owners of Hilmar Cheese Company.

Hilmar Cheese Company operates a cheese and whey products facility in Hilmar, California. This plant currently processes approximately 12 million pounds of milk per day in American-style cheeses such as cheddar and Monterey Jack. In addition to our California facility, Hilmar Cheese Company will be building another American-style cheese plant in Dalhart, Texas, with plans to begin operations in the fall of 2007. We plan for the Texas plant to eventually process 9.5 million pounds of milk per day.

As our Texas plant will fall under the purview of the Federal Milk Marketing Order system, we are keenly aware of the effect of Federal order pricing on our entire company. I testify in support of Agri-Mark's Proposal No. 1 and the National Cheese Institute's position. In addition, we urge USDA to issue and implement an expedited final decision. While we agree that there are other changes that should be made to the pricing formulas, those changes can be made through future hearings. It is critically important that manufacturing allowances be updated as soon as possible.

According to the recent CDFA cost study, the increase in cheese processing costs from the period that includes 1998 and 1999 to the period of 2004 is 4.5 percent. As Hilmar Cheese is a participant in the CDFA cost study, I am familiar with the process and believe that it is a sound one. I can verify that we saw increases similar to the average increase reported in the cost study. While our significant growth since 1998 was able to mitigate some of our increased cost on a cost-per-pound basis, we were still not able to overcome increases in costs with gains in efficiency. The major drivers of our cost increases from 1998 to 2005 include packaging (up 56 percent), supplies, which would be mainly chemicals, (up 11 percent), repairs and maintenance (up 113 percent) and water. All increases are on a cost per pound of cheese basis.

Hilmar Cheese Company cost increases from 2004, the period covered by the most recent CDFA manufacturing study, to 2005 have increased much more dramatically than in previous years. In this time period, our actual cheese production increased slightly, but costs per pound of cheese increased as well. In fact Hilmar Cheese Company's cost increase from 2004 to 2005 was more than the total increase in costs from the entire period from 1998 to 2004. Major drivers of cost increases since 2004 were utilities (up 32 percent), packaging and water expenses. Those increases were not reflected in the most recent CDFA data because that data does not cover 2005. For these reasons, we support updating the results of the cost studies using energy indices to bring the make allowance as up to date as possible.

Thank you for this opportunity to share Hilmar Cheese Company's position in this matter.

MR. ROSENBAUM: Thank you.

Your Honor, at this point I would like Exhibit 54 be admitted into evidence

THE JUDGE: So admitted.

[Whereupon, Exhibit No. 54 was received in evidence.]

MR. ROSENBAUM: And the witness is

available for cross-examination.

THE JUDGE: Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Ben Yale. Good afternoon. Good evening. Whatever it is

THE JUDGE: Dinnertime.

MR. YALE: Dinnertime.

Is that a hint that I should make it quick so that dinner can come?

BY MR. YALE:

Q. You indicate in your testimony that your Texas plant will fall under the purview of the Federal milk marketing order system. Is it your understanding that Hilmar intends to have that plant fully regulated?

A. That is an option that we are considering.

Q. But it is also true that Hilmar has, as any cheese plant in the country, the option of not participating in the marketing

-- the Federal order system?

A. That is correct.

Q. And it can negotiate at that point any price that it wants with its producers?

A. That is correct.

Q. And if it so negotiates with producers without having to pay that, it can reflect its make allowances or whatever it wants to into its pricing, right?

A. Whatever price it is that we pay would have to be competitive with the producer pay price in that area, which would include Class III pricing.

Q. And if the -- so then, what the -- ultimately, what a plant has to pay isn't necessarily just a function of what the make allowance is, but it is also a function of competitive forces with producer and supply and the marketing in the supply area, right?

A. True.

Q. Does the -- in your -- in

California, you are subject to minimum pricing under that order, right?

A. Correct.

Q. And that's for all the milk that you receive from producers, the market-grade milk that you receive at that plant, right?

A. Market grade, yes.

Q. Do you receive any Grade B or non-market milk?

A. Yes, we do.

Q. And those prices, you can negotiate independently with those producers without CDFA requiring a minimum price?

A. Correct.

Q. Approximately what percent of the milk you receive that's not market grade?

A. I don't know that answer.

Q. Now, the milk that you do receive at Hilmar -- first of all, you have some producers who are owners of Hilmar, right?

A. Yes.

Q. But not all the producers that supply your plant are members?

A. We don't have members.

Q. I mean, not members, owners?

A. Right.

Q. So I want to refer to just the producers who are not owners that supply your plant.

A. Right.

Q. Now, when you pay those producers, do you pay them just their respective quota and overbase or do pay them any money in excess of that?

A. We have a premium program which is independent of the regulated price. In other words, if the premium -- if the -- if our premium program or our pricing program is above the minimum price, we pay that. If it is below the minimum price, we have to pay the minimum price.

Q. And is that price based upon things

like quality or is it just an -- is it an over-order premium or --

A. It is the price of the cheese yield formula.

Q. So like a modified Van Slyke formula for --

A. Correct.

Q. And that has some kind of a butterfat recovery and a make allowance in its pricing?

A. Correct.

Q. And I think what you said is if it's over, then you pay that, and if it's under the minimum price, then by law you are required to pay the minimum price?

A. Right.

Q. Being Van Slyke, then the -- the component that comes in can largely reflect whether the producer is going to receive that price, right?

A. Exactly.

Q. So there may be like a Holstein producer may have difficulty, depending on what the formula is, but the -- well, if it's Van Slyke, he may have difficulty making anything above the minimum price, right?

A. Right.

Q. Generally speaking, in the last year, have producers been receiving more than the California minimum prices for overbase and quotas -- the market rate?

A. We have, generally speaking, yes.

Q. But there may be some producers that have not due to their component?

A. I'm sorry?

Q. You say generally. What -- the exception being?

A. Well, we have a -- they all receive more than a minimum price. We have a minimum that we guarantee.

Q. Okay.

A. Even to Holstein producers.

Q. So everybody -- so blue milk has value. That's what you are saying?

A. When it's all that's available, yes.

Q. Because Hilmar has been a big promoter of the Jersey milk, has it not?

A. I'll buy components however you get them to me.

Q. Okay. I have no other questions. Thank you

THE JUDGE: Other questions of this witness?

Thank you, ma'am. You may step down.

Mr. Rosenbaum, do you have another witness?

MR. ROSENBAUM: Your Honor, I think USDA had a couple witnesses. Maybe you could go with them

THE JUDGE: Very well. Ms. Deskins.

MS. DESKINS: I would like to call to the stand John Poole.

Whereupon,

JOHN POOLE,

having been first duly sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please tell us your name and spell your name for the hearing reporter.

THE WITNESS: My name is John Poole, P-O-O-L-E

THE JUDGE: Very well, Mr. Poole.

EXAMINATION

BY MS. DESKINS:

Q. Mr. Poole, could you please us what your current position is.

A. I'm an Assistant Market Administrator of Federal Order No. 1, the Northeast Marketing Area.

Q. Can you tell us what states the Northeast Marketing Order covers?

A. It covers New England, with the exception of Maine; New York; New Jersey, parts of Pennsylvania; Maryland; Delaware;

parts of Virginia, yes.

Q. Do part of your job duties include helping to contact people regarding hearings?

A. Yes. That function is handled out of the Albany office, which I'm in charge of.

Q. Can you tell us how you contact what's known as interested persons?

A. We do it by means of mailing and e-mails. We have an interested persons list that we send out, regular U.S. mail to them with hearing announcements or whatever is required.

Q. And in regards to this hearing, did you send such notice to interested persons?

A. Yes, we did. We sent a copy of the press release from the USDA along with a copy of the Federal Register hearing of notice.

Q. And do you happen to recall approximately when you would have done that?

A. It was done on January 5th, the day that it was published in the Federal

Register.

Q. Now, does the Milk Marketing Administrator's Office of the Northeast also maintain a web page?

A. Yes, we do.

Q. Is there anything on this web page regarding this hearing?

A. There was an announcement put on the web page the same day with a green marker on it denoting that it was new, and if someone was to click on that, they would go directly to the AMS web page, where all the information about the hearing notice was and all the documentation for it.

Q. Thank you. I have no further questions.

I do have one question.

For interested persons, if somebody moves and they don't contact you, is there any way you would know their new address?

A. Most of our mailings go out with

return address requests on it. If someone were to move and we didn't get that back, we would have no way of knowing.

Q. Thank you

THE JUDGE: Questions of this witness?

Mr. Vetne.

EXAMINATION

BY MR. VETNE:

Q. John Vetne, counsel for Agri-Mark.

Mr. Poole, Exhibit 36 -- and you might be familiar with it -- is a November 15, 2005, notice to interested persons telling interested persons that the Department would soon be noticing this hearing. Do you recognize that?

A. Yes, I do.

Q. Okay. And would that notice -- that particular notice to interested persons, could that have gone out the same way that your hearing notice went out on January 5?

A. Yes, it would have gone out in a similar fashion.
Q. And to the same people on the list?
A. Yes.
Q. And with respect to nonmember producers, are they on the list of interested persons?
A. No, they are not.
Q. Co-op representatives?
A. The list consists of our pool handlers, pool and non-pool handlers, cooperatives, attorneys, academia, state agencies, extension agents, consultants, county firms, the press and also any individual farmer who has requested to be put on the list. We do have a number of dairy farmers that are on the list.
Q. All somebody has to do is to write or call you and they are on the list?
A. Send us an e-mail, call, whatever.
Q. Okay. Thank you.

A. We -- on a regular basis, every couple of years, we also send out notices to our entire mailing list, which is all producers, and a very large list, well over 20,000 names, with what they are currently receiving from us and if they wish to be put on any other supplementary mailing list.

Q. And, actually, it's a put-up or shut-up letter. If you want to keep receiving something, let us know; otherwise, you are off the list. Right?

A. Yes, that is correct

THE JUDGE: Other questions?

Thank you, Mr. Poole. You may step down.

Ms. Deskins, is there another witness?

MS. DESKINS: No, that was my only witness.

THE JUDGE: Very well. Anybody else this evening? Mr. Rower?

MR. ROWER: No.

MR. ROSENBAUM: Give us one moment, Your Honor.

Your Honor, just to talk through, we have three more witnesses who we currently plan to call. Of course, as Your Honor knows, there is this issue about the scope of the hearing that could change things dramatically, but at this point we are assuming that the hearing is defined the way we think it is defined. We just have three more witnesses, and then I think beyond that there is only maybe three more as well.

We would -- we have Mr. Yonkers, Dr. Yonkers prepared to testify. He has a relatively -- he has about a 16-1/2 page statement. And he would logically be our next witness. We would be happy to have him come on at this point, but we would like to finish him if we are going to start him. And so, we are prepared to go forward in that fashion.

THE JUDGE: Mr. Yale.

MR. YALE: Well, Your Honor, the discussion, Your Honor, was we were going to bring some board members up that were kind of a quick, you know, witnesses and stuff, and that's fine, but this is a heavy.

And in all due respect -- I mean, not that Mr. Yonkers, or Dr. Yonkers, is heavy. He is properly proportioned. It is the -- I think the hour is starting to reflect in my conversation. But his testimony is terribly important, and I would prefer that we start that fresh.

It just -- it puts my client at a risk, I believe, at this late hour to do so. And that really wasn't kind of the discussion we had earlier.

MR. ROSENBAUM: One second, Your Honor.

All right, Your Honor, I think we

would be prepared just to start in the morning, then, under those circumstances

THE JUDGE: Mr. Beshore.

MR. BESHORE: Well, the caucus had decided we were going to go later this evening to try to clear the deck for Dr. Cryan in the morning. He's agreed to distribute his testimony this evening, make that available. Now we have gone about 15 minutes, and they don't want to put on any more witnesses. I think if we are here, let's go.

MR. ROSENBAUM: Well, Your Honor, I should make a point. We are prepared to go forward, but we think if Dr. Yonkers goes, he should put on his direct and be cross-examined tonight, and we are prepared to do that.

MS. DESKINS: Could we make a proposal that we could get Dr. Yonkers' statement tonight and also the proposal tonight, and it might speed things up in the morning?

MR. ROSENBAUM: Well, I think if we proceed with Dr. Yonkers, we would like to proceed in his entire --

MR. YALE: That's just too much. I might add, Your Honor, there is nothing to keep Dr. Cryan from being the first one on tomorrow even if we defer on Dr. Yonkers.

MR. ROSENBAUM: Your Honor, I'm going to propose a substitute witness instead that will not take as long as Dr. Yonkers, and we'll go forward with him. The testimony is on its way down. It will be here very shortly.

MR. VETNE: Your Honor, in order to conserve time -- are we still on the record?

THE JUDGE: We can go off the record if you wish.

MR. VETNE: No, I was hoping we would still be on. In order to conserve time, since Ted's testimony is being retrieved from the room, Mr. Gulden has a little bit of additional testimony which corresponds with a little bit of additional testimony of some prior witnesses. He presented a separate little piece supporting the anticipated proposal by National Milk to index the energy component of the make allowance

THE JUDGE: Well, let's take Mr. Gulden, then, while we are waiting.

This will be No. 55, Mr. Vetne.

[Whereupon, Exhibit No. 55 was marked for identification by the judge.]

Whereupon,

NEIL GULDEN,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Mr. Gulden, you are still under oath. Your new statement has been marked as Exhibit 55.

Mr. Vetne, do you want me to fill in

for you here?

MR. VETNE: No, I -- is he still under oath from last time?

THE JUDGE: He is still under oath.

EXAMINATION

BY MR. VETNE:

Q. You have prepared a statement to supplement your prior testimony concerning the issue of indexing variable future energy cost, correct?

A. Yes.

Q. Please proceed with your prepared statement.

STATEMENT FOR THE RECORD OF NEIL GULDEN

A. I am Neil Gulden. This is in support of indexing energy costs in Federal order make allowances.

I'm Neil Gulden, Director of Fluid Marketing for Associated Milk Producers, Inc. (AMPI).

We understand that National Milk

Producers Federation will be proposing the adoption of monthly indexing adjustments to the energy components of make allowances. It is also our understanding that the indexes used will be from the Bureau of Labor Statistics for Industrial Natural Gas and Industrial Electrical Power Distribution.

The greatest cost increase by far is for natural gas. The attached graph, Attachment 1, shows AMPI's percentage change in gas costs from the prior year for 2004 and 2005 compared to the BLS series WPU0553 percent change for Industrial Natural Gas. There are obvious monthly differences but on average in 2004 AMPI's percentage change was slightly less than BLS. In 2005 our change in cost was about 10 percentage points higher than the BLS. The BLS series appears to be a little conservative relative to our experience on gas cost change, but we believe it will represent a long-term big picture view of both gas and electrical cost changes across the country.

Most of the testimony at this hearing is focused on updating the make allowance cost for cheese, butter, nonfat dry milk and dry whey through 2004 by using RBCS and CDFA surveyed data. AMPI supports the use of the BLS series WPU0553 for fuels and the BLS series WPU0543 for electricity. These adjustments would be made to the energy cost portion of the make allowance of the commodities listed above, as determined by the Secretary, for use in calculating Class III and Class IV formula prices.

All energy costs, especially natural gas, have seen unprecedented increases in 2005, particularly in the months of September through December. Attachment 2 shows AMPI's average natural gas cost by month for 2004 and 2005. 2005 averaged 31 percent over 2004, but September through December averaged

65 percent over the same period in 2004.

The steep energy cost increases in late 2005 need to be included in any emergency decision. If including indexing in an emergency decision is somehow going to delay the process, we urge the Secretary to at least include some recognition of these tremendous 2005 cost increases. We would propose that at least the average annual percentage increases for 2004 to 2005 for the BLS series WPU0553 for industrial natural gas and the BLS series WPU0543 for industrial electricity be used in an emergency decision to adjust make allowances in Class III and Class IV formula prices.

If the BLS indexes are later included in a final decision and updated to the most current month, adjustments could be made for the fact that some increases had already be accounted for.

This concludes my statement, Your

Honor

THE JUDGE: Questions of this witness? Dr. Cryan.

EXAMINATION

BY DR. CRYAN:

Q. Roger Cryan, C-R-Y-A-N, with National Milk Producers.

Neil, do I understand that you support indexing -- energy cost indexing for make allowances provided they don't -- in any way that does not slow the immediate decision?

Let me restate that. Let me rephrase the question. Do you support energy cost indexes in a final rule if it does not slow down the interim rule?

A. I would prefer, as my statement reads, to have 2005 energy prices considered in the emergency decision.

Q. I understand that. But in terms of putting the regular indexing adjustments, ultimately you would support having that in the formula?

A. Ultimately I would support that in the final decision, yes.

Q. Thank you very much

THE JUDGE: Other questions? Ms. Deskins.

EXAMINATION

BY MS. DESKINS:

Q. I'm just trying to clarify what you are doing here. You are proposing something if a proposal comes in?

A. Yes, I am proposing, to my knowledge of what Mr. Cryan is going to testify to, like other witnesses, and I'm proposing to support indexing of energy costs.

Q. Okay. I'm just trying to understand this for the record. Are you supporting -- you apparently have seen some proposal. Are you supporting his proposal? Are you proposing a modification of that proposal if it comes in?

A. I am supporting the idea of energy indexing, for one thing.

Q. But you are not proposing it?

A. It would be -- no, you are right. You are right. I am not proposing that. I will leave that to Mr. Cryan to lay out the details of that.

Q. So if it comes in, then this testimony would be relevant to that proposal once it is submitted?

A. Yes. Yes, it would.

Q. Okay. I was just trying to understand. Thank you.

EXAMINATION

BY MR. VETNE:

Q. Just to clarify, your testimony related to two --

THE JUDGE: John Vetne.

BY MR. VETNE:

Q. -- to two related issues, Mr.

Gulden. One is that the emergency rule, if it can, include consideration of energy cost increases from the survey period in 2004 to 2005, and that has been proposed by Mr. Wellington, and you support that?

A. I do support that.

Q. And the other component of this testimony is that that same process ought to be incorporated in a rule that allows for variable energy costs to be indexed and that, to your understanding, will be proposed by Roger Cryan, and you support that?

A. That's my understanding

THE JUDGE: Other questions? Mr. Beshore.

MR. BESHORE: This is not -- it is preliminary to possible questions of Mr. Gulden, but I'm perplexed by Ms. Deskins' questions because I haven't heard any objections thus far in this hearing by anyone, proposed motions in limine or anything else, to energy costs. I think that the --

THE JUDGE: I believe you are correct.

MR. BESHORE: I think that issue should be understood to be part of the hearing.

MS. DESKINS: Well, the problem is no one's made a proposal. They are commenting on a proposal that may come in. So there is no proposal that's part of the record.

THE JUDGE: Yes, what he is saying is he anticipates it being done, and he is saying that he would be in favor of indexing the energy cost. I mean, that concept is understandable.

Other questions?

Mr. Rosenbaum, are your exhibits here yet?

MR. ROSENBAUM: Yes, we are ready, Your Honor.

THE COURT: Very well.

Thank you, Mr. Gulden. You may step down.

Whereupon,

MIKE McCULLY,

having been first sworn by the judge, was examined and testified under oath as follows

THE JUDGE: Please be seated and tell us your name and spell your name for the hearing reporter.

THE WITNESS: My name is Mike McCully. Last name, M-C-C-U-L-L-Y.

THE JUDGE: Mr. Rosenbaum, his statement will be marked as Exhibit 56.

[Whereupon, Exhibit No. 56 was marked for identification by the judge.]

MR. ROSENBAUM: Thank you, Your Honor. And he has provided another document which I have put on the table which we would like to have marked as well

THE JUDGE: Very well. It will be

Exhibit 57.

[Whereupon, Exhibit No. 57 was marked for identification by the judge.]

EXAMINATION

BY MR. ROSENBAUM:

Q. Mr. McCully, you have prepared a written statement which has been marked as Exhibit 56, I believe. Would you please read it in the record for us.

A. Thank you.

STATEMENT FOR THE RECORD OF MIKE MCCULLY

My name is Mike McCully, Associate Director of Dairy Procurement at Kraft Foods, and I'm testifying on their behalf. I have worked for Kraft over nine years and currently have responsibility for U.S. milk procurement, U.S. and global dairy market analysis and price forecasting, and U.S. dairy commodity risk management. Kraft is a member of the National Cheese Institute and the International Dairy Foods Association, and this testimony supports Agri-Mark's Proposal No. 1 and NCI's position. We also urge the Department to issue and implement a final decision and rule on an expedited basis. Kraft feels there are additional changes that need to be made to the milk price formulas, but they can be addressed in future hearings.

Kraft is both a manufacturer and purchaser of dairy products used in our retail and food-service business. Kraft has manufacturing facilities and buys milk in the following states: New York (Lowville, Campbell and Walton), Pennsylvania (Lehigh Valley), Wisconsin (Beaver Dam), Missouri (Springfield) Arkansas (Bentonville) Idaho (Rupert) and California (Tulare and Visalia). Kraft also has other facilities that receive dairy commodities (for example, cheese, cream and nonfat dry milk) for the production of products such as processed cheese, natural cuts and shreds, frozen pizzas, and macaroni and cheese. For these facilities, we procure cheese from California, Idaho, New Mexico, Colorado, South Dakota, Iowa, Wisconsin, Minnesota, Illinois, Michigan, New York and Vermont, as well as import cheese from New Zealand and Australia. Kraft has closed or sold many manufacturing plants over the last 25 years and relies increasingly on dairy products we purchase from others.

For the dairy industry to be successful long-term, there needs to be a profitable dairy farm sector as well as a profitable manufacturing sector. Unfortunately, with the adoption of current make allowances in April 2003, coupled with dramatically higher costs over the last several years, the manufacturing sector has suffered. Prior to 2000, Kraft was concerned the adoption of product formulas to price milk would lead to the very problems we've seen over the past few years. The issue we are discussing at this hearing specifically addresses the inability of manufacturers to cover increased costs through the sale of finished products. If manufacturers attempt to do this, the circularity of the formula results in milk cost increasing by the same amount, and thus not recouping their higher costs.

The current milk price formulas use manufacturing cost data from 1997 through 1999. Cost to dairy plants have increased, some dramatically, since that period as the following data provides. Referring to the California Department of Food and Agriculture's annual manufacturing cost studies -- and it lists out a website.

Do you want me to read that off or --

THE JUDGE: That's all right.

THE WITNESS: Okay.

The February 2000 study contained

costs from 1998 to '99 and is therefore a comparable time period to the manufacturing allowances used in the current Federal order formulas. From February of 2000 to the November 2005 study which contained 2004 data, the manufacturing costs increased for each commodity: Butter (+ .411 cents per pound or 43 percent), nonfat powder (+ .215 cents per pound or 16 percent), and cheese (+ .0076 per pound or 5 percent).

According to the Department of Energy --

THE JUDGE: If you would, just refer to the web page set forth on the written statement.

THE WITNESS: Okay, I'm going to refer to several web pages in the next paragraph. The first one, according to the Department of Energy, which is http://www.eia.doe.gov/emeu/aer/txt/stb0810.x is, the average retail of price electricity for industrial customers has increased from 4.4 cents per kilowatt hour, including taxes, in 1998 to 5.54 cents in 2005 (October year to date). This amounts to a gain of 1.60 cents or a 24 percent increase since 1998. Furthermore, the average price of natural gas for industrial users has increased from $3.14 per thousand cubic feet in 1998 to $8 in 2005 (October year to date).

Again, it references the web page. Do you want me to read it off?

THE JUDGE: That's okay.

THE WITNESS: Oh, okay. It's another Department of Energy website.

This amounts to a gain of $4.86 or an increase of 155 percent since 1998. Finally, looking at labor costs, the Bureau of Labor Statistics measures the cost of compensation per hour worked, again referring to the Bureau of Labor Statistics website. Using the broadest measure of all compensation for all civilians, it shows the cost per hour worked has increased from 19.76 cents in 1998 to $26.05 in the third quarter of 2005, a gain of $6.29 per hour or 32 percent. Clearly, these figures point to significant increases in the costs of energy and labor as well as the cost of manufacturing.

Moving from a macroeconomic to a microeconomic view, I would like to provide some data specific to whey manufacturing costs. While others will give their experience with whey drying costs, Kraft does manufacture both whey powder and nonfat dry milk powder at its California plants. At the May 2000 hearing Kraft noted consensus and testimony that it cost more to dry whey than to dry nonfat dry milk. This is due to lower solids in whey, more water to remove, and an additional manufacturing steps. We also testified that at that time, Kraft's Tulare, California, plant had whey make costs that were 2.6 cents per pound greater than the nonfat dry milk make costs at the Visalia, California plant. It was noted depreciation costs likely added to the whey make cost at Tulare, but the point was that the cost was higher, and this difference continues to exist. Kraft also manufactures whey powder at its Campbell, New York, plant. While data from 1997-99 wasn't available, the plant's cost of manufacturing whey powder has increased over 50 percent from 2000 to 2005.

In preparation for this hearing, we also looked at historical trends in specific costs such as electricity, energy and labor. Again, while data from 1997 to '99 wasn't available, I did acquire data from one of our cream cheese plants. From 2001 to 2004, electricity costs increased 21 percent; natural gas costs increased 27 percent; and labor costs increased 10 percent. These cost increases clearly point to a need to update the current make allowances.

With a nationwide network of manufacturing plants and suppliers, we continually analyze costs of internal manufacturing versus purchasing from an external source. One example of this analysis is the cheese plant we used to operate in Canton, New York, which made 640-pound cheddar blocks. On January 27, 2004, Kraft announced the closure of the Canton plant. Instead of making the cheese internally, Kraft would procure the cheese from other locations in the U.S., notably regions with a less onerous regulatory environment (for example, Idaho) or outside the Federal order system (for example, California). In the press release announcing the closure of the plant, we alluded to the unfavorable economics for continuing to operate the plant:

"As a small plant, Canton doesn't

benefit from economies of scale that could help lower overall costs and make it competitive with cheese plants elsewhere in the U.S. Plus, it lacks profitable means to process whey, a byproduct of cheesemaking."

In its last year of operation, the total cost of making cheese was 23 cents per pound, which is well above the make allowance in the USDA milk formula. We use this example to point out the inherent dangers of product formulas and make allowances that do not cover smaller, less efficient plants. Our experience has shown these types of plants are not competitive in the long run, and the industry risks losing a significant number of these plants if economic conditions do not improve.

Further highlighting the financial challenges faced by cheesemakers, Dr. Ed Jesse and Dr. Brian Gould from the University of Wisconsin published a paper in October of

2005 entitled, "Federal Order Product Price Formulas and Cheesemaker Margins: A Closer Look."

At this time I'll pause. This is the paper that was referred earlier today that is now Exhibit 57. This is the conclusion and summary, and this is the full paper that has been entered into the record.

BY MR. ROSENBAUM:

Q. As Exhibit 57, correct?

A. [The witness nodded.]

Q. Yes?

A. Correct.

In their summary conclusions they stated the following:

"This analysis points out several problems with using product price formulas to establish a value for milk used to make cheese. These problems stem from the fact that product price formulas do not and cannot replicate competitive conditions except, perhaps, coincidentally. In particular, competition would dictate cheesemakers gross margins rise and fall in response to changing costs. Formulas hold margins to a fixed amount that can only be changed through a laborious hearing process."

The paper also analyzed manufacturing costs and were summarized as follows:

Using readily available cost data and numerous assumptions, we simulated the impact of higher natural gas and electricity prices on the cost of manufacturing cheddar cheese along with associated dry whey and butter. We estimate that since 2003, energy costs per hundredweight of milk processed into cheese increased by more than one-third, adding about 13 cents per hundredweight to manufacturing costs.

Unless offset by higher product prices, correcting the flaws in product price formulas that we have noted would result in a lower Class III price. This raises the question of whether changes would inequitably alter the sharing of revenues between dairy farmers and cheesemakers. Put more directly, farmers can argue -- quite legitimately -- that since they receive no assurance of profitable milk prices under Federal orders, why should cheesemakers be treated any differently.

In response, we note that fixed cheesemakers margins made be fine if they assure reasonable profitability, promote efficiency and productivity growth, and encourage competition for cheese milk at prices above the Federal order minimum. On the other hand, fixed margins can be a serious problem if they consistently yield subpar returns and cause disinvestment in cheesemaking. Farmers and cheesemakers are partners -- both must be profitable over the long run to sustain a healthy dairy industry."

That's the end of that quote.

In summary, we feel all sectors of the dairy industry need to be profitable for its long-term success. Unfortunately, the make allowances put into place for 2003, and subsequent cost increases, have placed undue financial strains on the manufacturing sector. Therefore, we support the changes proposed by Agri-Mark and NCI's position. We feel there is a need for an expedited decision on this hearing, and request the Department issue and implement a final rule as soon as possible. I appreciate the opportunity to present Kraft's viewpoint on this issue, and welcome questions regarding my testimony. Thank you.

MR. ROSENBAUM: Your Honor, at this point I would move that Exhibits 56 and 57 be admitted into evidence.

MR. YALE: We will would object to

57, Your Honor.

THE JUDGE: I'll admit 56. Exhibit 57 will be admitted for the limited purpose of being a reference to the statement and not for the facts stated in that, and the Secretary may use it for whatever purposes he wishes.

[Whereupon, Exhibits No. 56 and 57 were received in evidence.]

MR. ROSENBAUM: Thank you, Your Honor. The witness is available for cross-examination

THE JUDGE: Yes, sir, Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. Good evening.

A. Good evening.

Q. You made a statement -- you do make the statement here about the circularity of the pricing?

A. Correct.

Q. Have you done a study to actually establish that there is circularity of pricing in the market?

A. Me personally, no.

Q. Are you aware of anybody who has done a study of the circularity?

A. I have seen several different ones, yes.

Q. Are these peer-reviewed studies or are these just people who have tried to analyze this without a peer review?

A. If you can define peer review as in university setting or --

Q. Yes, university setting.

A. I have seen those as well as private.

Q. Does -- Kraft does continue to manufacture some cheese, right?

A. Yes.

Q. And although it manufactures less cheese today than it did five years ago, right?

A. Hard cheese. We still have the same network, actually, probably more, on cream cheese and cottage cheese than some of the other cheeses.

Q. Does it produce any of the commodity cheddar that's reported to NASS?

A. Yes.

Q. What plants report that?

A. Tulare, California. It makes several styles of cheeses, and cheddar is one of them.

Q. And this is cheese that it then sells to other parties?

A. Let me take that back. On cheese, no. On whey and nonfat, yes, out of those plants. I'm sorry.

Q. When you make this comment about -- well, let me go back. You talk about -- what are the -- do you know the names of some of these studies on this circularity?

A. Off the top of my head, no. I think the one that I quoted from, the full report there addresses some of them in there as well.

Q. What percent of the total cheese market or cheese production in the United States -- let me withdraw that and start this over.

What percentage does the cheese reported to NASS represent of the total cheese marketed in the United States?

A. I used to know that number off the top of my head. I can't think of it right now.

Q. It's a small percentage of total cheese?

A. Yes, that would be safe to say, of total cheese.

Q. Of total cheese.

A. Yes, because it only captures cheddar.

Q. Right.
A. There are many other styles.
Q. Yet, the make allowances that we are talking about affect all styles of cheese?
A. Correct.
Q. Now, commodity cheese, the cheddar cheese that's reported to NASS, isn't it true that that represents among the lower-cost cheese, the cheddar cheese that's made available on the market, other than undergrades, but I mean in terms of cheddar that meets the standards?
A. I'll preface this by saying I'm not a cheesemaker and not that close to our cheese procurement to be able to answer with any real accuracy, but I would question if that's accurate. But I honestly don't know enough -- I know we buy hundreds of different cheese styles, and there are some that are above and below the standard price, the CME price.

Q. Which brings up my next point, is that the standard practice to sell cheese in the United States is the CME plus or minus the basis, is that correct?

A. Block or barrel, depending on style, yes.

Q. Right. And that price, the individuals can negotiate. There is no law that requires that they have any basis or a small basis or a large basis or anything, is that correct?

A. That is correct.

Q. Totally market driven?

A. That is correct.

Q. And this -- and there is also no requirement that they have to account for differences off of the CME in payments to producers, is it? It is not part of the formula?

A. For any certain style?

Q. For any certain style.

A. I guess I don't completely follow your question.

Q. Well, I mean, if I sell cheddar at my plant at CME plus a nickel, I don't have to account that nickel to my producers unless either minimum pricing or competitors' prices require me to pay something more than I want to, right?

A. If I follow your question, if you sell it for a nickel over the CME on cheddar, you would report 5 cents over to the NASS, but it would get back in the milk price.

Q. All right. Let's talk about -- first of all, let's talk about cheddar that is reported to NASS. The NASS, though, is a weighted average of all the cheese that is sold and reported to NASS, right?

A. For cheddar, correct.

Q. For cheddar. So unless my sale at plus the nickel represented the general market conditions throughout, I would not have to pass on that to my producers if the NASS average was much lower than that, right?

A. It is going to be included in the NASS average, I guess. I can't make the extrapolation to the milk price.

Q. But it won't be fully in the NASS, it will be weighted out by all the other sales?

A. That is correct.

Q. But if I'm selling a cheese, an aged cheese, for example, a cheddar, I don't report that to NASS, right?

A. If it is outside the window of what NASS is requesting, that's correct.

Q. And I sell that at CME plus or minus amount, I don't have to report that to NASS, right?

A. Yes.

Q. And it is not going to show up in the price that's used to compute the Class III price, correct?

A. Correct.
Q. So I then can -- if the market for cheese or the cheese I'm selling will bear it, I can in fact push my costs on to the marketplace?
A. Correct.
Q. That I do not have to share with producers, right?
A. Correct. And you could also, when the market is going the other, possibly lose that. So it's --
Q. That is right, because it's a market-driven factor. And that's even been the case with the M&W, there was that period of time when the cost to produce the cheese and what you were selling it, the competitive structure in Minnesota and Wisconsin was such you had to pay more than what you were -- you want to pay because of the your cost of make, right?
A. We sold and closed plants back then,

too.

Q. Right. That's a natural market dynamic that goes on, right? And it may be brutal to those that are on the short end, but it's a natural marketing dynamic with respect to cheese, just as it is in any other industry, right?

A. Correct.

Q. Now, let's take cheddar for a second, and let's talk about all the other cheese. Do you know what the percentage of cheeses are that are non-cheddar that are marketed, that are produced in the United States?

A. Cheddar cheese versus total, I think the non-cheddar is close to 50 percent.

Q. And that happens to be one of the growing areas, right, with the cheese?

A. Well, mozzarella, specifically --

Q. Right.

A. -- over the last 10 or 15 years has

been the growth, yes.
Q. But it wasn't that many years ago that it was the other way around?
A. Correct.
Q. So this 60 percent clearly is not reported to NASS, right?
A. That's true.
Q. And to the extent that a plant can negotiate a higher price to offset its energy or labor or packaging or whatever else, it does not have to give that to the producers if it doesn't want to, right?
A. That would be -- you could suppose that could happen.
Q. Now, there is also -- and I don't know how you would classify, but there is beginning to be a growing amount of nonstandard cheeses that are produced?
A. I have heard of those.
Q. And I don't know that Kraft makes those, so I'm not -- and there may be

somebody in the room that does, but we'll know. But those cheeses, sometimes some of them are called pizza cheeses or some other nonstandard name, right?

A. Correct.

Q. And would you still consider those as part of that total cheese production that you are mentioning is 60 percent as non-cheddar or is that another category that we --

A. That's probably a better question for -- I'm not intimately involved and do not have knowledge of how USDA collects data for cheese production, so I'm not --

Q. That's fair. But let's assume that it is.

A. I heard your assumption statement yesterday, so I don't think I want to do that.

Q. Half of it, I don't like. If is the pizza cheese, for example -- again, that's another cheese at which can be set at prices that don't have to be reflected back into the producers' formula, right?

A. In some respects. There still is a national marketplace for different cheeses, and you have to be competitive on milk price. So it's not quite --

Q. Not totally divorced, but it is not the mechanical -- but those dynamics -- let's back up.

That dynamic that that cheese in that marketplace, you know, and having -- selling pizza cheese does have, at some point, an effect on other cheeses because there's a demand for the milk, and it might affect the demand for some cheese availability and so on and so forth. That's just part of the dynamic of the marketplace for milk and cheese processing, right?

A. That would be a good way to put it, yes.

Q. All right. So there is no -- that's a natural thing, and that's something that the Federal order -- this margin does not affect, right? This fixed margin?

A. It does not affect?

Q. It does not affect directly?

A. I would say it directly affects everyone making or using Class III milk.

Q. It sets a minimum price for the milk?

A. Correct.

Q. Okay. But there is still the availability of the manufacturers of those cheese to choose to market cheeses that are not part of the NASS survey and sell that at a price that they can be more in control of their margin than that of the cheddar, right?

A. I'm not that -- that's an assumption I guess you could make. I don't know if I completely agree with it.

Q. Let's go another step. There's been

a lot of this -- I think we can agree in theory, can we not, that if you don't get enough return on investment in a given industry over a period of time it will die, right?

A. Correct.

Q. And when we look at the cheese industry today -- well, first of all, even in a healthy industry there are new entrants coming into the business, there are existing entrants that are consolidating with others, right, and there are some old ones that just go out for whatever reason, right?

A. Could be talking about cheese plants, dairy farmers, car factories.

Q. Right. Banks. Anything, right?

A. Correct.

Q. That's just the nature of a healthy industry, right?

A. [The witness nodded.]

Q. But the sign of an unhealthy

industry is when you don't see the new entrants and you see the losses and maybe consolidations, right, potentially?

A. Potentially.

Q. But wouldn't you agree that, in the last 5 to 10 years, that there has been a tremendous development of cheese capacity in the United States, new entrants into the business?

A. Tremendous would be a strong word, and it's also -- you also have to look at that regionally.

Q. All right. On a national basis, how would you describe the growth?

A. Growth west of the Mississippi, specifically the western states, and we can identify only about three of them.

Q. But they have been very large plants?

A. Absolutely.

Q. And then some that have been

announced as well, right?
A. Yes.
Q. And with their coming on, it either reflects the fact that others have gone out or others may go out in response to these plants coming out, right?
A. If you follow your logic trail of natural progression that very well could happen.
Q. Now, those types of plants represent a huge investment, do they not?
A. Very much so, yes.
Q. And you work for a large company. I'm sure you have been involved as they make large financial decisions, right?
A. Yes.
Q. And there's a thing called due diligence?
A. Correct.
Q. And people try to think through all kinds of scenarios and how this is going to

work to make sure that there's no surprises when they make a particular decision, is that right.

A. Well, there are always surprises.

Q. There are always surprises. You just want them to be few and not --

A. You want them to be small.

Q. You want them to be small.

Now, if you have a plant making those types of investments, large investments, doesn't that indicate that this idea of the make allowance is not an issue for the dynamic dairy industry because people are willing to make huge investments even with the make allowance in the marketing system we have today?

A. My response to that would be, if you look at where the plants have been built, is outside of the Federal order system.

Q. And that would include New Mexico and Texas?

A. Are loosely regulated. And we just heard from a previous witness that their new plant in a couple years, when operational, they question whether they will be pooled or not.

Q. So what you are saying, then, is this issue of the make allowances and whether they're a problem or not is a regional problem, not a national problem?

A. State that again.

Q. That the problem with the make allowances vis-a-vis continuing the operation of cheese plants is regional and not national?

A. No, I think it's national because we have the same -- I've given the same type of testimony and will probably do again this year in California, that there are problems with the make allowance.

Q. What about, for example, the Southwest that's bringing on large cheese plants as we speak? That's not an indication that the make allowances are a problem in that industry, is it?

A. One plant?

Q. Well, the size of the plant.

A. With the size of the plant?

Q. Yes.

A. I mean, obviously, with their economies of scale, and I don't know their exact cost structure, but I would assume it is going to be profitable. They also have -- there is also a lot of milk there that we heard earlier that is shipped out of that area.

Q. Right. But the problem is, they don't need a make allowance adjustment because it seems like the problem -- their market dynamic is taking care of itself, where New York, based on the testimony, may need that adjustment, is that right?

A. I think if you talk to most people

across the country, whether in Idaho or California, outside the Federal order system or other plants within the Federal order system, I think they would agree it would be a national problem.

Q. Of course, you know, the problem is that producers always complain they don't get enough for their milk, and plants -- and I've been in this business for too many years to know, they've always complained they take too much. I mean, isn't that the grousing that just goes on, and they just -- right?

A. That's the nature of this whole system, correct.

Q. Now, you talk about large, in here -- in fact, you make this comment, that concern about the size and make allowances for a particular size of plant. I think you are talking about your Canton, New York, plant. Now, I don't know if you were here, I think you were, and saw the exhibit that CDFA has with its make allowance in its report.

A. Very familiar with those.

Q. And I know you are. And it explains that, at their make allowances, that almost two-thirds of the cheese produced in California is done in plants that have more profit or do it profitably or at a lower cost than what the make allowances are that they report. Do you understand that?

A. I understand that, yes.

Q. So is it your position that the make allowance should be so low or so high that all plants are profitable?

A. That's probably a little exaggerated.

Q. At what point do we draw the line?

A. That's not my decision to make.

Q. Just lower than the site of your plants?

I withdraw that question.

You mentioned in your testimony and

even in your answers to me, you talk about the fact that loosely regulated or unregulated areas of the country seem to be having the growth in cheese production?

A. Right, cheese production, milk production.

Q. Right. And will this change in the make allowance alter that dynamic?

A. In those areas?

Q. Yes.

A. Probably not.

Q. Is that evidence to the fact that maybe the market is finding a way to get outside of the regulatory scheme in order to function as opposed to staying within the system?

A. That would be one way to look at it.

MR. YALE: I have no other questions

THE JUDGE: Very well. Other questions of this witness? Mr. Schad.

EXAMINATION

BY MR. SCHAD:

Q. Dennis Schad, Land O'Lakes. Good evening, Mike.

Just one or two questions relative to cream. I understand from your testimony that Kraft buys and sells cream?

A. Correct.

Q. I assume it buys it and sells it in California and also states that are loosely regulated by Federal order?

A. That is correct.

Q. Can you share with us the terms of those transactions?

A. Just generally, it's CME AA's butter market times multiplier.

Q. And is that true in both California and in Idaho?

A. To my knowledge, it -- again, I probably shouldn't have answered this because

I'm not directly involved with cream purchasing. But to my knowledge, that's the way -- California is the tougher one because we have our plant in Visalia that we ship out cream to our plant in Rupert. So that's inter-company pricing and so forth based off the component price in California.

Q. Thank you very much

THE JUDGE: Mr. Beshore.

EXAMINATION

BY MR. BESHORE:

Q. Good evening. Can you tell us what products Kraft makes at a number of its plants here that it has retained in the Federal order system such as the three -- working off page 1 of that Exhibit 56, in New York, what are you making at Lowville?

A. I'll again preface this by saying we have hundreds of products, so I'm going to give some big ones. Lowville is cream cheese. Campbell is mozzarella and ricotta. I'm just talking about cheeses. I mean, that also has a whey operation and a dry whey.

Q. Okay.

A. Walton is the cultured products type cheese, sour cream. Lehigh Valley is a new beverage product we have just coming on the market, a coffee beverage. No Class I issues there.

Q. Well, it has milk in it. Is it a dairy plant?

A. It is a cheese plant that's just starting to receive milk for this new coffee product.

Q. It's a cheese plant that's not been manufacturing cheese?

A. It's a processed cheese plant. They just receive cheese, barrel cheese, for processing and in blocks for shredding.

Beaver Dam, primarily cream cheese. Springfield, Missouri, is cream cheese. Bentonville, Arkansas, is a cheddar for processing, using proprietary technology. Rupert is cream cheese. Tulare is several styles of Parmesan and I believe some Romano and then cheddar. Visalia is a combination plant, culture products, the Knudsen cottage cheese and sour cream in addition to a butter-powder operation. Tulare also makes dry whey.

Q. The cultured products at Walton, are they all Class II products?

A. Yes.

Q. What products do you report to NASS?

A. The whey out of Campbell, New York, and the whey and the nonfat dry milk out of Tulare, the other California plant.

Q. Did you say you make butter out of Visalia?

A. We have a butter-powder operation. There is some -- there is a churn there, but we tend to use most of that internally.

Q. Therefore, it wouldn't be reported to the NASS?

A. Correct.

Q. The Canton, New York, plant, what did it make?

A. 640 cheddar blocks, roughly 30 million pounds a year.

Q. You characterized it as a small plant. Can you give us some idea of the volumes of milk processed into cheese at that plant?

A. I just quoted 30 million pounds a year of cheddar cheese. Back that out into 300 million pounds of milk. It varied seasonably, obviously. We heard the previous people testifying to the amount of seasonality, especially in that part of the country.

THE COURT: Other questions of Mr. McCully?

Mr. Wellington.

EXAMINATION

BY MR. WELLINGTON:

Q. Bob Wellington, Agri-Mark.

Mike, we heard a discussion earlier that there was a relationship between the CME cheese price and many of the other varieties of cheese that are not traded on CME?

A. Correct.

Q. Are you familiar with the NASS price survey and how that price survey changes relative to the CME?

A. Correct.

Q. Is there a relationship between that price?

A. Yes, there is, and it's usually the NASS trails the CME price by normally two weeks or so.

A. Within that two weeks, though, it moves pretty much penny for penny, would you say?

A. Yes. For the statisticians that are

in the room, the R squared is very high, over 95, I believe.

Q. Okay. So the average price of -- the average price difference between the NASS and CME, has that grown closer in the last couple years? Have you noticed that trend?

A. We do that analysis usually a couple times a year, and I cannot remember the trend off the top of my head.

Q. So if there is a relationship between the NASS and the CME and the CME and all of the variety, would you draw a conclusion that there would be a relation between the NASS and all varieties, probably all probably should move together?

A. Correct.

Q. Thank you

THE JUDGE: Other questions?

Mr. Yale.

EXAMINATION

BY MR. YALE:

Q. I want to follow up that question of Dr. Wellington.

The selling of non -- we are just going to talk about other cheeses, not the ones that were reported. That price is a negotiated price between this manufacturer and the buyer of that cheese, right?

A. The entire price?

Q. No, the --

A. The difference?

Q. The difference --

A. Like called the basis or what have you.

Q. Right. Right. You negotiate the basis minus two cents, plus a nickel?

A. That's typically the way --

Q. That's the way it's done, right?

A. Yes.

Q. Right. And let's say you are selling a cheese and it tends to be plus 3 cents, and supplies get long, that basis begins to shrink, right?

A. That's what happens normally.

Q. Or, if it gets tight, that basis will widen, right?

A. Correct.

Q. Okay. And so -- but that change in those particular varieties may not necessarily reflect what's going on in the commodity cheddar variety, right?

A. That would be true.

Q. So that the basis spread and shrinking that's going on in, say, Swiss does not necessarily mean that there is a change in the basis on in, say, cheddar?

A. Over what time? Short time period? Long time period?

Q. Short time period. Short time period.

A. Short time period. That could happen.

MR. YALE: I have nothing further

THE JUDGE: Other questions?

Very well, Mr. McCully, you may step down. Thank you.

Mr. Rosenbaum, do we have another witness?

MR. ROSENBAUM: No, Your Honor, I would suggest that we break at this point.

MR. RASTGOUFARD: I just had a housekeeping issue that I wanted to address, perhaps off the record.

THE JUDGE: Very well. We'll be in recess until 8:30 --

MR. ROSENBAUM: Let me just add, I understand Mr. Cryan is going to provide --

THE JUDGE: Excuse me. That's correct. Dr. Cryan, I believe, is prepared to at least make his statement available at this time. It will be marked for identification purposes as Exhibit 58.

[Whereupon, Exhibit No. 58 was marked

for identification by the judge.]

THE JUDGE: The exhibit has been received. I guess at this time we can be in recess until 8:30 in the morning.

[Whereupon the hearing was adjourned at 6:39 p.m.]