VOLUME IV

BEFORE THE SECRETARY OF

THE UNITED STATES DEPARTMENT OF AGRICULTURE

AGRICULTURAL MARKETING SERVICES

In the Matter of Proposed	)	Docket Numbers
Amendments to Tentative	)	AO-14-A77, et al ,
Marketing Agreements	)	DA-07-02
and Orders	)	

National Public Hearing

Thursday, March 1, 2007

9 13 o'clock a m

Holiday Inn Select

15471 Royalton Road

Strongsville, Ohio 44136

BEFORE

JUDGE VICTOR W PALMER

US ADMINISTRATIVE LAW JUDGE

UNITED STATES DEPARTMENT OF AGRICULTURE

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and

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I N D E X

I N D E X (CONTINUED)

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EXHIBITS

	MARKED	RECEIVED
Exhibit No 20	764	850
Exhibit Nos 21 & 22	845	850
Exhibit No 23	852	880
Exhibit Nos 24 & 24-A	879	926

- - -

JUDGE PALMER: Why don't we get you sworn in.

GARY GENSKE

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

JUDGE PALMER: Mr. Genske has been called to the stand and has been sworn, and we have a projector. Is this what we call Powerpoint?

MR. GENSKE: Yes.

JUDGE PALMER: So we are going to do a Powerpoint projection of a lot of numbers. I see I have here a printed out copy of this. Should we mark that?

MR. YALE: Yes. We need to mark that as an exhibit.

JUDGE PALMER: Mark this as 20.

(Thereupon, Exhibit 20 was marked for purposes of identification.)

JUDGE PALMER: It is Exhibit 20, it is a compilation of data.

MR. YALE: Regarding farm income and expenses.

JUDGE PALMER: All right, sir.

DIRECT EXAMINATION

BY MR. YALE:

Q. Mr. Genske, would you for the reporter. spell your name.

A. It is Gary Genske, G-a-r-y G-e-n-s-k-e.

Q. And, Mr. Genske, how are you employed?

A. I am self-employed in our own CPA firm.

Q. What is the name of that firm?

A. Genske, Mulder & Company, CPAs.

Q. Can you describe that firm?

A. Yes. It is a three-office accounting firm in California. We have 16 partners. approximately 60 employees, and we specialize in accounting and supporting the dairy industry.

Q. And in that regard, how many dairy farms -- or how would you describe the scope of your practice in terms of the number of farms, the production, et cetera?

A. Yes. Our firm represents about a little over 10 percent of the milk produced in the country in 27 states, from Hawaii to the East Coast.

And our client base is primarily in the Western United States, where we represent more than 20 percent of the milk produced in the

Western United States. And by the way. I am also a dairy farmer.

Q. I was going to ask that as the next question. Where are you a dairy farmer at?

A. We have two dairies milking 4500 cows in Roswell, New Mexico, on two farms.

Q. Is that 4500 total or 4500 each?

A. We have about 10,000 total head of cow. 4500 milking through the barn three times a day.

Q. Now, how did you begin working with dairy accounting?

A. I became employed in about the end of 1973 or beginning of '74, I don't quite remember the exact date, with a firm that had some dairy clients, and this is the area that I became most interested in. And from that, I opened my own firm in 1981.

Q. And that is the firm you just described?

A. Yes.

Q. All right. Are you licensed by any state in any capacity?

A. Yes. Certified Public Accountant. State of California.

Q. And where did you get your degree?

A. Long Beach, after I got out of the

military.

Q. Okay. And how long -- what was your military experience?

A. I graduated in Saginaw, Michigan from high school and decided to buy a new car at my wife's recommendation, instead of going to college. But immediately turning 18, I got drafted, and the new car had to go away.

But anyway, I ended up going into the military, I made three tours to Vietnam.

Q. And you were discharged, honorable discharge?

A. Yes.

Q. Now, have you, in your position specializing in dairy accounting, do you make any lectures or write any works or anything in that regard?

A. Yes. Some of the material you see here today is just some of the material that we publish in dairy publications across the country.

And these materials today are out of a presentation that I made at the Tulare Farm Show, the largest farm show in the country, for dairies anyway, just a couple of weeks ago. I

am presenting it again in Orlando. Florida and in northern California in two months. I have been lecturing on these matters for, oh, at least 20 years and writing articles.

Q. Have you ever been a witness as an expert regarding farm income or expenses?

A. Numerous times.

MR. YALE: Your Honor, we would move that he be recognized as an expert in dairy farm income and expenses.

JUDGE PALMER: Is anybody interested in doing a voir dire, and if so, we would reserve it. But I want to find out if anybody wants to Very good, we accept him as an expert

BY MR. YALE:

Q Could you give us a producer perspective in terms of income and cost of operating a dairy farm today? Before you do that, I want to ask you, so we have something to compare against. based upon your years of experience in analysis of dairy farm income and dairy farmers. expenses, and different regions and the like, do you have a rule of thumb in terms of what you expect a dairy farm to generate per

hundredweight in order to be profitable, return a standard of living to the owner-operators, to retire debt, return on investment, is there some kind of a number? We see these numbers. Is there a number we should at the end of the day be able to compare it to to determine whether they met a minimum level?

A. Yes.

Q. And what is that number?

A. Well, as you will see, going through these slides, there are different levels of cost of production. The East Coast has at least a $2.50 per hundredweight higher cost of production than those in the West. And a lot of reasons are climate, size of operation and marketing and all sorts of things.

But I can point that we will see net profits here.

Q. Right. On a net profit basis, what would you expect to see per hundredweight to determine that they reach a satisfactory level of profitability, generally?

A. You will see our projection for 2007. We should probably see on the bottom line, at a minimum of $1.50 per hundredweight.

Q. As we look through these and watch you make your presentation, if that number is above that. then we have met the standard, in your opinion. that ought to be met by a dairy farmer If it is below that, then they are behind?

A. They are definitely behind The East Coast, not just taking my word for that, on the East Coast, we review pretty much the same materials produced by the Farm Credit Lending System. They have their own cost study, and they project approximately $2 a hundredweight has to be added for owner's living and debt payment.

Q. Very well, if you'd provide that perspective, and I may ask questions as we go through.

STATEMENT FOR THE RECORD OF GARY GENSKE

A. Slide number 1 -- and I am just getting over a cold. so I am going to get through this somehow.

Slide number 1 is one of our analyses of -- the only reason I show it is to give you a sample of what our normal dairy profit and loss statement looks like. It also shows a comparison of milking cows two times a day

versus three times. That is almost irrelevant for today. But it is kind of fun to look at and there is always a debate in the accounting world about two versus three times milking per day.

I would like to go down this statement quickly. Above here, we will look at the various income components. And again, of the approximately 500 large dairy clients that we have within our firm, every profit and loss statement is essentially prepared in this same manner.

They are reviewed, not just simply compiled, which includes some audit procedures done, so we can accurately inform the readers of the financial statement of the true profitability of that organization within a given time.

So these financial statements are prepared in accordance with generally accepted accounting principles, on the accrual method of accounting. much like you would see on the stock exchanges. This presentation, however, is elaborated somewhat so that producers can use these numbers as benchmarks. They don't want to look like the average guy, they want to be better than the

average.

So included in these statements are, of course, the income components. And from the income components and deducted from the income are the feed costs, which is the next set of -- first set of expenses. Deducted from that is the herd replacement cost. It is estimated that approximately one third of a dairy herd is turned over in a year, replaced. They sell off the low producing and sick and remove the dead cows and have to replace with new cattle. That is a major cost of operation segregated here.

And then we have the other operating costs that represent, as you can see, a wide detail of expenses that producers can, you know, try to measure their own, on their own, to try to improve operations and whatnot.

And average statistical data down below. this represents, as you will see in some of the other slides as well, so that the formats are basically the same, just so that now you understand how the numbers flow.

The average statistical data at the bottom represents the two time a day milking herd size average with 1759 milking a day, three times was

1950 cows milking a day. The average production. two times 68 pounds per cow per day. and then we have the butterfat tests. These are component tests, butterfat and solids nonfat. Then the herd turnover rates, as I said, roughly 33 percent, or a third of the herd, is turned over every year.

Just to make it clear, three times a day is, in our opinion, more profitable than milking two times a day.

The next slide -- all of a sudden, it is not working. Thank you very much.

This is just another example of some of the material that we publish, and there is always a debate over what kind of herds are profitable. Jerseys versus Holsteins. And it is not here to support some of the questions today, it is just an illustration of some of the materials that we publish and produce.

Again, by the way, the Holsteins, if we look right here at the bottom, I have got my arrow pointed, if I can point it, right in that area, you will notice the average net profit per cow in this comparison between Jerseys and Holsteins, in this certain given amount of time

was as you see there, Holsteins coming up a little bit better.

Okay. The background on this looks like an old Chino, California dairy, that is probably demolished, where homes sit today. We will talk about the sales of real estate and how it has impacted the dairy industry to a large degree.

But the next slide covering that photo is the current published USDA herd size, comparing 1998 with 2005. And the indication there is, of course, in 1998, there were only 220 dairies that milked -- well, that had over 2000 head. And by the end of '05, there were 523 dairy farms in the country of that size.

And you can also see that when you look at herds of 500 on up, that represents about half of the milk produced in the country. Of the 523 over 2000, I would say somewhere between a half and two-thirds of those are clients of our firm and are mainly located in the West.

I would like to skip to the next one. The next slide shows a compilation -- I might add. we produce and have produced for 25 years cost studies, income and expense analysis that are very similar to the first page of our exhibit

here. We produce cost studies for these different states, California -- and have for 25 years, by the way -- California, Idaho. Texas. Washington, New Mexico and Arizona.

We produce an additional one that has not been produced that long for the High Plains States as well. It is not here today.

Like I say, there are -- some of these same kind of reports are produced by the Farm Credit System, representing New York, Pennsylvania, New Jersey and I believe Vermont, which I do reflect numbers later on from that study in here as well.

This is the average dairy income and expense summary for the entire decade of the '90s. The question this usually answers is. "I am a California dairyman, and my property is being sold for development, where is the best place to go that is still somewhat close to California?"

This is what has historically answered that. This does not answer that question any longer, however.

But the points here for today are that the net income per cow we'll focus on is just to the

right of this arrow up here. And the average for all six states for that whole decade was $317.

The average per hundredweight for that entire period is slightly above, is $1.31 net profit per hundredweight.

Now, there is a lot of data and numbers and a lot of things that producers and whatnot look at in this. But it is enough to just point that much out. Because the next slide is -- and now I will compare the '90s with so far in this millennium or this decade in just a moment.

We can see in the years 2005 -- 2000 through 2005, the net profit per cow has dropped from the $317 down $206 profit per cow. The hundredweight net income has dropped down to $1 a hundredweight. And recall that dairymen must have $1.50 in the West and probably $2 in the East for break even, when you consider the owner's living allowance and enough to cover their principal debt reduction. And not having that spread does not allow dairymen to modernize and make much of a living.

We will compare in the next slide the '90s with the 2000s. As you can see, these are just

simply the hundredweight costs from the previous two slides.

The 1990s average at the bottom, as you will see, was 11.16, average cost of production now. In 2000 to 2005 it was 12.87. an increase of $1.71 a hundredweight, and a 15 percent increase.

The next slide tells a better story of the more current conditions. This is slide number 7. Cost of the '90s again was 11.16. It is broken down by region. And just in '04 and '05 alone, we have seen the cost of production in those two years alone going up to $13.50. $2.34 a hundredweight increased cost over the '90s decade, a 21 percent increase in cost in '04 and '05. And of course, '06 those costs are higher yet, which I will be updating this and publishing this soon with the '06 numbers included.

Just to recite the last three lines, the 10-year average milk price in the '90s was $13.40 a hundredweight. And if we were to say. all right, dairy farmers require at least the cost of production increase, which is 21 percent, we should be paid on an average across

the country 16.21. And, in fact, last year. if I had to recall, I think, our dairy averaged $11 on its milk price.

And so we ask where that spread is going. Of course. I will editorialize, if I have all day. to do that.

I would like to skip now to the next, number 8. Our projection a year ago for the year 2006, knowing that fuel prices at that time and interest rates were rapidly growing, again, we saw milk prices starting to decline. We projected $1.81 a hundredweight loss at the bottom line on an average.

I don't have the December 31s completed. Our firm is preparing year-end financials for all of our clients right now. Probably late April, early May, we will have the actual numbers. However, slide 9 shows everything through September of all of our client base.

The loss, however, not as great as we projected a year ago, almost a year ago right now, only came up at 83 cents a hundredweight loss. An average producer milking 1800 cows lost $284,000 through the nine months ending September of 2006.

The losses that we had predicted that did not materialize is the fuel costs started coming down in the last third of this year. So we overestimated last year the cost of fuel. Interest rates did not continue to rise, they pretty much flattened out. And we did not predict the milk income quite accurately. We predicted 12.35, this is only 12.01 that has actually materialized. But probably by the end of the year it will be right close to that.

This is also, if we look at this net. again. down here near this arrow, the 83 cents. these are actual financial statements issued. I have dairy clients milking a thousand cows that have lost over a million dollars. And I have some dairy clients that have no debt and put in a lot of their own labor that may have made 2 or 300.000 in profit.

And in California, there is a quota system. and those that own quota pay a little more. Those that have -- those that have what is called milk shipping rights or pool quota in California, get paid $1.70 more a hundredweight for their milk. So those guys stood somewhat of a chance in coming out about even. That is by

far the minority in the entire West.

So what you see here nationally is our average client lost 83 cents a hundredweight when that should have been flipped around at $1.50 at least profit to cover all debts.

The next slide is just simply the bottom portion. I didn't know the media source here today, so if we all have copies, we have already seen this on the previous page.

The next page, 11, or slide, is considerably more detail by year by state Again, this produces a lot of detailed information for anybody wanting to know about any particular time, and the profitability or not, again, of each location.

Now, I have included the New England at the bottom. And that is right off from their own reports through the Farm Credit System of averages. I share my numbers with them and they share theirs with me.

Just to tell you what this all means, is in Arizona, for example, in the entire decade of the 2000s, they have averaged 27 cents a hundredweight net profit. And obviously, they are probably close to just barely cash flowing,

not allowing anyone to do much in expanding, a lot of maintenance is deferred until milk prices will get better.

The next state down is California, it is $1.12 a hundredweight. Again, it needs to be that $1.50 on an average.

Below that you can see the Midwest, which is the Colorado, Nebraska, Kansas, we consolidate all of our clients and we call it the High Plains, have only netted 39 cents a hundredweight.

Idaho, which used to be the most profitable state in the country, is 65 cents a hundred. New Mexico, $1.18; Texas, 68 cents, on down through Washington, $1.34.

In the West United States right now, the State of Washington, in my opinion, it probably has a little bit of an advantage. It seems like the entire State of Washington's production per cow is always averaging a little higher; and the fact the state will pretty much not allow new dairy construction at all and have not for the last several years, they seem to have gotten a little better foothold in that corner of the country in the State of Washington on their milk

marketing. So they have done a little bit better in this decade than the average.

The next page is simply the totals from each location, which I didn't know the media here today, so I have included that.

Page 13 is our projection for the year 2007. I truly believe -- I am not an advocate of milk futures being paid -- being acquired by dairymen. But the futures market indicates a $15 milk price, which is much improved from our $11 from last year. But we have some serious issues coming up. I have read articles where up to 25 to 30 percent of our corn crop by the year 2008 will be going into ethanol plants that are currently under construction.

And, of course, corn at $4 plus per bushel not only raises the corn price, but when we feed 12 to 15 pounds of corn grain a day out of a total 55-pound ration, and then on top of that. we feed approximately 30 to 40 pounds of corn silage, when all of that feed is diverted into producing ethanol, we are going to then have to go out and buy other commodities to replace corn, and of course, that has raised all commodities up to approximately $40 to $50 more

per ton.

When our average grain price in 2006 was approximately $145 a ton -- our grain is mixed with several commodities -- we would expect that the average producer will be paying in the neighborhood of 180 a ton, and that is with 3 something corn, a bushel. Now we are going to see 4 to $5 corn by the end of possibly '07 and into '08.

The biggest increase of cost that we are going to have as a producer is the feed cost. I have increased -- I have simply taken the September results and put what we estimate to be a change from the 2006 September numbers. And the biggest cost increase, of course, is going to be grain.

Twenty percent hardly covers that $40 per ton increase. It would be more like a 30 percent increase. However, on an average, some producers have locked some up ahead of time, of about, in my office alone, we work with about 100 large dairy clients, and I don't think five have booked ahead. Just about all of them are on the market at these higher prices right now.

And everywhere I go and everybody I talk to

says the same thing. Nobody has booked. Prices were rapidly increasing toward the end of last year, as the Government indicated they would back all these ethanol plants. So a lot of this corn is being diverted. So all other commodities will go up.

So where we had about a $6 per hundredweight feed cost in September, right there. we are at about $7.32. And I believe that that is really accurate for this coming year. Also being in the dairy business. I feel it.

The herd replacement cost, obviously, if you are raising heifers or somebody else is raising your replacement cows and the feed costs are up 10 percent or more, those costs also have to go up.

We feel labor will probably go up slightly because of immigration issues. I have a feeling that somehow we are going to end up with more cost of operation with labor. It is not a material increase.

The bST hormone, producers across the country are not only being paid not to use it, there are a lot of co-ops, Cal Dairy, the third

largest dairy co-op, I believe it's the third. in California after August will not accept milk with that in it anymore. And some of the other co-ops are following. So that cost will go down.

Environmental costs continue to go up for all dairymen. That is Clean Air Standards, Clean Water Standards. In New Mexico, we have to get a new permit every five years. On our own dairies, we spent last year over 250,000 in mostly capital improvements that don't even show up as a period expense. And as the milk prices get better, repairs and deferred maintenance will also get taken care of.

Going up to the top here, if I had to think about it again, milk income, of course, we are going to use this $15 a hundredweight for next year as our average for the year. Then the significant thing that has happened is the dairy farmers normally sell off all of their bull calves. I have only cut that by 25 percent.

But a year ago from today, we were getting about $175 for day old bull calves. Today we are getting $30. So I may not have cut this calf thing enough. I only have a 25 percent.

and it should probably be more like an 80 percent drop. But we will see. Hopefully that calf market will come back.

The last thing that we have predicted to change materially between '06 and '07, believe it or not, I believe production could be dropping for several reasons. Dairy farmers are always trying to find ways to feed their cows. You have to feed them 50 to 65 pounds of feed a day, that when they try to cheapen their ration, their feed ration, production suffers. Also. with the shortage -- or the lack of the use of bST will also cut production.

So I would say, and I am going to predict a year from now, that 66 pound average in our client base might be that production average versus last year at 68 pounds per cow.

So in spite of the fact that we are all celebrating the $15 increase in milk price. let's look down at our cost to production. 15.17. We are lucky, us farmers, for 30 some years, we have been waiting for the pendulum to swing back and forth. It seems like when it gets good, it never stays good, then it swings back where it's just horrific like last year.

And now that we see the pendulum coming back to the profit side, the costs are just going to eat us alive.

I am predicting that we on an average could see a 34 cent a hundredweight net profit next year. But again, if it is not $1.50. there is no room for reducing debt or much for owner's living.

On our dairies, I am proud to say that our cost of production is low, but over the last -- in this decade, we have probably averaged only between 23 and 40 cents profit. I can say very precisely that our debt per cow today is higher than it has ever been.

Our operating lines of credit are in place. so that if we do run short in the cash flow, we have an operating line of credit we can borrow back against. There are a lot of unfortunate people in the dairy business who do not have the luxury of that line of credit.

So we are going to be survivors, but we are not happy survivors.

Number 14, again, is just simply trying to enlarge the bottom of the previous page.

Finally, number 15, it is really an ad that

I try to drop from airplanes. But I do produce this in every place I can. The unique thing about this is that regardless of what anybody says or anybody publishes, this is something that is near and dear to my heart, because I produced this myself, and I am about ready to update this again.

This is the seventh annual illustration explaining why we should be paid more for our milk. I am not going to editorialize on the CWT program at the moment.

About the middle '90s, I am trying to move it, about the middle '90s, I started noting rapid increase in prices. Traditionally what happens is, as I said before, retail prices were. in the middle '90s. at about $2.50 a gallon for milk, $3.50 a pound on average for cheese.

By the way, I didn't go to Nielsen. I didn't go to anybody else, you are looking at the guy that produces those numbers themself. I go around to retail stores myself. Of course. we travel all over the country. So guess what I do in my evenings, I am in the dairy case at stores.

And at this particular time period. dairymen were paid $12.10 a hundredweight back in that same year.

Now, if we compare -- this is through March of '06. I am about ready to do the '07 one. Retail prices have gone up to $3.75 a gallon for milk. I think that is published everywhere. The unfortunate thing is, what you see published also includes retailers that are selling milk as loss leaders. Now, how is that a good marketing plan for anybody? But that is always held against dairymen. "Well, we are only getting $3 for our milk." Well, sure, that is a loss leader for the store to draw people in.

So, anyway, as of March 6, we saw -- I saw milk at about $3.75 a gallon. This is higher than the California average. Again, I will not pick up loss leaders in this number. And cheese is at 4.50 a pound. But dairy farmers were paid at that time, and this is in California, $10.80 a hundredweight. Now, if dairymen were paid based on the change in retail prices, we should be expecting 21.20 a hundredweight for our milk.

Again, as the milk prices paid to dairy farmers drops, retail prices don't, but the

minute the dairy farmer finds a way through a lack of milk supply, my experience in 34 years of watching this says that that is the excuse the retailers give to ratchet the prices up even more. Dairy farmers start getting paid a little more, they, say, "Oh, the cost of milk is going up, we have to raise the retail prices."

I am showing you here that the pendulum swings back and forth, it seems like the retail prices have constantly gone off and producer prices have not.

Anything that takes more off the backs of the dairy farmers is ridiculous. We have nowhere to go to try to recapture our costs. So that is my slide presentation.

MR. YALE: Why don't we trade places so I can ask questions.

(Thereupon, a discussion was held off the record.)

CONTINUED DIRECT EXAMINATION

BY MR. YALE:

Q. One question I forgot to ask. You talked about you owned a farm or two farms in New Mexico. How is that milk marketed? Well, I mean, generally. Who do you sell your milk

through or to?

A. Dairy Farmers of America.

Q. Now, I just want to follow up on that last slide. Let me try to paraphrase what I think you were trying to say. That is, you have shown through your numbers -- and we will go a little bit further on that -- there is not enough income for farmers.

I think the last slide is simply to show there is money in the market. If some more of that came back to the farmers, they could reach the levels that you believe they should be reaching?

A. We don't have a mechanism in place to capture that nationwide. That's correct.

Q. Now, as we went through these numbers, it appears that there are few instances, few years and few regions in which your target of $1.50 was reached and almost none in recent years; is that true?

A. That's correct.

Q. Now, the question that one has to ask. though, is that if this is, in fact, the reality, and has been for some time, why do we continue to see the investment in large dairy

farms and more large dairy farms in the country?
A. Well. aside from the addiction to it, there has been a considerable source of funds outside of farming that have played a big role in these 500 large farms and a very large number of those are clients. A lot of our clients from the Los Angeles area have seen three major economic booms on real estate. The last being, of course, the Chino, Corona, California, that area is approximately 35 miles west, and the only area undeveloped around Los Angeles.

And so producers last year, up until this short, in my mind, short-term home building slow-down, were on their 30-, 40-acre dairy farms milking a thousand cows, were being paid 500.000 to 600,000 an acre for that land. Of course, that allows them to go bigger somewhere else.

And the fact of the matter is, you cannot build, economically speaking, a dairy, a thousand-cow dairy farm anymore. Environmental rules require that you have so much more land. and in order to cover all the costs and make it a profitable enterprise, they have to -- my recommendation actually is to grow to a 2000

milking facility for a lot of reasons. I won't get into that.

Some have done 4000 construction projects. This past year, there were over 95 new dairies being planned in the new hot area of the West Texas panhandle. And it looks like today that only about five of those look like they are going to go through now.

Q. What was that number again?

A. There were about 95 new dairies in the West Texas panhandle, and those dairies would be 3, 4, 5000 and a couple 10,000.

That shouldn't bother anybody, because we only have 9 million cows in the country. So it is just replacing them from somewhere else. It isn't 10,000 new cows. They are going to go from somewhere else.

They have clients that are going to be forced to sell out this year and they will be bought up by people that have these real estate funds.

Other source of funds also, I might add, is producers from outside the United States are coming in, from the sale of their real estate in quota or based shipping rights in another

country, Europe, coming into this country and flooding with new dollars into the economy as well.

Q. Now, as part of that, you mentioned that they have the farms and they have the huge price per acre. Does tax policy contribute to that decision to build that dairy larger?

A. Is this a let's do away with tax --

Q. No, it is not. The purpose of the question, Gary --

A. Yes, the answer is "yes."

Q. Okay. That is a policy issue that we have no control over, but it is also a major driving force in dairy; is that right?

A. Yes. If someone gets $20 million for their real estate, they can do a tax-free exchange into another $20 million piece of property and not pay any income tax. It is all deferred, it doesn't go away. It is deferred into the new facility.

If you have a 3000 to 4000 per cow cost to build. that is a 6, 7000-cow dairy.

Q. Okay. That was the question. You answered my next question, is, how does that translate into the next dairy?

So they go from 3 to 500 to 5 to 6000 with the same dollars?

A. Right.

Q. Now, at the same time, based upon these economics, do you see people who are outside of there -- you talked about it being an addiction. You have people from California expanding with their money and Europe with theirs.

Is the dairy industry attracting outside investors into building dairies under the current economic situation?

A. Not too much in my experience, no. Dairying is so specialized that if you don't really know how to run a dairy or know much of the economics of it, just being an investor in one, large corporate dairy farms just about always fail.

When I say that, I don't mean the proprietor, large proprietor run dairies. I am talking about -- I could make mention of a lot of large corporate grain companies and even a couple of co-ops that have actually built their own dairy farms and failed, because they just don't have -- you can't have employees run and a corporate board micromanaging. It has to be

hands-on. So I don't see a lot of that.

Q. In your statement, I believe, for 2006 through September, you have estimated an 83 cent per hundredweight average loss. And this would be page 10 or slide 10 of Exhibit 20. I believe it is.

You know, that is a number. How does that translate into the operation of the farm? What starts to happen at the farm when these types of numbers are occurring?

A. I indicated one small area earlier and that is, the maintenance is not kept up with. Equipment begins to start running into the ground.

The biggest areas that are affected are probably in the feed side. I personally know one dairy that just started feeding the absolute cheapest commodities they could, and of course. that cuts their production, and it is a recipe for disaster.

They are trying to hold out until the higher milk price pendulum swings back. But probably the biggest area is they don't get rid of nonproducing cows.

Dairy farmers are given loans based on the

number of cows they have in their herds. operating loans for their dairy herds. I should say. They will then keep -- to keep the bankers happy, they will keep noses around that shouldn't be there and don't produce much milk.

Again, those cows will start producing less milk. When the operation produces less milk at a low milk price time, it is a recipe for disaster. Some of those are going to happen very, very soon.

Q. So then aside from, you mentioned that in these low prices, they change their grain ration, they hold on to lesser cattle. What are some of the other things that dairymen do, what do they do with their livestock? Is there any reduction in their total numbers, or is there anything else that they do in an effort to try to maintain cash flow for a short term?

A. Well, a lot of producers raise their own replacements, their own born heifers, they will sell off that livestock, which will eventually come back in a higher cost to replace cows later, buying them back on the open market at probably 6 to $800 a head higher.

On the livestock side, you said?

Q. Yeah.
A. Cattle that should be sold off and replaced with new cattle aren't, and so production drops.
Q. Cattle that should be retained for the future, they get rid of?
A. And sometimes they have to downsize to make payments at the bank, yes.
Q. Now, you mentioned in your discussion a thing called -- I don't know whether it was a feed line or a cattle line. Would you like to explain how this is set up in terms of the cash flow for a typical dairy farm, in terms of their feed line, cattle line and their other debt structure?
A. Typically, in areas where, in the Farm Credit System that exists all over the country -- our two dairies are financed by the Farm Credit System in New Mexico. You have three primary loans. One is real estate facility loan, mortgages, and the second would be cattle operating loan, and the third is the feed operating loan.

If dairy operations also are involved in farming some of their own crops, they may have a crop loan as well. Crop loans theoretically are

to be repaid when the value of the crop comes off the ground.

The cattle loans, banks will allow up to $700, 800 per cow in an operating loan.

And on the feed loan, if we buy -- in the fall, we will buy harvested corn and silage and inventory it to carry us until next harvest. We get loans to carry those commodities, as well as grain commodities, if we make good buys on those a head.

But the physical inventories of those commodities, the value of those has to match the operating loan as well.

And where -- and what has happened now. I would say probably 75 percent of my clients are not conforming to their loan requirements because they have fallen behind.

Q. And that means they don't have the cash to buy the cattle when they need them?

A. Yes.

Q. Or take advantage of availability of feeds at reasonable prices when they need them?

A. That definitely has been a serious problem. yes.

Q. And when they reach that situation, is that

an indication that their equity within that whole operation has pretty well been expired, in terms of used up in one way or another, or is there some equity left?

A. Well, the majority of dairies have some equity, they have definitely been eating away at that equity.

The equity in a dairy operation is what has been feeding them for the last five years. So there is -- there has been a gradual deterioration of dairy producers' net worth.

Q. So is it safe to say that the milk -- representing who you have intimate knowledge of. and it is about 50 percent of the milk supply, has been made available to the consuming public. only because the dairymen have been willing to give up their equity in their operations to supply it?

A. Well, that is a way to say it, yes.

Q. And how long can that continue, to be able to maintain a healthy dairy production?

A. Well, the question is, how long can it go along that way. And really, that is in the bankers' hands, because if the bank fails to renew these lines of credit, which are annually

renewable, as these loans start coming up, we are seeing, okay, let's refinance the real estate and pull money out. Of course, the banks see $15 coming, but they don't see that -- and now they are starting to realize that cost increase that is going to follow right along with it -- I am sorry, I started rambling.

Q. The idea was, how long can this last?

A. Well, we can't see another year of it. because the banks simply are not allowed to lend money to operations that continually lose. And so far, the large dairy lenders have kind of looked the other way, hoping the future will be brighter. They have history watching that pendulum swing back and forth too.

Some of the smaller lenders will pull the rug out from underneath dairymen immediately. This is really happening now. I am spending a lot of my time in negotiations with clients and banks right now.

Q. You mentioned big dairy lenders. Are there several lenders that dominate the financing of dairy farms?

A. Wells Fargo Bank in the West has actually spread all over the country. There is Rabobank

does, Bank of America, Farm Credit System is located all over the country, independently-owned branches. There is Bank of the West and several others.

I know there are names of banks that don't come to me at the moment in Wisconsin and New York that do some dairy lending as well. They pretty much all have what is called these normal and conforming lines of credit available to profitable dairymen.

Q. But it is relatively concentrated into a few lenders?

A. Yes.

Q. So that if once for a lender the industry reaches a point, there could be significant number of farms that are impacted by those decisions?

A. Yes, that is becoming apparent now.

Q. I can't remember the year, but wasn't there a period of time, I believe, when Bank of America, back in the early '90s, late '80s, early '90s, called a significant number of loans?

A. That timing was paralleled with the real estate decline in the middle '90s as well, yes.

Actually, today, of a hundred large dairy clients in just my office, no one banks with Bank of America. They have completely downsized to the point where they -- it better be a very, very solid operation before they will get involved.

Q. When that happened, though, that was a very dislocating situation within the dairy industry. having to deal with that type of restructuring that that resulted, right?

A. That's correct.

Q. Did that result in a number of people going out of the business?

A. Yes. As the illustration shows, in '96, there were some 117,000 dairies recognized as individual dairy farms by the U.S. Government. We are down into the 70,000 range now. And I know three or four are going out this year myself.

Q. Now, I want to move, kind of change subjects here, all on the same topic. There towards the end, you indicated a prediction of $15 milk for 2007 and expenses of $15.17. And really what that is is just to kind of get you thinking. But the real question is, do you see

a direct correlation between the price of milk and the cost of the feed and the fuel?

By that I mean, if there is an increase in fuel or feed cost, do you necessarily see an increase in milk prices?

A. Never.

Q. Okay.

A. We have no mechanism in place to recapture any cost whatsoever. It is just simply, here is our milk, will you please get the best you can for it.

Q. And kind of wrapping up here, just a couple of other quick issues.

You indicated, I think just a little bit ago, you said there were at one time 95 farms planned for the panhandle of Texas and now there are only five in construction.

What is the time lag from the time a decision is made to build the dairy, until the dairy is built, so that if we were to look -- for example, I would assume that it is 2005 or 2006 is now having an impact on the milk construction in 2007, is that a fair statement?

A. Yes.

Q. So how far -- I mean, what is the time lag

from the time the decision is made, irrespective of what will happen in the short term on prices. that the dairy is going to go forward and be built?

A. Well, the timing in getting a dairy built in California right now, I don't think you are going to see many new dairies built at all because of environmental regulations. And we are predicting in California, if you clear all the hurdles, environmental impact reports and whatnot, it could take at least five years. And who knows what the economic situation will be in five years.

In the Texas panhandle, however, permitting process to allow dairies to be constructed have been very lax. They are trying to attract dairies. Even in that case, there is a permitting process and approval of neighborhoods and everything else of perhaps as much as six months, without objections, construction can then begin and the construction, in best case scenarios, is seven, eight, nine months and worst case, with bad weather and materials, it can be a year total construction time.

Q. Okay. Now, we had a Penn State economist

testify yesterday who looked at the ratio or I think he called it a milk margin for Pennsylvania. But looking at that, he showed. or indicated that dairy producers in Pennsylvania are coming off of a very bad year. their cash flow was tight, and are not in a very strong position to enter 2007.

Does that describe what you see in the dairy industry, the producers that you work for?

A. In Pennsylvania, yes, absolutely.

Q. What about in the Southwest?

A. I think I have shown -- that is one of the reasons -- that was the question that was going to be asked. Here are my numbers. They speak for themselves. And the answer is, yes, of course. it is a severe impact.

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

JUDGE PALMER: All right. Let's continue. Do we have some questions for the witness? Yes, sir.

CROSS-EXAMINATION

BY MR. GALARNEAU:

Q. Hi, my name is Clay Galarneau, with Michigan Milk Producers, Mr. Genske. Welcome

this morning. Just a few questions on some of the slides you had. I appreciate the information.

A. Can I have your card later?

Q. Yes.

A. I am headed for Michigan this afternoon.

Q. On page 1 toward the bottom, you have the -- well, first off, your analysis is looking at the milking two times a day versus three times a day. And at the bottom you show average milking cows of 1759 under two times per day and 1950 under the three times per day. I was curious why that number would be different?

A. The profit and loss statements of all of the two-time-a-day producers that we have netted in 1700 milking.

Q. Oh, so it is not a comparison of the same farms under two scenarios?

A. No, no, no, these are true financial results. But there is a second answer to that. And that is, if you visualize milking, let's use an example. 3000 cows per milking shift. if you can milk 3000 cows in eight hours, and you can run 3000 cows through your barn, okay, so -- well, okay. I will just back up and say it is

really a function of --
Q. I understand, it's two different populations.
A. Two different complete populations running their operations differently.
Q. All right. In the expense line, you have labor. And did I understand that that does not include an owner salary?
A. That's correct.
Q. Also, in the income and loss statement, are there any other incomes, like MILC payments or any other Government programs?
A. That is in the other income, MILC.
Q. Oh, that line, "Other."
A. In the line, "Other," up above, as well as "Co-Op Patronage Dividends," if there are any.
Q. Do I also understand that you do not encourage farmers to sell milk futures?
A. I definitely do not.
Q. Could you explain why, briefly?
A. In my opinion, and the short answer is, it is gambling. And I will also explain, if you look through my data, dairy farmers for the last several years have all lost money at trying to attempt to fix a minimum price for their milk.

And I even have a bigger answer for that. if you want it.

Q. I bet there is.

A. If you want to have a beer regarding that later.

Q. On page 13 then --

A. Well, let's go back. Why do we encourage them to buy milk futures, when they can go out --

Q. You mean sell?

A. Sell or buy. You can do either. Quits or calls. They could do gold, they could do silver, they could do pork bellies. You see what I am saying? Trying to get them involved in an investment arena -- you got me started.

Q. I didn't want to debate that subject. But on page 13, when you projected 2007 milk income. you are projecting $15 based on your analysis of average milk futures.

A. I was using that as a guide, and my experience shows that a lot of things can play into it.

Actually, I think there are several things that can affect the milk futures this year, and that is importation of more heifers that would

be perceived the production would be higher. milk futures will drop out of the sky.

Reduced production could raise the milk futures. So what any of us can do is just kind of look at all the indicators that move the milk price, and looking at some of the historical prices and how -- what factors contributed to those conditions. We have 54,000 cows being retired in the end of March and first of April.

We also have the possibility of a second herd retirement program before the end of the year. That would tend to raise those futures. Those futures are going to be all over the board by the time this year is over. You wait and see. But this is my best guess.

Q. It is your best guess. You also mentioned you were an accountant?

A. Correct.

Q. CPA. Probably conservative, conservative in your estimates of income and maybe slightly aggressive in your expense analysis?

A. Not aggressive at all. I have showed you the September figures, and again, they are what they are. And I would like anybody to tell me that these expenses I project for next year will

be lower. If anything, they will be higher. Is that what you are saying, am I being conservative in estimating the increases or just conservative in estimating the income?

Q. I thought you might be aggressive on allocating the expenses.

A. No, sir.

Q. Okay. You also, I believe I understood you to say that you felt there was a ballpark number of $1.50 a hundredweight that allows a farmer the net income that he needs to clear in order to have a salary and pay down debt.

A. Yes, sir.

Q. Your average herd size here is about -- well, you have it on here -- about 2000 cows?

A. Yes.

Q. Or slightly less than that. But it looks like annual milk volume, 40 million pounds, plus or minus?

A. I would have to do the math.

Q. At $1.50 a hundredweight, at 40 million pounds of milk, it would generate $600,000?

A. If you did the math.

Q. How much of that would be the farmer's salary, versus debt repayment?

A. Probably average draw for a dairy farmer. which would be cash draws for about everything. it would be somewhere between 80 and 100.000 a year. If you remember, I was talking about these operating lines of credit. It requires they be repaid. If you don't have the cash flow to pay them back, pretty soon the bank won't give you the money to borrow. Dairy cow loans usually are set up, they are annually renewable and are financed out on seven years. So that means you need a hundred dollars per cow a year to profit, just on the cow loan alone, not talking about the real estate or any of the other loans, net profit. They just flat out don't have it to repay debt.

Q. Well, but looking at your income statements and your projections as well, when depreciation is a noncash expense, wouldn't that be used to repay debt?

A. That is just one narrow definition of depreciation.

The other is that that is the cash that is supposed to go back in the operation to keep it operating efficiently, replacement of equipment and all of that.

So then do you -- you say, okay. I will forego -- that is why I mentioned earlier. I will forego the investment, any new equipment. but I will have to then try to keep the bank happy. There isn't enough -- you can't put a $1.50 or a dollar profit over $1.50 of costs.

MR. GALARNEAU: Thank you.

JUDGE PALMER: Other questions? Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. Good morning, Mr. Genske, my name is John Vetne, I am counsel for Agri-Mark and others. Let me first ask you about your advertisement.

Is this material and your future publications available on a Web site?

A. The detailed material on all pages except this one is, yes.

Q. And it is available to nonclients?

A. Well, maybe.

Q. "Maybe"?

A. Yes.

Q. You don't need a password to get in?

A. Yes, you do. In fact, we are revising the page, instead of two passwords, it now only has

to be one. At the moment, I can't tell you what my wife is doing with that.

Q. Okay. But the password is available without cost?

A. Just call me, yes.

Q. I want to make sure I understand what these lines and columns mean. I am just looking at page 1 for an example. In response to a question, you said the line for "Labor" under "Other Operating Expenses" does not include owner salary. Is that also true for a corporate farm in which the owner has an identified salary?

A. I don't have a situation like that. We have -- I strongly urge farmers not to incorporate, so I don't even have any corporations in the dairy industry. I might have one, excuse me, that came to me that way.

Q. No corporations, no LLCs?

A. LLCs, but those are characterized as distributions, not expense to salaries, that is correct.

Q. Is the table or schedule on page 1 basically a summary of how income and expenses are reported on Federal tax returns?

A. No, sir.
Q. Okay. How does it differ?
A. This is accrual basis accounting. Income tax reporting is a different accounting system, which is called cash basis accounting.
Q. All right. In the line under "Other Operating Expenses" for taxes and licenses, would Federal income taxes be included as one of those expenses under that line?
A. No, sir.
Q. Okay. State income taxes?
A. No, sir.
Q. That would be someplace else. Where would --
A. Well. that is part of the $1.50 that they would have to have.
Q. So that would come as a function of the net income at the bottom, on the bottom line?
A. What would?
Q. Federal or state income taxes.
A. No, it would be in addition to that net profit at the bottom, not part of.
Q. Not part of. But it would come out of that?
A. Yes, sir.

Q. And the way this is set up, I note -- maybe you can explain. A line for revenue produced by the sale of cull cows, let me ask you if that is implicitly included in the lines under "Herd Replacement Cost"?

A. The caption "Herd Replacement Cost" has two components. The loss on sale of cows is a function of matching the cost of the replacement cow with the proceeds received from the sale of the cull cow.

Q. There is a revenue from the sale of cull cows, but if that revenue is less than the combination of acquisition costs and depreciation, it is shown as a loss?

A. That's correct. It is netted in there, the income is netted against the cost for replacement.

Q. And what is the standard amortization period for depreciation of dairy cows?

A. For cash basis or accrual basis accounting?

Q. As it shows on this schedule, accrual basis?

A. It would be seven years, a seven-year life.

Q. And what percent of the acquisition cost is depreciated during that seven years?

A. A hundred percent of the cost.
Q. If you depreciate a hundred percent of the cost, how do you have a loss on sale of cows?
A. If you pay $2,000 for a cow and she is replaced within three years, we haven't written that whole cow off, we have only written off three years' worth, and there is a big cost remaining, matched against a beef check.
Q. I see. The loss on sale of cull cows would be a result of cull cows that are sold before the end of the depreciation cycle?
A. Whatever it is, yes. This is the best I have ever seen a lawyer talk about things like this.
Q. That is because I didn't wait until last to ask questions.
A. That was a compliment.
Q. Thank you. Okay. I am looking still at page 1, but on other pages, pages 7, 11. 12. you have information from various client regions, California, Idaho, Texas, Washington, New Mexico. Arizona and High Plains, for example, on page 7.
A. Yes, sir.
Q. Where you have aggregated information such

as on page 1, how is that weighted by your various client regions?

A. How is it weighted where?

Q. Okay. What portion of the aggregated data on page 1 represents production by cows in California to the total?

A. Oh, it is just simply the average of all the financial statements that we prepare from all the regions on page 1, in the year early 2000 this is -- okay. That answered that.

Q. Pardon?

A. I think that answered that.

Q. Okay. So the average represented on page 1 represents a total production of your clientele, and what portion of that total production is from the different regions, from California. from New Mexico?

A. I don't know at this time. This particular slide or report has been done, completed for a couple of years now. So, honest to goodness, we try to make a fair representation. I get the call all the time, what is more profitable, two times or three times. And there is no one answer. This is just how they fell in our sample of financial statements for those years.

There are no tricks.

People really want to know and they will make judgments based on numbers that we produce. So, I mean, they have to be pretty reliable.

Q. In your sample of financial statements. this doesn't represent the product of all your financial statements, page 1, for example?

A. Well, there may be a few excluded that are not finished at the time we do these. But it is more than 90 some percent, yes.

Q. So it is not a sampling of your clients? When you say "sample," you are sampling the whole population of your clients?

JUDGE PALMER: It is his entire clientele except a few that have been excluded?

BY MR. VETNE:

Q. It is your entire clientele?

A. Yes.

Q. Okay. You don't know sitting here -- well. let's say for the most recent year, 2006, nine months ending 2006 on page 9, what portion of your clientele, in terms of volume, was production in California, compared to the total. New Mexico compared to the total?

A. Just California alone? If this is a

deposition, I am told I am not supposed to guess.

Q. Well, estimate.

A. Am I allowed to guess?

JUDGE PALMER: You can guess.

BY MR. VETNE:

Q. You are allowed to give a judgment range.

JUDGE PALMER: Well. I just told him he can guess.

THE WITNESS: Would you repeat the question?

BY MR. VETNE:

Q. Approximately what portion of the total represented in the data on page 9, nine months into September 30, of your total volume production in your clientele is California milk?

A. I have never been asked that question before, and really, we handle a third of New Mexico. 25 percent of Texas. So, really. I don't have a feel for it. In Idaho, we do 20. 25 percent. Twenty percent of California, by the way.

Q. Twenty percent of California milk production?

A. Is produced from our clients, yes.

Q. And a third of New Mexico milk production?
A. Yes.
Q. And Washington?
A. Again, these are only estimates. We have not run those numbers for three or four years.
Q. Right, just roughly.
A. And we continue to grow. Arizona, maybe 20-some percent. Washington, 20-some percent.
Q. I notice on the map on the last page in your advertisement, shows the location of your clientele.

Do the averages reflected, where your client base is aggregated, include all of your clientele, including clients outside of the identified regions or states that you represented? For example, New York. Pennsylvania, Virginia, Ohio?
A. They would all be included.
Q. They would all be included?
A. Yes, yes.
Q. Do you produce any separate publication for the Northeast clientele region?
A. I do not.
Q. What portion of your clientele are from the Northeast states identified here?

A. Oh, in many states, we may have only one producer, up to three, four, five, not enough to produce a cost study with.

Q. Okay. You may have answered this. In a couple of the pages, let's look at page 12 again. nine months ending September 30. in several pages where you break down costs or income per cow, Washington seems like a good place to dairy, and yet observing NASS data. production has grown by nearly a hundred percent in New Mexico over the last ten years and Washington has been stagnant. I would wonder why.

And you said that the state has regulated in a manner that doesn't permit new production growth?

A. Or severely restricted new production growth. yes.

Q. Is that basically the reason why there hasn't been --

A. I think so, yes.

Q. You make reference in a couple of pages to New England. In one instance, you indicated that was Farm Credit information. Is that Farm Credit information wherever you identify New

England?

You mention it on page 11, but there is also New England data on page 12.

A. That's correct.

Q. It is not your produced data?

A. That's correct. I also have Japan and Germany, if someone cares. They don't do any better either.

Q. With respect to the portion of your client base that is California, what portion of that milk volume is quota milk?

A. Probably about half.

Q. Half of the volume?

A. I would say so, yes.

Q. Which is a volume substantially in excess of California quota milk to total California milk production?

A. That is correct.

Q. And that latter number is 20 percent or so. is that correct, or less?

A. What latter number?

Q. Quota milk, California quota milk to total California milk production.

A. Yes, I think so, about that.

Q. I am looking at page 8, and in addition, on

page 9 -- on page 8, you show a net income for calendar year ending December 31, 2006 for your entire client base.

A. That is not correct. Page 8, you said?

Q. Page 8.

A. Is a loss.

Q. I am sorry. You show a negative net income.

A. Correct.

Q. Okay.

A. Okay, there is a lawyer.

Q. A parenthetical net income.

(Laughter.)

Q. I assume that number includes some farms that had positive net income and other farms that had negative net income greater than 181?

A. I will tell you that this is only our projection that we put out a year ago. This isn't any actual result.

Q. In your projection, would you project that some of your farmer clients would have a positive net income and some would have a negative net income greater than 181?

A. Have a loss greater than 181?

Q. Yes.

A. Yes, sir.
Q. And some would have a number that is not in parentheses?
A. Yes.
Q. As far as the regional distribution of those variations, if you can comment, would they tend to follow the regional differences that you have elsewhere noted for the various production regions of clients that you represent?
A. Well, that was a compound question. Could you break that down into about three or four?
Q. Okay. Elsewhere you have shown, as we discussed, that profitability is somewhat higher in Washington than in some of the other regions in which you have clients, perhaps a bit lower in the High Plains States and so forth.
Do you expect that the aggregate projections that you make on page 8 would reflect a similar distribution of either greater loss or some measure of profit that follows the general pattern, for example, on page 12?
A. My page 8 and page 13 are simply my estimate of the consolidation of all of the financial statements that we issue for all of our clients in all of the areas that we service.

So the combination and results we estimated for '06 on page 8 was prepared in the same manner as the page 13 for our projection. There is no difference in the method of trying to get to a true net bottom line.

Q. My question probably wasn't clear.

JUDGE PALMER: I think I understand it. He is saying that you did say in respect to page 8 that the $1.81 loss will be greater for some dairy farmers and less for others, and he is wondering when you are looking at those that would be greater or lesser, would that be equivalent to the regions that you have identified as being more profitable?

BY MR. VETNE:

Q. On page 12. Washington, for example for --

A. Do we have any big winners and big losers in each area?

Q. Yes.

A. The answer is "yes."

Q. It would more or less correspond with the data on page 12 among your clientele?

A. Yes.

Q. And, again, your clientele is not represented in the New England line on page 12?

A. That's correct.

MR. VETNE: Thank you.

JUDGE PALMER: Let's take a recess for 10 minutes.

(Thereupon, a recess was taken.)

JUDGE PALMER: Are there any more questions for the witness? Yes, sir, Mr. Schad.

CROSS-EXAMINATION

BY MR. SCHAD:

Q. Good morning, Mr. Genske. My name is Dennis Schad, I work for Land O'Lakes. I would like to say I appreciate your coming. And your numbers, I have not seen before, and I am sure they will add value to the hearing record.

I have probably just a few questions.

JUDGE PALMER: I bet you do.

BY MR. SCHAD:

Q. If we go to page 9, and it is one of your financial records, and I am using it because I am learning -- I just want to understand how you define an average. When I see a number, for instance. of milk amount of 4 million 1, is that the weighted average of your 500 farms?

A. It is, when you enter in all these profit and loss statements and tell the computer to

divide by the number of statements that exist.
yes.
Q. Okay. So it is just --
A. But there are a few different ways -- there is a weighted average -- you know what I am saying? When you just simply compile the results of all these operations and then tell the computer out here on the right. "Okay. Do an average of all these columns," that is what this is. But there are three or four ways to say "average."
Q. I am understanding. Thank you. Mr. Vetne asked a lot of the questions I wanted to ask. But I would like to go to page 11. And yesterday Mr. Yale put into evidence Exhibit 19. and I am going to give you my copy of Exhibit 19, and had -- you have it?
A. There happens to be one sitting here.
Q. Oh, great. If there were six pages there. would you turn to what would be page 6.
A. I better look at what you have.
JUDGE PALMER: Let me look at 19 for a minute and see what you are talking about. Okay.

BY MR. SCHAD:

Q. And Number 19 --

A. Can you tell me if this is the document?

Q. I believe it is.

JUDGE PALMER: Take the witness to the page you want him to look at. Open it to it for him. These are not numbered, actually.

BY MR. SCHAD:

Q. And what this was reported to be yesterday was a report from ERS reporting an average for two different states, Vermont and Ohio. Page 6 that I pointed you to is Ohio, monthly average costs of producers' cost per milk sold 2003.

A. Yes, I see.

Q. I would like you also to turn to page 11 on yours.

A. Yes.

Q. Okay. On yours, on page 11, you have a grouping for Midwest, and I will identify page 11 as -- would you identify page 11?

JUDGE PALMER: It is identified by itself. It is in the exhibit. Go ahead.

THE WITNESS: Exhibit 20, page 11.

BY MR. SCHAD:
Q. My question is, would you tell me more about the grouping called Midwest?
A. Yes. The Midwest would represent a combination of our dairy clients from Colorado. South Dakota, Nebraska, Iowa, Kansas. I think that is about it.
Q. Okay. What I was intending to ask you was a comparison between the Ohio and your Midwest. Would you feel comfortable making a comparison between the two documents, that both purport an average cost of production for 2003?
A. This report represents an Ohio -- I haven't seen this. So I am --
Q. I understand.
A. It is Ohio, and it is a compilation of -- well, can you tell me what it is?
Q. It is from the Economic Research Service of USDA. It is published monthly and it purports to show --
JUDGE PALMER: You know. I don't think we are going to get very far with him doing this. He didn't use this particular report to prepare his. He used his own materials and they are different, they are

different. That is the way they are.

We will let everybody argue it in brief. He isn't going to be able to tell us whether he has all the hay and the straw and --

MR. SCHAD: I wasn't going to go into detail.

BY MR. SCHAD:

Q. I don't think you can make a comparison. because you don't have any farms in that part of the Midwest. I was going to ask you if that would be true.

A. There are two items that are on here that are the opportunity cost of unpaid labor and capital recovery of machinery and equipment. Those two items are not captured in my profit and loss summaries. So those are the differences between the two that I can see.

JUDGE PALMER: He had one other one. Do you have farms in Ohio?

THE WITNESS: Yes.

JUDGE PALMER: How many?

THE WITNESS: One or two. I am not sure. We have 16 partners.

MR. SCHAD: Thank you very much.

JUDGE PALMER: I don't mean to push, but I think it is time we have to push. Any more questions? Mr. Wellington.

Mr. Wellington, you didn't hear my admonition earlier. I would like to get you on today. One of the ways to get you on today is to get this witness off.

And since his testimony is really about numbers, I got a lot of questions about numbers through Mr. Vetne, for example, how he prepared the report, et cetera, et cetera. I don't know that we need a lot -- I am going to be using my authority under the Rules of Practice, if I need to -- I didn't say that earlier, but it says in the Rules of Practice. "When necessary, in order to prevent undue prolongation of the hearing, the judge may limit the number of times any witness may testify to the same matter, or the amount of corroborative or cumulative evidence."

I think there is a tendency sometimes to say, here is a witness, let's ask him about other things. Go ahead, sir. With that admonition, go ahead.

MR. WELLINGTON: Actually, there

were some things about prices that I would be curious of his opinion on. I don't think we need to talk about that.

THE WITNESS: Call me later.

CROSS-EXAMINATION

BY MR. WELLINGTON:

Q. I guess my questions would be limited to pages 11 and 12, on the New England data. That is where most of my members are at.

A. Yes.

Q. In fact, I gave you my card, because when I looked at this table, my first impression was that you would be recommending all your clients come to New England based upon the profit there.

A. I know better than that.

Q. You know better than that?

A. Yes.

Q. Your numbers here are basically representative of your clients, but they are not necessarily representative of the average producer in the state you operate in or in New England; would you agree with that?

A. It is representative of all but the New England, yes, sir.

Q. All but New England?

A. All but New England.
Q. Are you familiar at all -- you said you had to use Farm Credit numbers. Are you familiar at all with those or you just basically received a number from them and plugged it in?
A. I have their report and I just simply transcribed their numbers that I could easily match up as the apples-to-apples comparison and transcribed them onto this from their reports.
JUDGE PALMER: That is strictly in respect to New England. The rest are your numbers?
THE WITNESS: Correct, the rest are mine.
BY MR. WELLINGTON:
Q. And that's what I'm saying. My concern is that, this be used to say New England farmers are doing so much better than the rest of the country.
A. Well, again, this was a bank that produced this.
Q. Right.
A. Again, I might also add that banks receive information in all different forms. I am not even saying they are from reliably prepared

statements. They have to show bankers they are doing well or they won't get their lines renewed.

Q. Correct, and if you are getting a loan from Farm Credit, do you typically have to be better managed than the average operation, would you think?

A. Farm Credit or any of the major lenders. yes. Or you don't get a loan.

Q. So you don't know this to be typical for New England? I guess that is my bottom line.

A. It is their report.

Q. Okay. But if they came out with their report that showed something different from this, you wouldn't necessarily disagree?

A. No.

MR. WELLINGTON: Okay. Thank you.

JUDGE PALMER: Thank you. Mr. Wellington. Those were precise and on point. I am sorry I gave you all the admonitions.

MR. WELLINGTON: That is fine.

JUDGE PALMER: Anyone else? Yes. Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Good morning, Mr. Genske.

A. Good morning.

Q. Just a couple of quick questions. With respect to the New England information, can you be more precise in terms of the source of that information, which Farm Credit organization within New England or names of individuals they communicate with?

A. Yes. I don't have the report with me. But I do have it back in my office. And all of the different Farm Credit offices say their name slightly differently across the country. So all I can, at this time, is say it is a Farm Credit consolidated report.

JUDGE PALMER: Well, what I am going to do, I am going to ask you to send that information to Mr. Yale, and Mr. Yale will communicate it to Mr. Beshore.

MR. BESHORE: Fine.

BY MR. BESHORE:

Q. Now, with respect to a couple of lines of information on your summaries, and we can look at the first page of Exhibit 20, and I am

calling your attention to it, just to clarify a question or two about the average statistical data for average number of milking cows and average daily production per cow at the bottom.

A. Which page?

Q. Page 1. I assume on any of the tables where those lines appear, they would have been calculated the same way?

A. Correct.

Q. Okay. How do you determine the average number of milking cows, and is that strictly a number that reflects lactating cows or all cows of milking age, including those that are dry?

A. It is only the cows going through the barn and in the tank, in the milk tank. You also have a hospital pen. The milk from those do not go in the milk tank. These are actual cows milking in the milk tank.

You have, in addition to those hospital cows, a small number, and in addition to that, roughly 15 to 20 percent of dry cows in those numbers.

Q. In regard to herd size, the herd size is here. If you were to include the dry cows and the hospital cows, you would increase that by 20

percent roughly?
A. Just multiply those by 118 percent or something like that.
Q. Okay. Now, average daily production per cow then, is that -- how do you calculate that figure?
A. We have the production reports from different co-ops and creameries, and we, as one of the inputs of this, of course, we input the average number of cows being milked for that operation and the production totals.
So the computer just calculates the average for us.
Q. And again, that is on cows going through the milking parlor?
A. They call them wet cows, yes.
Q. Wet cows. Now, any -- you do not have any figures on here for yearly average production per cow, but we see that figure on USDA and NASS data routinely.
A. Well, mine is here.
Q. The yearly average?
A. Yes.
Q. I am sorry, can you point me to that?
A. It is right below the number of milk cows.

the number at the bottom, under stats.
Q. That is average daily production milk cows?
A. That's correct.
Q. But if we are going to translate, if we wanted a number for average annual production per cow, just per each individual cow, the cow is not going to produce 365 days a year?
A. No, you would multiply this, for example. this 68 pounds by 305 days.
Q. And that would be --
A. That is the lactating period average, yes.
MR. BESHORE: Okay. Thank you.
JUDGE PALMER: Any more questions? Yes, sir, Mr. Rosenbaum.

CROSS-EXAMINATION

BY MR. ROSENBAUM:
Q. Steve Rosenbaum with International Dairy Foods Association. I have a question about the last page of your Exhibit 20. That document purports to have information regarding the trends in retail fluid milk prices and retail cheddar cheese prices from April 1996 to March 2006; is that correct?
A. That is those two single periods of time, yes.

Q. And have I understood correctly --

JUDGE PALMER: I think I will simplify things. The document is here, but I don't think that could be used as good evidence of cheese prices, if that is where you are going.

MR. ROSENBAUM: Your Honor, he put it in the record, not me.

JUDGE PALMER: Oh, I understand. But I would say right now, I will make a ruling that we have other ways to find out what the cheese prices are, rather than something he has on this one-page document that basically is a flier to prospective clients and people that want to use his service.

And I am not saying his figures are right, wrong or anything else, but I would suspect that they are probably a little bit idealized.

And since it would take us a long time to go through how he put these figures together. I am not going to receive the last page of this document to establish anything about what the fluid milk prices, the cheddar cheese prices or the producer pay prices are.

I am not tearing it off. I will leave it with the group. But I am just saying. if anybody --

MR. STEVENS: Your Honor?

JUDGE PALMER: Yes.

MR. STEVENS: I mean. I think that the other parts of the document we talked about, certainly, this part of the document is an ad.

JUDGE PALMER: Basically it is an ad.

MR. STEVENS: Certainly, it can accompany the record, and you can make your points in the brief.

MR. ROSENBAUM: Well. I don't know what that means, to say it accompanies the record.

MR. STEVENS: It is part of the record.

MR. ROSENBAUM: Well, it has to be removed. If it is not being admitted into evidence, it should be removed and it should be marked --

JUDGE PALMER: Let's do that.

MR. STEVENS: Well --

MR. ROSENBAUM: The rules provide that if a document is not being admitted into evidence, then it is to be separately marked.

MR. STEVENS: We already have one document that's been offered of proof. And it is in the record.

JUDGE PALMER: Yes, we did.

MR. ROSENBAUM: I know. All I am saying is, this is a hybrid of a document. partly in and partly out. I don't think that is a proper way to handle it. I am with you, that things can accompany the record. I am suggesting --

JUDGE PALMER: Let me hear from Mr. Yale. He is standing behind -- quiet for a minute.

MR. ROSENBAUM: I am suggesting we simply remove that page and mark it as Exhibit 20-A. but not admitted.

JUDGE PALMER: Wait a minute, everybody. Let me hear from Mr. Yale.

MR. STEVENS: Let's hear from other people and see where we go.

MR. ROSENBAUM: I'm sorry.

JUDGE PALMER: What would you say

to that?

MR. YALE: Your Honor, this was not admitted, it was testified to say that this represented those actual prices. He said himself that this was a number that he collected, and its purpose was only to show in the marketplace, in his opinion, there was more money that could be available to pass on to producers. That is all that is there, and that is all it was used for. It was testified to that. We are not going to use it to say this is what retail cheese prices are or anything else.

It is perfectly admissible, based on what he testified to and no more than that. And your own instruction said how far it could go and it ought to go.

MR. ROSENBAUM: Your Honor, we cannot have a situation where a witness is permitted to testify that "I have looked at certain data and I draw conclusions from that that there is money in the marketplace." You cannot allow a witness to testify to that, which he has testified to, and not allow me to challenge the validity of that analysis.

JUDGE PALMER: Go ahead, let's

keep going. I thought I could shorten it, but I can't.

THE WITNESS: I will be short.

JUDGE PALMER: Well, maybe not. Go ahead. Mr. Rosenbaum.

BY MR. ROSENBAUM:

Q. Your document purports to show that retail fluid prices rose from $2.50 a gallon in April 1996 to $3.75 a gallon in March of 2006. correct?

A. Loss leaders excluded, as the asterisk shows.

Q. That is your definition of what a loss leader is?

A. That's correct.

Q. And are you aware of the fact that the Bureau of Labor Statistics itself tracks milk prices?

A. I am aware of the Nielsen reports issued through the State of California that reports all milk sales, yes.

Q. Do you know that the Bureau of Labor Statistics, to use their phraseology. sends economic assistance to record the prices of 80.000 items each month, for purposes of

computing the consumer price index and other purposes?

A. But you are also aware that many of the respondents to that use milk as a loss leader to get people into their stores. And that, many times, is used as a -- well, we are only getting 3.25 for milk in this area, so dairymen can't make more.

Q. What about cheddar cheese, are you saying that is done with that as well?

A. Is what doing with what?

Q. Loss leaders.

A. I routinely don't see any severely discounted cheese prices.

MR. ROSENBAUM: I would like to mark a couple of documents, if I could, as Exhibits 21 and 22, Your Honor.

JUDGE PALMER: All right.

(Thereupon, Exhibits 21 and 22 were marked for purposes of identification.)

JUDGE PALMER: So now we have marked for identification two documents, one is Exhibit 21, it refers to cheese, and the other one is 22, it refers to what?

MR. ROSENBAUM: Milk.

JUDGE PALMER: Oh, I see, milk. Okay.

BY MR. ROSENBAUM:

Q. Showing you Exhibit 21, do you see that the Bureau of Labor Statistics reports that the price per pound of cheddar cheese was $3.436 in April of 1996?

A. Yes. $3.436. yes.

Q. Whereas you, in your last page of Exhibit 20, you were indicating a price of $2.30 a pound; is that right?

A. That's correct.

Q. And do you see that the Bureau of Labor Statistics reports that in March of 2006, the price of cheese per pound is $4.365?

A. Yes, I see it.

Q. And you report in your last exhibit, last page of Exhibit 20, a price of $4.50 a pound. correct?

A. Correct.

Q. Now, your statement that there has been a 95 percent increase in retail cheddar cheese price between April of 1996 and March of 2006, is based upon the assumption that the cheddar

cheese price was $2.30 in March 1996 and $4.50 in March of 2006, correct?

A. That is my personal observation of prices at that time. But that is what it is saying, yes.

Q. That is the math. It is a $2.20 increase. divided by $2.30?

A. Yes.

Q. And you would, I am sure, agree with me that if one substituted the Bureau of Labor Statistics numbers, the percentage change increase would be, well, less than 30 percent?

A. Could be, yes.

Q. Well, it would be four --

JUDGE PALMER: We will accept your math.

THE WITNESS: I understand how it's done.

JUDGE PALMER: And if your math is wrong, somebody will point it out.

BY MR. ROSENBAUM:

Q. And would you agree with me that, if one were to pick other months for comparison, for example, let's say December 1999 as compared to the most recent date available, January 2007.

one would have concluded that there was a quite small increase in cheddar cheese prices only from $3.845 to $4.059.

A. They are Government numbers, they must be right.

JUDGE PALMER: I tell you what, we are going to receive it, because it is a Bureau of Labor Standards Statistic and we will receive 21 and we will also receive 22. You have some questions, I presume, Mr. Rosenbaum.

BY MR. ROSENBAUM:

Q. Back to the last page of your Exhibit 20. with respect to retail fluid prices -- retail fluid milk prices, you are, once again, comparing what you thought was the April 1996 price. versus the March 2006 price, correct?

A. That is what I observed then, yes.

Q. And you will see, looking at Exhibit 22. your number of $2.50 for April of 1996 is pretty darn close to the BLS number of $2.537, correct?

A. Yes.

Q. But there is quite a disparity between the $3.75 per gallon that you list in the last page of your exhibit for March 2006, as I say, $3.75, and the BLS corresponding figure, which is only

$3.161, correct?
A. The numbers are different. But these answer different questions than what are asked when these are prepared.
Q. Well, you have no reason to challenge that BLS is being consistent in its methodology between 1996 data and 2006 or 2007 data, do you?
A. I have no opinion on it.
Q. And I had asked you about the effect of choosing other comparison months for milk. Let's do the same ones we did for cheese.
If one was to compare the price of a gallon of fresh, whole, fortified milk in December of 1999, which is shown as $2.875, to the current price. the most current price, January 2007. which is $3.067, you would agree with me that that would show a quite modest increase in retail fluid milk prices?
A. And there are a whole lot more Costco type sales going on today than what there were back then, and Wal-Mart.
Q. And do you understand that BLS engages in sampling methodologies in an effort to come up with what it believes to be actual average prices?

A. I don't know what they do.

MR. ROSENBAUM: That is all I have.

JUDGE PALMER: All right. Fine. Let's receive some exhibits, since I have a whole bunch of them here. Let's receive 20. which was his statement, we will also receive 21 and 22.

(Thereupon, Exhibits 20. 21 and 22 were received into evidence.)

JUDGE PALMER: At this point in time, we will receive the whole of 20. Are there any other questions for this witness? Yes, Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. Mr. Genske, I noticed a difference in the data reported in your exhibit. On page 1 of your exhibit near the bottom, you report an average solids nonfat test for producers that are your clients. And on page 8, 9, 10, 13 and 14, you do not provide that data. You provide an average protein test instead. I wanted to ask you about that.

The protein test that is reported on the other pages seems to be approximately 3 percent

or slightly over 3 percent.

For the period in which you do not report protein, would the protein portion be similar where total solids, not fat, are 8.7 percent, protein would be 3 percent, so whatever 3 percent is of 8.7 is the percentage of protein and total solids.

A. You can feed cattle and change the components of protein -- excuse me, of butterfat and solids nonfat. I don't believe there is yet a way to feed cattle or care for cattle any differently to get a higher protein content. So the protein content is just about always around 3 percent, 3.05 or something like that.

Q. All right. And protein is a bit -- or Mr. Metzger may say substantially higher in Jersey herds.

A. Yes.

Q. So is the mix of Jerseys to Holsteins in your clientele consistent from year to year?

A. Actually not. There has been an increase in our clients' interest in Jerseys, but it is still very small to the total.

Q. For those years in which protein is reported but not solids nonfat, do you know

sitting here whether there is a significant variation from the 8.7 percent observed on page 1 for the earlier years?

A. No. It pretty well runs a standard rate in that range.

Q. And those aggregates that are averaged in your data reflect regional differences in both solids nonfat and protein, correct?

A. Correct.

JUDGE PALMER: Does that conclude it? I think so. Thank you very much, sir. Thank you. I appreciate your coming all the way to give us your testimony and your help.

(Thereupon, a discussion was held off the record.)

(Thereupon, Exhibit 23 was marked for purposes of identification.)

MR. VETNE: You have a prepared statement on Proposals 10 and 11, don't you? Do you have any preliminary remarks before you read your testimony?

MR. WELLINGTON: No.

JUDGE PALMER: Let the record show that was Mr. Vetne and this is Mr. Wellington now testifying from his prepared remarks. Go

ahead. Exhibit 23, so marked.

STATEMENT FOR THE RECORD OF ROBERT D. WELLINGTON

MR. WELLINGTON: My name is Robert D. Wellington. I testified earlier this week on Proposals 1 and 2, and I now wish to do so regarding Agri-Mark Proposals 10 and 11.

Proposal Number 10. Under current Federal Order provisions, both the butterfat and protein prices use the Grade AA butter price as a value for all types of butter production, resulting from the use of Class III and Class IV milk. While that may be an appropriate value for Class IV component value calculations, it is not so for all Class III component values. The intent of Proposal Number 10 is to adjust the protein price component to compensate the USDA's use of the Grade AA butter price to represent the price of whey butter in the Class III price calculation.

The Class III yield calculation for milk testing 3.5 percent butterfat and 2.99 percent true protein assumes 90 percent butterfat retention in cheese with the remaining fat being used to produce butter. However, because this butterfat is a residual of the

cheese making process, it cannot be manufactured into Grade AA butter, but is used for whey butter production.

The 10 percent of the butterfat not used in cheese production represents approximately 0.35 pounds of butterfat for every hundred pounds of milk testing 34.5 percent butterfat. That butterfat is manufactured into 0.42 pounds of butter, according to USDA's formulas. However, the butterfat and protein formulas further dictate that the resulting 0.42 pounds of whey butter be priced as if it were sold as Grade AA butter.

It is illegal under USDA's own regulations for whey butter to be labeled and sold as Grade AA butter, and such product does not have that Grade AA value in the marketplace.

Agri-Mark's whey butter selling prices average $0.074 per pound below that of Grade AA butter. That $0.074 difference multiplied by the 0.42 pounds of whey butter for each hundredweight of milk equals $.02957 per hundredweight of milk. This overstates the Class III milk value by that amount. Using USDA standard of 2.9 pounds of protein in that same

hundredweight of milk, the value per pound of protein should be reduced by $.01 ($.02957 divided by 2.99.)

Accordingly, we propose the following order amendment: For the order language, amend Section 1000.50(n) by including the following additional paragraph: (4), I guess it's (n)(4), Subtract $.010 from the price computed pursuant to paragraph (n)(2) and (n)(3) of this section.

That concludes my testimony on Proposal 10.

I will continue on with Proposal 11. This proposal seeks to amend the Class III product price formulas by reducing the adjustment for cheese manufactured in 500-pound barrels contained in the protein price formula from 3 cents to no greater than 1.5 cents per pound.

USDA has noted in past decisions that the historical difference between the NASS prices of 40-pound -- that should be 40-pound block cheddar and 500-pound barrel cheddar has averaged about 3 cents. This was a primary reason for establishing and maintaining that surcharge to barrel prices in the Class III

product price formula. However, since January 1st, 2000. that price difference has averaged less than 1.5 cents per pound. Those prices have been drawing even closer together in the past several years. In 2004 and 2005. those differences averaged less than one cent per pound. In 2006, that difference was less than a quarter of one cent per pound.

As we reviewed the two alternative proposals in the hearing record regarding this same issue and provision of the orders, we have concluded that either of those two proposals was a better way of dealing with this price distortion problem, rather than just making a one-time price adjustment that could likely need further amendment in the future.

Accordingly, Agri-Mark withdraws its support for Proposal 11 at this time. We look forward to reviewing the hearing evidence and testimony regarding proposals 12 and 13 and will likely register our support for one of these proposals later in the hearing process.

JUDGE PALMER: All right. Let me see if I understood that definition on Proposal 10.

The way you read it is .010, and that is really a penny per hundredweight?

MR. WELLINGTON: Exactly, Your Honor. Thank you.

DIRECT EXAMINATION

BY MR. VETNE:

Q. Mr. Wellington, I have just a few additional questions. You referred to Agri-Mark's whey butter. Does Agri-Mark process its own whey cream into whey butter?

A. Yes, it does.

Q. Does that processing take place at the cheese plant in which milk is converted to cheese?

A. It used to. But we've just changed that and we now transport it to our regular butter facility in West Springfield.

Q. So your cheese plants are located in Vermont and New York; is that correct?

A. That's correct.

Q. And from that location, whey cream is transported to Springfield, Massachusetts?

A. Yes.

Q. Does Agri-Mark, in addition -- well, let me ask this: Does Agri-Mark process all of its own

whey cream or is some sold?
A. Pretty much all of its own whey cream it processes.
Q. Is the skim component, or the skim byproduct whey-whey skim, is that also processed at the Springfield plant?
A. No. The whey is actually processed at our Middlebury facility. To the extent that it is made at our Middlebury facility, it is condensed at our Cabot facility and brought over to Middlebury, and it is separated to try to get some of the lactose out at our Chateaugay facility, and the lactose is land spread and the protein is brought over. That is a rather complex procedure that doesn't relate to this proposal.
Q. Can you spell Chateaugay for the reporter, please?
A. Oh, gosh. C-h-a-t-e-a-u-g-a-y.
Q. This is in New York?
A. That is in New York. The northernmost tier of New York, very close to Canada and Vermont.
Q. So the whey byproduct is transported and consolidated to one facility?
A. Yes.

Q. And the whey butter is transported to a different facility from all of your plants?
A. That's correct.
Q. And none of this price difference that you are suggesting in the amended order language. Section 1000.50(n), captures the additional cost of transporting?
A. No, it does not.
MR. VETNE: Thank you.
THE WITNESS: I would make one correction, Your Honor, when you said that order language was one penny, I think you said per hundredweight. It is really a penny per pound.
JUDGE PALMER: Per pound. I am sorry. I didn't understand that. It makes a big difference.
THE WITNESS: It sure does.
MR. VETNE: The witness is available.

CROSS-EXAMINATION

BY MR. GALARNEAU:
Q. Clay Galarneau with Michigan Milk Producers Association.
JUDGE PALMER: I got it right that time.

MR. GALARNEAU: Thank you.

BY MR. GALARNEAU:

Q. Good morning, Bob.

A. Good morning, Clay.

Q. Bob, you provided the current yield analysis on whey butter being .42 pounds per 100 pounds of milk in the current yield formula?

A. That is the butter yield that I use, and I use the same for whey, for whey butter.

Q. Whey butter, that's correct. Do you have what the yield is for cheese in the current formula?

A. For 3.5 percent milk, yes. Well. I believe it is like 9.6 something, I think Mr. Yale actually quoted it. I don't have the exact number with me, though.

Q. How about the pounds of whey from a hundred pounds of milk?

A. I think that is somewhere around .586, something like that. I am sorry, 5.86 pounds, something in that area. I just don't have the numbers in front of me.

Q. I will have to get those at a later time then. That is really where I was headed. So if you are not prepared to talk about that, then

thank you.

A. Okay. Those numbers are actually derived from the formulas, so they can be -- I have derived them and I have them on my computer, I just don't have them with me.

MR. GALARNEAU: Thanks.

JUDGE PALMER: Other questions? Yes. Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. Good morning, Bob.

A. Good morning.

Q. In your testimony earlier this week, and correct me if I am wrong, you testified that Agri-Mark does not produce any of the commodity cheddar cheese that is reported to NASS, or does not report any cheddar cheese to NASS?

A. We don't report any cheddar cheese to NASS.

Q. And part of that is because the volume is small and erratic?

A. Of our commodity sales, yes.

Q. Yes. You are not here to testify whether the 90 percent butterfat recovery is right or wrong, you are simply saying that because the formula implies 90 percent, therefore. 10

percent of that is whey butter and it should be considered at a different price?

A. That is true. And, in fact, I will give you this, Ben. If the department decided it should be 94 percent butterfat retention, then it would be 6 percent of the butterfat would be then worked through this formula, and then that is how -- that is the level of the correction. I am not tied into one cent per pound correction, I am tied into represent the value of whey butter.

Q. What is whey butter used for?

A. It can be used, actually, for -- some people use it for table use. But, primarily, our customers use it for baking needs. commercial type baking needs.

Q. Would that be listed as -- is that treated in your report, or maybe it is beyond the point of reporting, is that a Class III or a Class IV product?

A. That would be a class -- I think we treat it as a Class IV use of butterfat. I don't think it matters on the butterfat side whether it is III or IV, because it has the same price.

But I am pretty sure that is a Class III

use of that. That is a good question. Ben. I am not sure offhand.

Q. And if they didn't buy the whey butter. then the market would -- they would have to get the regular Grade AA butter, is it a replacement for Grade AA butter?

A. Yes. And, in fact, that is sort of how this works, is that there are people out there who would prefer to use Grade AA butter. But they can get it -- they can get whey butter cheaper.

If they can get whey butter cheaper. depending how much cheaper, they can mix whey butter in with Grade AA butter, a certain percentage, and still get the flavor they want in their baked goods and other things.

They sort of substitute the ability -- if we lower the spread, for example, in the spring when we have a lot more whey butter, well, they are more inclined to use it. If we don't have a lot of whey butter in the fall, they turn around and use more -- well, you say that is more expensive.

That is why I went through and tried to get a calculation -- well, I did get a calculation.

7.4 was our pounds. When I look at our largest customers that buy both whey butter, and most of our whey butter and Grade AA butter, the difference was around 7 cents.

Q. Is that a consistent number?

A. Yes, it is. The 7 cents is very consistent. The 7.4 is a weighted average of all our sales. The reason why it is higher is that smaller customers will buy more when that difference is higher.

So if, for example, whey butter is very rarely frozen or other things. It is a fresh product, for the most part. So in the spring when we have more, if we say, "Well, we will give it to you for 8 cents under or 9 cents under." because we want to move the product. then they will say, "Oh, yeah, we'll be willing to buy more." So the average works out to be 7.4.

Q. Now, the whey butter can also be used to add to the fat in the vat for making cheese; is that correct?

A. I can tell you we don't do that. And I don't know any 40-pound block cheese makers that do. I don't know of any. We certainly don't do

that. There may be other cheese makers making other varieties that do that, but we do not.

Q. Now, and this is not a reflection on your integrity or reporting, but I want to kind of take -- sometimes people consider it a lawyer view that looks at things evil and the like, so bear with me with this question. You indicated that this is 74 cents a pound and that it --

A. 7.4 cents.

Q. 7.4 cents per pound. How can somebody who is not in Agri-Mark verify that number, whether that is correct, or whether that represents a price that is national in scope, or a weighted average like we have with the NASS butter and the NASS cheese?

I mean, is there a reported price, can I go to the Dairy Market News and see that whey butter is going at this price or is there a publication of some national butter manufacturers or something that reports this as the weekly price?

A. I don't believe there is, Ben. It is a negotiated price. Our understanding is, there are other whey butter makers, and so we have to be competitive or we are not going to move the

product

But in the sense of, you know, do you believe my number, it would be the same as if your past witness had details of his stuff These are details, I sat down with my cost accountants

In fact, I will tell you that my original proposal. when I talked to USDA, had 12 cents as the difference, instead of 7 4 I got that 12 cents, because I asked our cost accountants, when I saw there was a problem, I said. "What is the difference in price?" And they said. "Oh. 12 cents " So I thought, "Wow, that is a lot of money " I went to USDA and whatever

But when I am preparing for this testimony here. I want to make sure I really understand it and get on the stand and back my numbers

And so as I sat down, I found out a lot of that difference was they were looking at different packaging Our Grade AA butter is in a, sort of a cardboard container and other things

And then finally, when I zeroed in and said, no, we need the same packaging, I want to look at the same customers that we have, and we

do have customers who buy both Grade AA butter. We sell it in -- it is basically a waxy-like paper, one pound print.

When I did that, that is where we came up with the 7.4. So there is a lot of detailed work, sitting down with my accountants and my plant people so I would understand the process and we make sure we had a good number.

Q. Now, again, and I am not challenging yours. but my question is, is there a way to see -- well, let me back up. You indicated that there are times when the price of the Grade AA butter. the spread narrows and there are times that it widens, right?

A. On a seasonal basis, yes.

Q. They are two different commodities?

A. Right.

Q. There is a certain amount of arbitrage that can go between the two. You can move one into the other use, like you say, at the bakery.

A. Yes.

Q. But do you ever have a situation where that price actually approaches Grade AA butter prices?

A. It could get closer when butter supplies

are extremely tight, and so people are looking for butter, and if they can't find it because it is tight, then they might be more willing to settle for whey butter, so they will approach that price.

This is the price over the last. I believe it was about three years that we put data in for, and just because I looked at the most recent numbers. It can, but also, when there is a lot of butter and Grade AA butter was cheaper, like it actually was last year, they are more inclined to say, "No, I will use the good stuff." So it can move the other way too.

Q. You write that this penny represents about 3 cents a hundredweight?

A. Approximately, yes.

Q. In milk prices?

A. Yes.

Q. So this would be locked into the regulation that if the spread changed one way or the other. first of all, outside of Agri-Mark and those who were in it, we wouldn't know whether it was an appropriate number or not, right?

A. I can only testify --

Q. I know you can only testify -- that is my

point. It is only a privately known number. there is no public information that would be able to tell us that the market, for whatever reason, the fundamentals have changed, for whatever reason and now whey butter is worth more or less in relationship to Grade AA butter?
A. That is true. I would hope there might be some other witnesses that relate to what the whey butter relationship is. But I think my numbers are not atypical. We have a significant volume of whey butter. We sell somewhere in the area of about 5 million pounds of whey butter. We don't sell whey butter for other uses unless it is on a very rare basis.

I mentioned -- Mr. Vetne mentioned that there is whey butter that -- do we make it all into whey butter. And pretty much we do, but on occasion, if someone wants some whey cream. I am not sure what the use would be, but I am sure we would sell it to him if the price is right. But that is rarely that we do that.

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

JUDGE PALMER: Other questions? Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore. Bob, is it, to your knowledge -- well, Dairy Market News doesn't publish any information regarding whey butter prices?

A. I don't believe so, Marv, it is not something I track on a regular basis. So I am not aware of it.

Q. Are you aware of any published reporting of prices in that market?

A. No, and I asked some of my accounting people and they didn't have any other numbers that they use. It was basically competitively set. It is a give and take. They said our customers will say to them, "I can get it cheaper elsewhere," or whatever.

Then they have to decide if they can believe the customer or not and how much they want to move the product. No, I am not aware of that, Marv.

Q. Would you think the lack of market information -- I mean, Dairy Market News publishes ranges of prices on just about everything they can get data on.

A. Sure.
Q. Would you think the lack of published data might reflect the fact that that is a very small market?
A. It could be, Marv. I don't know. For us. it is a relatively large market, and it is -- the formulas do reflect that they use the Grade AA price, and we can clearly say that is not the Grade AA price, that there is a difference. We can say what our difference is.

Is this difference the exact amount year in. year out? No. I mean. it can be more or less. But you have to determine a number. We think this is a fairly representative number of it.

Certainly for our operations, it is representative.
Q. Do you purchase whey cream for processing?
A. We do, but it is a relatively small amount and I think we only really buy it from one or two customers. The overwhelming majority of whey cream is our own.
Q. So the 5 million pound figure, is that an annual production figure?
A. Yes, yes.

Q. Are you familiar with the fact that, at least in some states, whey cream can be used in AA labeled retail consumer butter?
A. No. I would like to know which states they are.
Q. Okay. You are not familiar with that in Wisconsin, there is a Wisconsin AA label?
A. AA butter or AA whey butter?
Q. AA butter.
A. Really? That I wasn't aware of. We don't sell -- I don't believe we have any customers in Wisconsin. but I am not sure.
Q. There has been testimony at the prior hearings that much whey cream is recirculated in the cheese making process, so that the, you know, the amount of it, the proportion of it that winds up in cheddar cheese can be very high.
A. There was, but most of the discussion I recall, Marv, was that it might have been more likely done in barrel production, or I know there was a discussion that it might be done in Italian cheese production.
I don't think it is done in block production, and that is sort of what we focus in

on, the make allowance and other issues. So that is really why I think we are here, because we do block production, we have whey cream left over, we turn it into whey butter, we sell it at a certain price, so we are trying to have that reflected in what we pay for the milk.

Q. But to the extent that it is done, just taking your comments, to the extent that it is done in barrel production or mozzarella production, all that milk and all that butterfat is being priced under the same formula here?

A. Well, it is. But I think we have a focus on -- we are trying to get to a common price. I thought that is the block cheese price, so we are focusing on that. We can look at a lot of -- I mean, yields of mozzarella are dramatically different from yields of cheddar. We are all trying to focus in on one process. one price. one yield. That is where I was trying to go to on this.

MR. BESHORE: Okay. Thanks.

JUDGE PALMER: Other questions? I have one about this whey butter as compared to whey powder. You said whey powder was becoming profitable. Can this whey butter be made into

whey powder?

THE WITNESS: Oh, no. The whey powder is the protein and the lactose in milk. It is very similar to an extent like nonfat dry milk powder. It is very digestible.

I didn't mention that when we had our conversation two days ago on the record. But, no, it can't be, because they are different components.

JUDGE PALMER: You can't curtail the manufacture of whey butter to use something. some part to make a whey powder?

THE WITNESS: Not at all, not at all.

JUDGE PALMER: All right. I just wanted that clarified. Yes, Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. What percentage of butterfat is in the whey butter as you market it, is it 40 percent, 80 percent?

A. It is 80 percent.

Q. Just like regular --

A. It meets basically all the standards.

Q. Then the 20 percent is whey skim. If 80

percent is butterfat, what is the other 20 percent?

A. Oh, it is other solids, moisture, mostly moisture. There are some other milk solids in it.

Q. Do those other milk solids carry the same percentage to the water as they do in just the whey skim?

A. I think likely they do. But I don't know for sure.

Q. Very good.

JUDGE PALMER: Yes, Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Just one other question, Bob. Who are Agri-Mark's major competitors in selling whey butter?

A. I am not sure. I think our customers can get it from other areas of the country, like they do regular butter. I am not sure if perhaps Great Lakes does some. On occasion we might buy some from them. There are other cheese makers who make them.

Q. Who make whey butter?

A. Well, yeah, I think similar that we might

do. But I don't know, Marv, I don't have the list of who our competitors are for that.

Q. Okay.

A. There is not a lot of whey butter makers, and in fact. I am not sure what Land O'Lakes does, for example, with whey butter. They might do whey cream and sell it for some other use.

MR. BESHORE: Thanks.

JUDGE PALMER: Any other questions at all? It appears not. I am sorry, Mr. Schaefer.

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. Good morning, Bob.

A. Good morning.

Q. Two questions, I think. The first one is. is when we look at the issue that you brought up here with the whey butter, doesn't that become a butter issue, rather than a protein issue, and wouldn't it more appropriately be addressed in the butterfat price portion of the Class III formula, rather than in the protein portion?

A. Well, but if it did, it would create a different butterfat value for cheese than it would for -- or for Class III and for Class IV.

So that is why we sort of used protein as a residual catch-all in the way we calculate the formulas now.

So that is why I did this. I said, "Okay. We are going to keep the butterfat component the same for Class III and Class IV, then the only place I have to put this as sort of a clearinghouse for the value is in the protein." Hence, that is why I put it into the protein.

Q. And the second question I have deals with your order language. And as I view the intent of your proposal is to -- with your specific numbers here, to reduce the protein price by a penny?

A. At 90 percent butterfat retention. yes.

Q. Correct, with what you have in your figures here.

A. Yes.

Q. As I read your order language. I don't think I would get that. But your intent is to reduce it by a penny?

A. Yes.

Q. So we need to write the proper order language if this proposal is accepted as you've presented it?

A. I would certainly say you were the experts more than I. So my answer is yes.

Q. Thank you, Bob.

JUDGE PALMER: You are completed. Thank you very much. It looks like we are at the luncheon recess. I just want to get a fix now on who we are going to be hearing from after lunch. So let's go off the record now.

(Thereupon, a luncheon recess was taken at 12:04 p.m., with the proceedings to be continued at 1:00 p.m.)

AFTERNOON SESSION

1:25 p.m.

JUDGE PALMER: I understand the Government has an announcement about where we may be holding this hearing next?

MR. ROWER: Jack Rower, for AMS Dairy Programs. We have a tentative reconvening date of April 9th, and tentatively scheduled for Indianapolis. We are waiting to hear on a hotel, at 1:00.

JUDGE PALMER: 1:00 start. All right.

MR. ROWER: We will provide people with more information as it becomes available.

JUDGE PALMER: And I presume the Market Administrators will have information on it and it will also be on the Web site?

MR. ROWER: Sure, we will make an announcement.

(Thereupon, Exhibits 24 and 24-A were marked for purposes of identification.)

ROGER M. CRYAN, Ph.D.

having been first sworn by the judge, was

examined and testified under oath as follows:

MR. STEVENS: Your Honor. I think before we left, we were going to admit Exhibit 23.

JUDGE PALMER: Yes. We will receive Exhibit 23 at this time.

(Thereupon, Exhibit 23 was received into evidence.)

JUDGE PALMER: The witness is sworn. And we are identifying his statement as Exhibit 24, with a statistical sheet attached. which will be 24-A.

DR. CRYAN: Your Honor, before I begin, I would like to explain that 24-A is a pair of graphs that were in the text of the statement, and it didn't come out when they were copied correctly. So in order to complete the record. I have offered a sheet that contains two graphs. Say when.

JUDGE PALMER: Go ahead. You may start.

STATEMENT FOR THE RECORD OF ROGER CRYAN, PH.D.

DR. CRYAN: Thank you. Your Honor. I thank the department for the opportunity to present our proposal. Our

proposal is number 17, as noticed in the Federal Register.

My name is Dr. Roger Cryan. I am the Vice-President for Milk Marketing and Economics for the National Milk Producers Federation, or NMPF, where I have been employed for the past six years. Prior to that, I was the economist for the Atlanta Milk Market Administrator in the USDA.

I am a graduate of the Johns Hopkins University and hold an M.A. and a Ph.D. in agricultural economics from the University of Florida. I am a Secretarial appointee to the USDA Advisory Committee on Agricultural Statistics, and I have been involved with agriculture and agricultural economics for over 25 years.

MR. BESHORE: Your Honor, before Dr. Cryan proceeds with the remainder of the statement, may I move that his testimony be received as that of an expert in his field?

JUDGE PALMER: I would believe there is no objection. We have heard from the doctor before, and he will be treated as an expert.

THE WITNESS: Thank you. Your Honor. NMPF is the voice of America's dairy farmers, representing nearly three-quarters of the country's 62,000 commercial dairy farms through their membership in NMPF's 32-member cooperative associations.

NMPF proposes that USDA change the manufacturing cost allowances, also known as make allowances, for cheddar cheese, nonfat dry milk, butter and whey, by incorporating monthly energy cost adjusters. In the appendix attached to this statement, NMPF offers specific language to effect that change.

Indexing Energy Costs in the Federal Order Make Allowances. Energy cost is by far the most volatile component of manufacturing costs. Other costs tend to increase more steadily and more gradually over time, and are. at least partially -- and are offset, at least partially, by increased manufacturing productivity.

But energy costs are different. Short-term, but often dramatic, energy price increases in recent years have often overshadowed and at times overwhelmed other cost

and productivity changes.

The current Class III and IV price formulas include fixed make allowances that incorporate an energy cost that is estimated at a single point in time. Given the increasing volatility of energy prices, a fixed energy cost component no longer makes sense.

For example, make allowances that were based upon the extraordinarily high energy costs of late 2005 would now be clearly excessive. Since that time, natural gas prices have decreased, regressing toward their long-term norms.

On the other hand, the make allowances that were applied in late 2005 were based in part upon 1998 energy costs and failed to reflect the costs of processing certain dairy products. The Producer Price Indices in figure 1, which is incomplete, essentially illegible in this statement, but is reproduced in Exhibit 24-A, demonstrates this point.

The use of a fixed point in time estimate of energy costs in calculating make allowances can unfairly disadvantage both dairy processors and dairy producers. When energy

prices rise dramatically, fixed make allowances fail to provide adequately for plant costs. When they fall precipitously, they provide an unfair windfall to processors at the expense of producers.

NMPF proposes a change that would be fair to all participants in the dairy industry. NMPF urges USDA to adopt a rule that incorporates a mechanism for monthly adjustments of processors' energy costs. NMPF further suggests that the energy costs adjustment mechanism be based on published Producer Price Indices or their functional equivalent. Such indexing would allow specific and regular adjustments, both up and down, to reflect dairy manufacturing plants' true costs of natural gas and electricity. Such a mechanism would be more equitable than the currently employed point-in-time estimate and it would contribute to maintaining the viability of processing pooled milk on each market.

NMPF recommends that the energy index adjustments be calculated from the Producer Price Indices for Industrial Natural Gas, BLS Series WPU0553, Base equals December 1990. and

the Industrial Electric Power Distribution Price Index. BLS Series WPU0543, with a base of 1982. weighted by the direct costs of electricity and fuels per pound of product, as estimated for 2004 by USDA/RBS and CDFA and for 2005 by Dr. Stephenson, or on the basis of an alternative presented below and discussed below.

NMPF does not believe that the long-term problem of energy costs can be addressed simply by making a new point-in-time estimate and maintaining the current method of calculating make allowances. Although a modest one-time adjustment could make the formulas appear more equitable under certain conditions, subsequent changes in the energy market could quickly render a new fixed make allowance obsolete even before it is implemented.

Any make allowance calculation based on a fixed point-in-time estimate will unfairly penalize processors when energy prices go above the baseline in the revised survey and unfairly penalize producers when the energy prices go below the baseline. Energy cost indexing makes sense and should be added to the formula.

Calculating the Energy Cost

Adjustment. Whatever make allowances result from this proceeding, NMPF proposes that they be adjusted each month to account for the rise and fall of energy costs. NMPF recommends that the electricity and fuels elements of plant costs be inflated or deflated according to the following formula. I believe everyone can look at the formula.

The resulting make allowances would be equal to a base make allowance, plus an energy cost adjustment. The energy costs to be inflated should be derived from the energy elements of each cost survey in proportion to their weight in the final calculation of each base make allowance.

The objective of the formula is to adjust the energy components of the cost of processing for each benchmark commodity. Energy is by far the most volatile element of the processing costs. Automatic adjustments to energy costs will cause the make allowance to more consistently reflect the costs that it is intended to reflect. The resulting make allowance would be neither too high, nor too low. as energy costs swing up and down.

Setting the Energy Cost Base The proposed language attached to this statement is based explicitly upon USDA's economic impact analysis, entered into the record as Exhibit Number 7 That analysis developed an energy indexing calculation based upon the proposal as. quote, "presented by NMPF at the reconvened hearing concerning Class III and IV make allowances during the week of September 14th. 2006," unquote, and that hearing is docket number AO-14-A74, but using the ultimate weighting of manufacturing cost data sources used in the tentative final decision in that proceeding

The numbers generated by the USDA analysis generally reflect NMPF's present proposal as applied to the current Federal Order make allowances, and given the limitations of the available data, those numbers could serve as a basis for implementing NMPF's proposal

USDA's analysis states that, quote. "Data from the Cornell study concerning energy costs per pound have not yet been released to the public," unquote

The USDA analysis, therefore.

constructs an approximation based primarily upon energy costs compiled by the California Department of Food and Agriculture. However, at the September 14th hearing Dr. Mark Stephenson of Cornell University did present survey data regarding manufacturing costs. In his testimony, he offered data on total energy costs for each of the four benchmark products. including fuel and electricity costs for each product.

Table 1 contains those costs from Dr. Stephenson's testimony, in addition to previously presented data on energy costs from the California Department of Food and Agriculture and USDA's Rural Business-Cooperative Service. All these are from the record of the make allowance proceeding. Transcript, there is a reference here to the transcript pages in which Dr. Stephenson's numbers were presented, and the exhibit in which the rest of the numbers were presented by myself.

As an economist, I believe this additional data may represent a truer calculation of processors' energy costs. NMPF

encourages USDA to consider this data.

If the Secretary decides upon an alternative make allowance or an alternative method of establishing the make allowance, we urge that a corresponding energy cost indexing methodology be adopted. If this proceeding leads to recalculated make allowances, it should also produce an energy cost index adjuster that corresponds to the data used to produce those make allowances.

The Secretary may decide to administratively update make allowances based upon annual or biannual manufacturing cost surveys of manufacturing costs, as has been proposed. If so, such surveys should tabulate electricity and fuel costs, and an energy cost index adjuster should be applied to those costs. Without indexing, even an annual make allowance revision based on an annual cost data will result in the application of energy costs up to 24 months old. Given the volatility of energy costs, not just from year to year, but from month to month, a monthly index based update is the only way to achieve equity in milk pricing.

Use of Industrial Natural Gas and

Industrial Electricity PPIs. Producer Price Indices are published by the Bureau of Labor Statistics, BLS, as a measure of changes in the prices of a large number of inputs to production. The prices for some inputs are measured separately for residential customers. commercial customers and industrial customers. Industrial customers include manufacturing and mining. These indices are published monthly in mid-month for the previous month.

The Producer Price Index for Industrial Natural Gas is designated as BLS Series WPU0553 and has a base of December 1990. meaning that the base -- that the index for December 1990 is set to 100. This series tracks the average price of natural gas sold by utilities to industrial customers, defined as manufacturing and mining operations. I indicate here that a note from the economist who works most directly with the PPI at BLS is attached. It is attached to the original exhibit in which the other data is presented. That is the exhibit referenced in the previous page from the previous hearing.

The detail of this note clearly

distinguishes the Industrial Natural Gas Index as the one most directly applicable to manufacturers' costs of energy.

The Producer Price Index for Industrial Electric Power Distribution is designated as BLS Series WPU0543. Its base period is 1982; that is, the index is set equal to 100 for the annual average of 1982. This series tracks the average price of electricity sold by utilities to industrial customers defined as manufacturing and mining operations.

Both of these series can be retrieved from the following page in the Web site of the Bureau of Labor Statistics using their Series ID numbers, and that URL is http://data.bls.gov/cgi-bin/srgate.

Evidence for Applicability of an Energy Cost Adjuster. The only consistent series of manufacturing costs over time is for California. This series provides a means of testing the fit of proposed energy cost adjustments to the make allowance.

The graph below, and more accurately. the graph in Figure 2 in Exhibit 24-A, shows the annual California cost survey results for

cheddar cheese and nonfat dry milk, along with make allowances for each adjusted with the electricity and natural gas adjusters originally proposed by NMPF in January 2006 Although the energy costs do not account for all of the long-term changes in manufacturing costs, they do appear to clearly account for much of the year-to-year variation

Energy, especially natural gas, costs are a large share of the cost of processing of nonfat dry milk Cheese costs in California have been trending downward over 15 years This long-term trend may or may not be representative of the nation at large

Nevertheless, the proposed make allowance adjustment does reflect much of the year-to-year variation in California cheese processing costs The graph shows how closely an adjusted make allowance fits the changes in California costs for cheese and nonfat dry milk

The proposed butter cost adjustment also correlates with changing costs in California butter plants, but uniquely among these plants, non-energy costs have risen considerably more than energy costs, so that it

does not show up easily in a simple graph.

California whey costs were not collected before 2003. For this reason. one is unable to directly test the fit over time of our proposed energy index for whey as one can for butter, nonfat dry milk and cheese. However. whey drying is so similar to nonfat dry milk production, that one can reasonably assume, as USDA did in order reform and in the 2002 Class III and IV price decision, the whey processing costs are closely related to nonfat dry milk processing costs. NMPF suggests that the evidence for nonfat dry milk also represents evidence for whey. That is to say, evidence of that principle.

Monthly Application of Energy Cost Adjuster. The energy price indices that NMPF proposes to be used are calculated each month by the Bureau of Labor Statistics. The make allowance should be made as current as possible by monthly updating. This would result in smaller, although more frequent, changes than if adjustments were made quarterly or annually.

Just as the milk price formulas are calculated and applied each month as a formula

of the dairy product prices, so should an energy cost formula be calculated and applied each month in the revised formulas.

Figure 1 demonstrates quite clearly how variable energy prices are on a month-to-month basis. Federal Order make allowances cannot effectively approximate true processing costs unless they are updated as frequently as is practicable.

Compatibility with and Comparison to Other Proposals. It is worth noting that NMPF's proposed energy cost adjustment is compatible with any milk price formula that makes use of make allowances. However, the energy cost base must be set to correspond with the costs in the period upon which those make allowances are based.

As such, the various economic analyses of the NMPF proposal by USDA and by Professor Bailey, don't truly capture the impact of our proposals, except as a simple add-on to another proposal. These analyses considered the NMPF proposal as Scenario J and treated it as an isolated change to the current status quo.

Cross-examination of at least one

witness in this proceeding suggests that the best way to address volatile processing costs is to establish especially large make allowances in order to cover any potential cost increase. NMPF and that witness do not agree.

As the record demonstrates, aside from milk prices, energy costs are the most volatile faced by dairy product manufacturers. and the only costs that tend to both rise and fall.

Applying an energy cost adjuster to the make allowance avoids the need to establish an overly generous fixed make allowance to accommodate this volatility. Allowing the make allowance to be adjusted as energy costs fluctuate is the most fair to both dairy processors and milk producers.

As a result, applying NMPF's proposal will tend to reduce the underlying make allowance necessary to accommodate ongoing manufacturing prices. In addition, energy price risk imposes additional costs on processors of benchmark dairy products and reducing these risks through an energy cost adjuster, will have the effect of reducing processing costs.

Over the long-run then, the NMPF proposal will not have a negative effect on producer revenue and rather should have a small positive impact.

Conclusion: The manufacturing cost allowances in Federal Order milk price formulas should be adjusted on a regular basis to reflect continuing fluctuations in energy costs. The use of an energy price index in the formula is the best and fairest way to deal with this issue.

Revised make allowances with energy cost indexing would provide specific relief to plants squeezed by higher energy costs, then reduce make allowances again when the squeeze is off.

We urge Dairy Programs and the Secretary of Agriculture to consider an energy cost adjuster that incorporates monthly cost indexing.

I have attached as an appendix specific language that we propose to effect this change.

And, again, I thank the Secretary for the opportunity to testify today, and I am

prepared to answer questions.

JUDGE PALMER: Are there questions? Yes, Mr. Beshore.

DIRECT EXAMINATION

BY MR. BESHORE:

Q. Dr. Cryan, just a question or two for clarification. On page 2 of your prepared statement. Exhibit 24, on the second line. as you read the statement, I believe you inserted the word toward the end of that line, "offset."

A. Yes, between "are" and the comma, it should say "offset."

Q. "Are offset, at least partially, by increased market productivity"?

A. That's correct.

Q. On page 2, there are two footnotes at the bottom, which you did not read. However, are they information regarding the sources of some of your data in the text which you have authored and which you wish to have made part of your testimony?

A. Yes. I would.

Q. There is some other data in Exhibit 24 which you did not read, such as the equation at the top of page 5. I take it that you would

also wish that equation printed on the top of page 5 of Exhibit 24 to be a part of your testimony, as if literally read?

A. Yes, I do.

Q. And the same would go for the data on Table 1 on page 5 of 24?

A. Yes, sir.

MR. BESHORE: That is all the questions I have at this time.

JUDGE PALMER: Any questions? Mr. Schad.

CROSS-EXAMINATION

BY MR. SCHAD:

Q. Good afternoon, Roger. My name is Dennis Schad. I work for Land O'Lakes. Hopefully I just have a couple of questions.

Would you agree with me that if the department chooses an energy adjustment, that the base that they choose is a very important component of their choice, the base time period?

A. It is important that you correspond to the base period for the data.

Q. Thank you. And we have a temporary final decision. If you were to recommend to the department what the base period should be, what

would you recommend?
A. I think the department in its economic analysis has correctly interpreted our intention with respect to defining a base period. If they choose to move forward on a -- if they were to apply it to that decision, I would suggest that they consider the data presented by Dr. Stephenson at the hearing that I have presented again here, in order to complete that.
But at least in general concept, they have applied the energy cost index adjuster as we have intended in the economic analysis.
Q. And just for the record, just the time period that you understand the Preliminary Economic Analysis to give?
A. It is somewhat mixed. I believe it is applied -- I don't know, I don't remember -- I think I remember, but I can't say for sure what basis they used for CDFA and for Dr. Stephenson's data.
So I wouldn't -- I don't want to give you an answer, because I don't know the answer.
Q. Just one more question. If the department chooses Proposal 1 and updates the temporary final decision using the CDFA 2005 numbers, you

would expect an adjustment to the base to reflect that?

A. I think that is consistent with the approach they took to the economic analysis, and again. I would recommend that they consider the numbers that Dr. Stephenson presented in order to get the numbers right, in order to establish a base that corresponds appropriately to the numbers that were used to establish the make allowance.

I think, you know, it is not about -- I am not even sure which one establishes a higher or lower base. But I think the numbers should be -- whatever information that is available should be applied consistently and comprehensively.

MR. SCHAD: Thank you.

JUDGE PALMER: Yes, Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. Good afternoon. Have you done any analysis to determine the use of forward contracting of energy costs or other risks offsetting by plants for their energy costs?

A. I have not.

Q. And you would agree, would you not, that plants have the ability to contract and offset the volatility that you talk about in your energy prices?

A. I am vaguely aware that there are futures instruments to address certain energy costs, but as I said, I have not studied the issue. I do not know whether the energy costs faced by dairy processors can be effectively -- the risk can be effectively managed through futures markets.

Q. If your proposal is adopted, would there be the need for them to use energy futures to offset their risk? Would they have any risk in energy costs?

A. It would be mitigated. It depends on the plant. No plant has characteristics which are perfectly aligned with any average. But they would tend to be mitigated.

Q. Okay. Do you know whether the mitigation would be more favorable to more processors than others, or less? You say -- let me rephrase the question.

You indicate that the profile for the plants are different, so the amount of energy that each plant uses is different, right?

A. I would think so.
Q. Do you know whether the offsetting of these energy costs would result in some plants obtaining a windfall by receiving more offset than what they are entitled to?
A. I am sorry, ask me the question again.
Q. Do you know whether some plants' energy usage is such that the reduction in the make allowances would more than offset any change -- or increase in the make allowances or adjustment, let's just say adjustment in the make allowances, would be different from what their actual adjustments and their actual energy costs were?
A. Anytime you have a survey, if the survey -- if the survey of energy costs effectively represents average energy costs, then necessarily certain plants have energy costs below the average and others have energy costs above the average.

So it would -- certainly there would be corresponding results.
Q. I want to go back to this other point. You are aware as an economist that the use of futures markets is a tool that can be used to

reduce volatility of a commodity such as energy. not set price, but it can be used to reduce volatility, the risk of volatility to a company?

A. I am aware of futures markets. I am aware of their potential to manage risk. I am also aware that there are people like your own witness that say futures markets are gambling.

Q. He has talked about the gambling of his Class III futures, right? He didn't talk about energy futures, did he?

A. He talked about futures.

Q. Do you adopt Gary Genske's testimony?

A. No, I do not.

Q. And do you adopt his view that use of futures is risky and gambling, is that your testimony?

A. It depends on the circumstances. There are speculators and there are hedgers.

Q. And a hedger is one that generally uses the product or sells the product?

A. Well, a hedger is one that uses futures instrument to offset price risk for something they are buying or selling. And a speculator. as my professor at Cornell said, is a sinner who is forgiven, because he adds liquidity to the

market.

Q. I would agree with that. Now, in your Exhibit 24-A, both Figures 1 and 2, it shows some run-ups from year to year. There is nothing that indicates any monthly change, so to speak, but it does appear in some of these periods, there appears to be a rather short-term fast run-up or down of prices; is that correct?

A. Yes, sir.

Q. All right. Now, have you looked at and determined on a month-to-month basis what you would anticipate the impact of the changes in manufacturing prices would be, or manufacturing make allowances would be as a result of your formula?

A. I have looked at those. I don't have the numbers in front of me. It has been quite some time since I first did that analysis, so I don't have those in front of me. I couldn't tell you what the results are.

Q. But you did do a month-to-month analysis?

A. I did.

Q. All right. Do you recall what the highest change was, up or down?

A. I do not.

Q. That could be computed based upon information you provided?

A. Yes, I believe it could be. And based on -- well, the department provided a set of annual numbers in their economic analysis, which has specific numbers for these Producer Price Indices, including their projections, based off another series.

And, of course, the graph in Exhibit 24-A. can indicate roughly how high the peaks were.

Q. Now, you would agree, would you not, that if processors are assured that their energy costs are going to be fully absorbed by the producers in the pay prices, that they would have no incentive to pass that cost on to their customers?

A. To pass it on to their customers?

Q. Yes.

A. It is my understanding that manufacturers will always try to get the highest price they can, because they have a profit incentive. I don't think that is accurate, the fact that their manufacturing costs are covered in the make allowance means that they will not attempt to get the highest price they can.

Q. Okay. So we take a scenario now that you have a processor, we have a make allowance, they have an opportunity to hedge their energy costs by some form of forward contracting or use of the futures market, they have the ability to pass some of that cost or at least attempt to pass some or all of that cost on to their customers. And in addition, they get a discount from their producers for their milk to cover those energy costs. You would agree that all three of those possibilities would be in existence if your proposal is adopted?

A. They are not consistent, they are not consistent. They are all -- I am sorry. Please restate the question.

Q. All right. As it stands today, if there is a change -- the processing plant, first of all, has the ability to hedge its costs through the futures market or forward contracting, or some other risk shifting mechanism, right, you would agree that exists today?

A. Today? It may. As I said, I am not specifically aware of instruments. But it may be an option.

Q. And it is also, as you indicate, that a

processor -- anybody, we all would like to pass on all the costs that we have on to our ultimate buyer, right, so that a customer who has higher energy costs would try to find some mechanism to pass some of that on to its buyers, if not all of it; is that correct?

A. We would all like to get the highest price we can for the products that we are selling. that's right.

Q. And also have an incentive to cover our costs and return a profit, right? Isn't that our ultimate goal?

A. Theoretically, they should be different. They should be independent of that. The desire to get the highest price the market will bear for your product is independent of what your costs are. Whether or not you can stay in business or not is not -- the two go together.

However, when you end up going to the market, you do what you can to get the highest price you can get.

Q. But both of those alternatives are available today?

A. There may be futures markets available.

Q. Okay.

A. And it is a free country, so people can get the highest price they can get.

Q. Okay. And your proposal does not take those opportunities away from them? Those opportunities will exist if your proposal is adopted?

A. Well, there is a difference. If our proposal is adopted and a processor's energy price risk has been mitigated or offset by the changes in the formula, in that case, the use of the futures markets would become gambling, it would become gambling.

Q. Okay. So we are going to replace the producer income as they hedge for the use of the futures market under your proposal?

A. We are going to apply a consistent and equitable make allowance, so that we don't -- we are going to apply a consistent and equitable make allowance so that processors' costs can be covered as they go up and down, with respect to volatile energy prices.

Q. I want to move on to a different topic.

You are aware, are you not, that in the Southeast orders, there are provisions now for hauling credits that are adjusted based on fuel?

A. Yes.
Q. And as it stands now, the Class I prices or the prices that plants pay in the Southeast is based upon the manufacturing price formulas, as it stands now?
A. Presently?
Q. Yes.
A. Yes.
Q. And unless the department adopts the proposal I think you have that is pending now with the Class I and II, unless it adopts that -- let me just rephrase that.
If the department continues its policy of using III and IV formulas for setting Class I prices as it currently does, that your formula would have the impact, as fuel prices go up, of reducing the Class I price; is that correct?
A. Under the current relationship between manufacturing prices and Class I and II prices. that's correct. It is National Milk's position that that should be amended.
Q. Now. I know that, and I appreciate that. But I want to take that a step further.
Let's assume for the moment that they are decoupled, for want of another term, but it has

been used, that the I and II are decoupled from the III and IV.

A. "Decoupled" isn't quite the right word.

Q. What is the right word?

A. Simplified.

Q. I would not agree with that, but if that's the word you want to use, whatever. Simplified, decoupled. complicated.

If you take that position, you now have a situation where on the high utilization orders in which there is a peak in energy costs, their prices will not go down, but in the low Class I utilization orders, because of their higher manufacturing, they would have a lower price to producers; is that right?

A. I am sorry, could you say that again?

Q. All right. If you have a situation where there are two different formulas, Class I utilization orders, such as the Southeast, and Florida, would see very little change in their pricing from month to month, due to the energy changes. But those with high Class III and IV utilizations would see a much more difference in their prices, right?

A. That could be the result, yes.

Q. And have you done an analysis to compare the relationship between altered blends between the Southeastern order, or Florida order, and. say, the Mideast or the Central or the Southwest order?

A. For combining our Class I proposal in the other hearing and this?

Q. Yes.

A. No. I have not. I would point out, though. based on the department's analysis, which shows almost no long-term average impact on these class prices, that even though there would be variations, they would -- in the long run. according to that analysis, neither one would end up at a meaningful advantage, statistically significant advantage.

Q. Those are annual averages in the economic analysis?

A. I believe they are.

Q. They are not monthly?

A. The USDA analysis, I believe -- I think you should look at Exhibit 7. I would rather not rely on my memory.

Q. Okay. I want to change to another thing.

Looking at page 3, you identify that you

want these changes to be based on published producer indices.

A. Producer Price Indices.

Q. Producer Price Indices. Is it National Milk's position that the data that is used to establish these prices, that plants -- minimum prices plants must pay and producers would receive is to be based on publicly available data in all the other areas, besides just fuel. there should be some public data available to determine the other aspects?

A. Please restate the question.

Q. Does National Milk have a policy that the data used to establish the minimum prices which producers receive and which plants must be paid be based upon data that is publicly available?

A. I don't believe we have such a position.

MR. VETNE: I would object to the question and answer.

JUDGE PALMER: Mr. Vetne, did you want to go on the record on that?

MR. VETNE: Well. I did. because the question is so broad it constitutes a trap. Who knows what might be lurking there, that. "Aha, we got you, because you made a very

broad generalization, in response to a question that didn't tell you what I had in mind."

JUDGE PALMER: Did we get an answer to it?

THE WITNESS: I said. "I don't believe we have such a policy."

JUDGE PALMER: I would overrule the objection. We have an answer.

(Thereupon, a discussion was held off the record.)

BY MR. YALE:

Q. Page 9, bottom of page 9, you talk about the California whey costs and you were unable to really track to see if there was any correlation between their make allowances and the changes in energy for whey. And you make a comment that whey drying is so similar to nonfat dry milk, that. you know. you go on.

Are you saying that -- are you mimicking or following the testimony that was given at these hearings that the drying of whey, the production of whey was basically a nonfat dry milk price plus the extra cost of energy and handling of that product?

A. Not necessarily. As I added a couple of

words when I read this, indicating that the whey -- that the evidence for nonfat dry milk can demonstrate the same principle not to be applied to whey drying, because they are similar processes. I think it was certainly an improvement that we have whey specific data now to establish these make allowances.

MR. YALE: I have no other questions.

JUDGE PALMER: Questions? Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. Good afternoon, Mr. Cryan, John Vetne, I represent Agri-Mark and other members of National Milk.

A. Good afternoon.

Q. We are here because of regulated make allowances. The accompanying exhibit with the sharp spikes in energy costs, prior to January of 2000, if there had been a similar spike or a spike of any other cost, that kind of change in make costs would have been reflected in pay prices surveyed by USDA to announce the MW or BFP, to the extent that competition for milk

procurement allowed an adjustment, correct?
A. I can't answer that question.
Q. Okay. You are not familiar with prior testimony that make allowance changes, cost changes were automatically captured in the MW price survey, to the extent those prices changed?
A. I know they are to some extent. But I can't make -- I wouldn't make a judgment. I don't want to answer that question. I am not --
Q. Okay. With respect to any processor or manufacturer of commodity dairy products included in establishing Class III and IV prices, if now an attempt was made to pass on a unique component like energy costs, that would in turn be recaptured into the regulated price. and the manufacturer then would not ultimately recover that additional cost, is that correct?
A. Can you state the question again, please
Q. It was an attempt to state the circularity issue
If a manufacturer, such as of nonfat dry milk, attempted to pass on increased energy costs that have spiked during a recent period, that increase would be recaptured in the NASS

survey --
A. That's right.
Q. -- and become part of the regulated producer price?
A. That's right, as I have testified, because of the nature -- because of the nature of the end product price formula for milk, the processor is in effect squeezed in between, can be squeezed based on the make allowance.
Q. Okay. The regulated price that would result from the use of an energy adjusted index would still only be a minimum price, and the amount -- if that is -- the amount of that recovery of that application of that index would still depend upon competition for milk?
A. The actual market price for milk would still depend -- anything over and above the minimum price would still depend on competition. that's correct.
Q. Yes, yes. So it does not necessarily follow that a reduction in a Class III or IV price because of an energy adjustment will remain in the pockets of the processor rather than producers?
A. Not necessarily, right, that's correct.

MR. VETNE: Thank you.

JUDGE PALMER: Yes, Mr. Galarneau.

CROSS-EXAMINATION

BY MR. GALARNEAU:

Q. Clayton Galarneau with Michigan Milk Producers. Hi, Roger.

Roger, many of your members of National Milk Producers Federation have balancing facilities?

A. Yes, they do.

Q. And those balancing facilities probably have wide fluctuations in their processing requirements at various times of the year?

A. Yes, I believe so.

Q. And would you think that would be why National Milk is looking for this energy adjuster, part of the reason why they would like that to be on a monthly basis, so that you could match energy costs with the production at the time that it is being produced?

A. I think that makes sense. There is seasonality of processing for balancing plants. and there could be a similar seasonality of energy. Certainly the electricity prices, and I haven't really looked at that issue

quantitatively, but the graph demonstrates a seasonality of electricity costs. And I expect there is some seasonality of natural gas costs.

And if you go with annual averages, you may not get an accurate -- you may not get a representative cost for a seasonal processing plant.

MR. GALARNEAU: That is all I had. Thanks. Roger.

THE WITNESS: Thank you.

JUDGE PALMER: Thank you. Any questions? Any questions over here? Mr. Schaefer.

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. Good afternoon, Roger.

A. Good afternoon, Henry.

Q. On page 2 of your statement, in the second paragraph down towards -- the third from the bottom line of that paragraph --

A. I am sorry, which page?

Q. On page 2, I am sorry. Your next-to-the-last sentence starts out. "On the other hand, the make allowances that were applied in 2005 were based in part upon 1998

energy costs." Should that be 2000 --
A. Perhaps.
Q. -- or something later than that?
A. I would defer to you if the current make allowances that resulted from the May 2000 decision were based on manufacturing costs for 2000. I thought they were based on manufacturing costs for 1998. I thought the data introduced at the 2000 hearing was based on CDFA numbers for costs in 1998.
Q. I guess that is what I am saying, that make allowances that were applied in 2005, we didn't apply any new make allowances in 2005.
A. You applied the old make allowances.
Q. Oh, okay. If you are looking at it that way.
A. Right, yes.
Q. Okay. All right. I believe in some earlier questions --
A. I am sorry, let me clarify that. The reason I indicate specifically late 2005 is because that is when we had some energy cost spikes that represented -- you know, that produced a substantial squeeze, just over -- I mean, it is extreme over a matter of months, for

dairy processors, and that is why I identified late 2005, not because new make allowances were applied in late 2005, but because we were talking about make allowances and what their effect was during that spike in energy prices.

Q. We had some -- we had some earlier questions, I believe, on coordination of some of this data, since we have gotten data on the record of this hearing, and previous hearings that do not necessarily coordinate timewise.

For instance, Dr. Stephenson's data covered. I believe. parts of 2004. parts of 2005, we now have CDFA data for 2005, although that CDFA data does not include a breakout of electric and natural gas prices.

So I would take it then, when we are looking at, if we would go with your proposal here and are trying to establish what energy costs that the adjustment should be applied to. that those costs should be adjusted to some sort of standardized time frame?

A. I would say that if the ultimate make allowance is based on some weighted average of Dr. Stephenson's numbers and the CDFA numbers, as I -- you know, as the previous one was, or

whatever weighting you have of whatever data you apply, that you could essentially establish a weighted -- a weighted base period

You could have the PPIs for the period you are looking at and then establish a base based on the same weighting that you are applying to the costs that you are putting into the -- that you are using to establish the make allowance

So, for example, for example. if you are saying that you have a product and you are saying that the CDFA -- and bear with me a little bit -- if the CDFA cost of processing is 5 cents, and the Cornell cost of processing is 4 cents, and they have equal volumes, and the two -- and you are coming up with a make allowance of 4 1/2 cents based on that equal weighting, you could say, here is the average -- okay, let's say the CDFA number is based on 2005, and these numbers, I think, are right But I wouldn't want to specify it

If the Cornell numbers are based on the middle of 2004 to the middle of 2005, you could say the Producer Price Index, the PPI, for 2005 for that energy source is at 250 and the Producer Price Index for the same energy source

for the other period that is from the middle of 2004 to the middle of 2005 is 200. then you could use 225 as the base cost for your calculation

So while the initial calculation may get a little bit involved, as it goes into the language, it is still just a number, just the same as in the language that I have offered as a base number to apply as a denominator below the current PPI

JUDGE PALMER I don't know if I should add this or not Wouldn't it be simpler to use sort of a rolling base, where you took the last 12 months and just kept upgrading it monthly?

THE WITNESS The problem -- in a given month, the costs that a plant faces are that month's prices

The base itself, in the make allowance that we are talking about, when we get a decision, for the most part, the make allowance would be a fixed number that would be based on some period that was surveyed

So we have a very volatile element of processing costs that we can adjust, because of

the availability of public numbers that indicate how the prices go up and down.

And by establishing a base that corresponds with the original make allowance, we can properly adjust the energy costs to cover that element of the processing cost.

JUDGE PALMER: All right. I will leave -- I'll stay out of it.

(Laughter.)

BY MR. SCHAEFER:

Q. In looking at the PPI indexes that you've discussed and told us here, I notice that they have a four-month correction, if you want to call it that. They revise their data over a four-month time period. Would you like to use the final numbers, or are you looking at using the initial numbers they come out with each month?

A. I think the most current numbers available are the best ones to use.

I think we have talked in some other cases about having some corrector after the fact. But in that case, it is generally because we are concerned about parties involved having some influence over the price. I don't believe the

dairy processors are going to substantially affect natural gas prices and electricity prices across the U.S. in order to manipulate any prices, any milk prices.

I think that would be counterproductive.

Q. In looking at table -- Exhibit 24-A and your Table 1, we notice that the natural gas prices are the most -- certainly very volatile. However, electric prices don't seem to show nearly that much volatility, when we look at this chart.

How would only using natural gas affect your proposal?

A. Well, half a loaf is better than none. That may be more than half. I would point out one of the reasons that the volatility of electricity doesn't show in this graph -- I am sorry. I will slow down. One of the reasons that volatility of electricity doesn't show up in this graph is because of the very large fluctuations in natural gas prices in the last seven years.

And also, the electricity is rising and falling in a band, where most of the other things are going up steadily. It is kind of

rising and falling, hiding behind the other ones.

I would encourage you to look at the numbers, consider the volatility on a statistical basis, rather than just eyeballing the graph, and consider whether to use electricity.

I acknowledge that the gas costs are a bigger problem than electricity, and certainly it would be better to have a gas adjuster than no adjuster.

Q. Along those same lines of volatility and input costs to the manufacturer, with the recent changes we see, have seen and heard about today in other costs, particularly on the farm side. you know, there has been a lot of talk about ethanol and so forth and so on, and potential labor cost changes and so forth. Are there any other factors that you think should be indexed?

A. With respect to processing costs at the dairy plant?

Q. Yes.

A. No. I think I probably testified to this at greater length in other circumstances. But I would suggest that many of the others are moving

more gradually. Even though labor is rising. there is a tendency for labor, for higher labor costs, higher labor prices to be offset by higher productivity.

And I believe that PPI, I believe any index for labor, any wage index, tends to be per unit of time, rather than per productive output, per unit of productive output. In fact. I have referenced a couple of papers that identify growing productivity in these industries.

MR. SCHAEFER: I believe that is all I have. Thank you, Roger.

JUDGE PALMER: Any other questions? You are excused, sir. Thank you very much.

THE WITNESS: Thank you.

MS. PICHELMAN: Your Honor, I would like to move that Exhibits 24 and 24-A be received into the record.

JUDGE PALMER: Yes, they are received.

(Thereupon, Exhibits 24 and 24-A were received into evidence.)

JUDGE PALMER: I am looking for my -- here it is. Is Mr. Yonkers now available?

MR. ROSENBAUM: Dr. Yonkers is available.

JUDGE PALMER: We are going to mark his statement first, and that would be 25.

(Thereupon, Exhibit 25 was marked for purposes of identification.)

ROBERT D. YONKERS, Ph.D.

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

MR. ROSENBAUM: Dr. Yonkers, we have marked your prepared written statement as Exhibit 25. If you would please read it for us.

STATEMENT FOR THE RECORD OF

ROBERT D. YONKERS, Ph.D., and

DIRECT EXAMINATION BY MR. ROSENBAUM

DR. YONKERS: This testimony is submitted on behalf of the International Dairy Foods Association, or IDFA --

JUDGE PALMER: We need you to -- oh, I see, you give your name later in the statement. All right, go ahead.

DR. YONKERS: -- a trade association representing manufacturers. marketers, distributors and suppliers of fluid milk and related products, ice cream and frozen

dairy desserts and cheese. IDFA represents the nation's dairy manufacturing and marketing industries and their suppliers. With a membership of 530 companies representing a $90 billion a year industry, IDFA is composed of three constituent organizations, the Milk Industry Foundation, or MIF, the National Cheese Institute, or NCI, and the International Ice Cream Association, or IICA.

IDFA's 220 dairy processing members run more than 600 plant operations and range from large multinational organizations to single-plant companies. Together they represent more than 85 percent of the milk, cultured products, cheese and frozen desserts produced and marketed in the United States.

As buyers and processors of milk, the members of IDFA and its constituent organizations have a critical interest in these hearings. Most of the milk bought and handled by IDFA members is purchased under the Federal Milk Marketing Orders, promulgated pursuant to the Agricultural Marketing Agreement Act of 1937, or the AMAA.

I am Dr. Robert D. Yonkers. Chief

Economist and Director of Policy Analysis at the International Dairy Foods Association. I have held that position since June 1998. I hold a Ph.D. in agricultural economics from Texas A & M University in 1989, a Master's degree in dairy science from Texas A & M in 1981 and a Bachelor of Science degree in dairy production from Kansas State University in 1979. I have been a member of the American Agricultural Economics Association since 1984.

Prior to taking my current position at IDFA, I was a tenured faculty member in the Department of Agricultural Economics and Rural Sociology at The Pennsylvania State University, where I was employed for nine years. At Penn State. I conducted research on the impacts of changing marketing conditions, alternative public policies and emerging technologies on the dairy industry.

In addition, I had statewide responsibilities to develop and deliver extension materials and programs on topics related to dairy marketing and policy. I have written and spoken extensively on economic issues related to the dairy industry, and I have

prepared and delivered expert witness testimony to state legislatures and to Congress.

MR. ROSENBAUM: Your Honor, at this point, I would ask that Dr. Yonkers be recognized as an expert.

JUDGE PALMER: He is so recognized.

DR. YONKERS: Thank you. Your Honor. This hearing was called to consider whether any changes should be made in the Class III and Class IV milk pricing formulas. IDFA and its constituent groups submitted two of the proposals that were included in the notice of hearing, and my testimony will address both the reasons why those proposals should be adopted and why other proposals should not.

To summarize IDFA's positions, we support the adoption of Proposals 1, 9 and 12 and oppose the adoption of Proposals 3, 7, 8, 14, 15, 16, 17, 18 and 20. We have no position on Proposal 13 and the portion of Proposal 6 that changes the butterfat shrink adjustment and yield factor from 1.20 to 1.211, but oppose the portion of Proposal 6 that would change the butterfat recovery factor from 90 to 94 percent.

We support Proposal 2 insofar as it would call for annual surveys of the costs of manufacturing, but do not support that proposal to the extent that it would call for the automatic updating of the make allowances by USDA without a hearing.

IDFA believes that Proposal 10 goes in the right direction, but that IDFA's own Proposal 9 is superior to Proposal 10. IDFA believes that Proposal 11 goes in the right direction, but IDFA's own Proposal 12 is superior to Proposal 11.

We understand that Proposals 4 and 5 have been withdrawn and, therefore, are not commenting on them.

The Fundamental Features of Product Price Formulas. Let me begin by pointing out some fundamentals of the current minimum price setting mechanisms, which we believe provide critical insights into the approach that USDA must utilize when addressing the proposals before us and resolving any disagreements or uncertainties as to the underlying factual data.

Since January 2000, Federal Orders have utilized the price of finished products to

determine the minimum milk prices that must be paid to farmers through a mechanism commonly referred to as a "product price formula."

Oversimplifying slightly, a product price formula sets the minimum price that farmers must be paid for their milk, at least by proprietary handlers, as the price handlers receive for their finished products, cheddar cheese, dry whey, butter and nonfat dry milk. minus the costs handlers incur in turning farm milk into those finished products, commonly referred to as the make allowance.

In performing this calculation. USDA must make assumptions as to how much of the finished products can be made from a given quantity of milk, the yield factors.

In general terms, a make allowance is the difference between the wholesale sales value of a manufactured dairy product and the cost to purchase the raw milk necessary for that product's production. This make allowance is used for many economic purposes, for example, to pay for the use of capital necessary to build and maintain the plant, to cover the nonmilk costs related to obtaining raw milk, to pay for

marketing the processed dairy product, to pay wages to employees of the manufacturing plant. to pay utility companies for the water. electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk and to cover a wide variety of other expenses, such as plant maintenance, equipment and insurance.

A hypothetical, but realistic example may help explain the concept of make allowances in product price formulas. Assume the example where the wholesale price of cheese is $1.40 per pound and the total cost of manufacturing and marketing that cheese is 20 cents per pound of cheese. A manufacturing plant facing these assumed economic factors would be able to pay up to $1.20, which is $1.40 minus 20 cents, for the raw milk needed to manufacture each pound of cheese.

What if this hypothetical plant is regulated under a Federal Order? If the make allowance specified in the regulated minimum price is 20 cents, this example plant can pay all the costs associated with manufacturing and marketing cheese after paying the regulated

minimum milk price to the milk producers supplying the raw milk.

If, on the other hand, the make allowance specified in the regulations were 15 cents, the plant would be required to pay a minimum price of $1.25, or $1.40 minus 15 cents. to milk producers supplying milk.

In this scenario, the plant would still receive the wholesale cheese price of $1.40, but after being required to pay the minimum milk price of $1.25, would only have 15 cents left to cover the total costs of turning that milk into cheese.

But with actual total costs of manufacturing and marketing cheese of 20 cents. the plant would be unable to pay for one or more factors of manufacturing and marketing. Obviously, the plant could not continue to operate like this for any extended period of time.

It is easy to see through this simple but accurate example the critical need for a make allowance that covers the total costs of turning raw milk into a finished dairy product. Without an adequate level of make allowance, a

manufacturing plant could not continue to operate, as it would have insufficient funds available to pay the vital costs necessary for operating the plant.

What is equally important to recognize is that the handler cannot escape from its conundrum by raising its finished product prices either. We can see why this is so by returning to our example. Recall that the handler is selling cheese for $1.40, the make allowance is 15 cents and the minimum price of milk is. therefore. $1.25. The handler is losing 5 cents for every pound of cheese it makes, because its true cost of manufacturing is 20 cents, but it only has 15 cents left over after it pays for its milk.

So why can't the handler simply raise its sales price to $1.45? The problem lies in the Federal Order minimum price formula. As previously noted, the minimum price is the price of the finished product minus the make allowance. In our example, before any finished product price increase, the minimum milk price was $1.40 minus 15 cents equals $1.25.

After the finished product price

increase, the minimum milk price is $1.45 minus 15 cents equals $1.30. Thus, all of the money derived from the increase in the finished product price has gone directly to the farmer in the form of a higher, legally mandated minimum milk price.

None of the money derived from the finished product price increase has gone to the handler. After paying the now higher minimum milk price, the handler still only has 15 cents left over, precisely the same amount as before it raised its finished product prices.

The same effect will result, no matter how much, or for that matter, how little, the handler attempts to raise its finished product prices.

You can plug any price increase you want into the equation. The result is always the same, because the pricing formula works as a ratchet. All of the finished product price increase gets passed on to the farmer in the form of a higher minimum milk price. None of it is available to the handler to make up for the shortfall between the make allowance and the handler's true cost of manufacturing. Any steps

it might take would be as futile as a dog chasing its own tail.

I would add to the foregoing the critical observation that exactly the same problems are created if USDA uses incorrect data or assumptions in determining the product price paid for the finished products or the yields that a manufacturer is assumed to achieve in turning raw milk into a finished product.

If, for example, the formulas were to assume that the processor is receiving $1.40 for cheese. when the price is really $1.35. the formula is condemning the processor to suffer a 5-cent loss on every pound of cheese it sells, even assuming USDA has accurately set the make allowance and yield factors.

This is so, because the processor must pay the product price minus the make allowance to the producer as a minimum price. and if the product price is 5 cents too high, the amount the processor is allowed to keep will be 5 cents less than its cost of manufacture. even if the make allowance and yields are accurate.

For example, the processor would be

paying as a minimum milk price $1.40 minus 20 cents equals $1.20, but if it only received $1.35 for the cheese, the amount it would actually have in hand would be $1.35 minus $1.20 equals 15 cents, which is 5 cents less than what the processor needs to cover its costs of manufacture.

BY MR. ROSENBAUM:

Q. Dr. Yonkers, let me just interrupt. In the example you just gave, the 20 cents is the make allowance, is that correct, the regulated make allowance?

A. Yes.

Q. Please continue.

DR. YONKERS: In reality, and as I will discuss later in greater detail. I believe that the current formulas contain precisely this kind of erroneous product price. because the current price formula overstates the amount that processors receive in the marketplace for whey cream.

Similarly, if the formulas overestimate how much finished product is being obtained from a given quantity of raw milk, for example, the yield factors, the formulas are

dooming manufacturers to incurring losses. because the formulas will assume that processors are selling more finished product, and thus obtaining greater revenues in the marketplace than is. in fact. the case.

Several of the yield factor proposals under consideration at this hearing would, if adopted. have this effect, and for that reason. must be rejected, as I will explain in greater detail shortly.

The foregoing aspects of the use of product price formulas illustrate how much heavier USDA's responsibilities have been since 2000. Or to put it more bluntly, these aspects reveal how much damage, sometimes even catastrophic damage, USDA can cause if it gets things wrong.

Before 2000, USDA utilized a system which based minimum prices on the competitive pay price paid by manufacturing plants in Minnesota and Wisconsin to producers of unregulated Grade B, or manufacturing grade. milk to set regulated prices. This was known as the M&W price series. Thus, the free market for farm milk set the regulated price and resulted

in an implicit make allowance for each manufacturing plant, equal to the difference between the wholesale value received for the dairy product minus the value paid for the raw milk used to make that dairy product

This varied over time, based on many economic factors, such as the capacity utilization of the plant, variability in the cost of inputs other than raw milk, like wage rates, energy costs and interest rates, and of course, the competitive environment for raw milk

Market conditions automatically and continuously determined what the raw milk price should be and how much of the finished product price a processor would retain USDA did not have to make those determinations, the market did so To a large extent, the system was on auto pilot

Now, USDA must try to mimic these market forces through product price formulas. and market forces cannot step in to fix the situation if USDA has assumed finished product prices that are too high, established yield factors that are too high or established make

allowances that are too low

For the reasons I have already discussed, a processor in any of those scenarios will be required to pay a minimum milk price that leaves it an inadequate amount of money to cover its true costs of manufacture And the processor cannot raise its prices in the marketplace to try to compensate, because that will only increase the minimum milk price the processor owes

I believe that the recent vote in the Upper Midwest order, which I understand nearly resulted in the termination of that order, was a direct result of the considerations I have outlined Cooperatives with manufacturing facilities in that order concluded that the product price formulas did not accurately reflect their true costs of manufacture, and thus doomed them to slow financial ruin

The challenges I have outlined are only exacerbated by the exceedingly long time it has taken to update make allowances The Federal Order changes resulting from Agri-Mark's September 2005 request for an emergency hearing were not implemented until February 2007. 17

months later, and were themselves insufficient for the reasons IDFA has pointed out in its comments on the interim decision.

The sharply rising costs experienced during that intervening time could not be addressed at all, given the combination of the inherent inflexibilities of the finished product price formulas and the inadequate make allowances that had been adopted in those formulas. These hearings provide the opportunity to fix those defects.

I will make two critical additional observations before turning to the specific proposals before us.

First, there should be no concern that applying the principles I have espoused will result in make allowances that are too high, yield factors that are too low or product prices that are too low, such that producers will be cheated out of a rightful price for their milk.

We are only dealing here with minimum milk prices. Cooperative associations will pass on to their milk producer members all of the wholesale sales value of dairy products in

excess of that needed to cover the total costs of manufacturing.

Since cooperative associations are significant players in the manufacturing of dairy products, they are a considerable force to be reckoned with in the marketplace. In order to remain competitive in the marketplace for raw milk, a proprietary plant would have to pay an amount at least equal to the cooperative association in the above example, as an over-order premium.

In short, market forces will result in over-order premiums that will adjust the amount being paid to producers if make allowances are set at a level higher than the actual costs of processing, yield factors that set at a level below actual yields or product prices are assumed to be lower than they really are.

There is nothing revolutionary about relying on the market for these purposes. After all, it is exactly what Federal Orders did for the first 67 years of their existence.

My second overall observation goes to the completely mistaken notion that the product

pricing system provides a fixed margin for processors. but no safety provision for farmers. or that the system somehow forces farmers to bear the cost of cost increases at the manufacturing level.

Processors whose costs are above the make allowances must either reduce their costs or suffer losses, and processors whose costs are below the make allowances will face competitive pressures for milk supplies that will result in over-order premiums.

As for producers, they must be subject to price signals that will cause them to produce more milk when rising market demand for finished dairy products dictates the need for more milk and to produce less milk when falling product demand so dictates. No purpose would be served by regulated milk prices that induce increased production without any market outlet.

Balancing this economic necessity is the fact that, unlike regulated processors. producers are not subject to regulations that fix the maximum margin between their output price and input costs.

Indeed, one can only imagine the

screams of protest that would have issued in 2004 and 2005, when we encountered the highest two-year period of farm milk prices on record. if dairy producers had been required by regulation to pass on those higher milk prices to their suppliers of grain or other inputs

Proposal Number 1 IDFA supports Proposal 1, which would update the make allowances used in the product price formulas used in all Federal milk -- excuse me, in all Federal Order minimum class prices to reflect the most recently published costs of processing data from the California Department of Food and Agriculture, or CDFA

On November 29th, 2006. CDFA published summary data from their latest study of processing costs USDA noted that costs of processing data from both CDFA and CPDMP were representative of actual industry costs of processing, and were comparable in methodology. and therefore, both should be used in determining make allowances This new data from CDFA has already been admitted as Exhibit 10

As USDA repeatedly noted in the recently implemented tentative decision

resulting from the January and September make allowance hearings, tentative decision, the CDFA data on the costs of processing represents an audited survey of manufacturing plants in that state. The CDFA survey data results have been endorsed and utilized by USDA since 2001 to set make allowances. There is, therefore, no reason not to incorporate the latest CDFA data in setting make allowances.

In the tentative decision, USDA only used the CPDMP data in setting the whey make allowance. IDFA submits that this was in error.

MR. BESHORE: Your Honor, may I just interpose or note an objection at this point? This starting here in the text of Exhibit 25 and for the next five pages or so. the testimony is essentially exceptions to a tentative final decision, which is under deliberation by the department, as opposed to comments on testimony in this hearing and what should be done in this hearing.

Now, I understand that the existing regulations are context for this hearing. But it is really stated as exceptions and argued as exceptions. It says USDA was wrong in this and

wrong in that, et cetera. I don't think it is appropriate.

JUDGE PALMER: I tend to agree. What do you think we should do with it, Mr. Rosenbaum?

MR. ROSENBAUM: Your Honor, there are proposals that were accepted into the hearing notice as to what the make allowance should be. Dr. Yonkers is testifying as to what he believes the make allowance should be.

JUDGE PALMER: Are you saying that -- he's differing from what has been proposed so far?

MR. ROSENBAUM: He is differing from what is currently in place and explaining how they should be changed.

JUDGE PALMER: All right. I will allow you to continue and note your objection.

MR. ROSENBAUM: Go ahead, please.

DR. YONKERS: USDA stated that in the CDFA survey -- excuse me, quote. "In the CDFA survey, dry whey drying costs may be unreasonably high because California has only three dry whey processing plants, where high cost plants appear to skew the costs

dramatically " That is 71 Federal Register. Page 67485

No data was presented at the hearing that could allow USDA to reach such a conclusion, given that individual plant data was not revealed, and therefore, no determination can be made about the distribution of costs of processing among the three plants in the CDFA survey

In fact, the data that is available points to the opposite conclusion than that reached by USDA USDA NASS reported that there were only five plants in California producing dry whey in 2004, and the three plants, 60 percent of all the dry whey plants in California, in the CDFA cost survey represented nearly 79 percent of the USDA NASS reported dry whey production in that state that year

The two plants not in the survey have far less volume processed on average than the three plants that were included in the CDFA survey

Given the record evidence as to the positive effect of economies of scale on processing costs per hundredweight with respect

to all dairy products, these two excluded plants in all likelihood had materially higher costs per hundredweight than the three surveyed plants The CDFA data, if anything, under-reports the average costs of processing dry whey for all five plants in that state

In addition, a comparison of the average volume processed per dry whey plant among NASS. CPDMP and CDFA reveals that it is the CPDMP data that is less comparable to the national average plant size than the CDFA data. not the other way around

The average dry whey plant in the CPDMP survey processed over 77 percent more volume than the NASS national average, while the average dry whey plant in CDFA survey only processed 16 percent more Therefore, the CDFA survey is more representative of the U S average than the CPDMP survey with respect to the costs of processing dry whey

USDA should, therefore. include both the CDFA and the CPDMP survey weighted average data in determining the dry whey make allowance Table 1 to this statement shows how USDA only used the CPDMP data to determine the dry whey

make allowance in the tentative decision and also shows how the latest CDFA data should be incorporated in determining the dry whey make allowance using the same methodology as that used by USDA to combine the CDFA and CPDMP data for the other three products.

JUDGE PALMER: You know, I still have a problem with this to this extent: I presume you filed exceptions to the tentative decision? This kind of material is in your exceptions to the tentative decision.

MR. ROSENBAUM: Some of these materials are, Your Honor, and some are not.

JUDGE PALMER: I think whatever happens to the tentative decision should be based upon that. What we should be talking about here is what is the appropriate standard for setting the make allowances the new proposal talks about. What troubles me a little bit is that this sounds like an appeal of the tentative decision.

MR. ROSENBAUM: Your Honor, there are various proposals, for example, Mr. Yale's proposal, which is not to use the CDFA data at all. That is an attack on the tentative

decision.

JUDGE PALMER: Well. I don't know if it is attack.

MR. ROSENBAUM: Well, it is saying and it is explaining why the rationale behind the inclusion of that data was mistaken. Mr. Yale is perfectly permitted under the notice of hearing to provide that evidence, not to object to it merely because it is inconsistent with the tentative decision.

JUDGE PALMER: Well, what I am talking about is the tone of this. It sounds so much like an appeal of the tentative decision. rather than, look, Mr. Secretary, here is the way the make allowances should be set and we should include this, without bringing back the tentative decision.

I think it is enough to say you have a disagreement with it without going back and forth. Maybe I am being unduly involved with the language. I don't want to think of this as another brief.

MR. ROSENBAUM: Well, I believe it is expert analysis by Dr. Yonkers.

JUDGE PALMER: I see some standing

up. I don't know if I need help or not. I will let you continue. Go ahead.

MR. YALE: Your Honor. I do want -- I mean, it is a fine line, but I mean, we share your concern, because we still have this open decision. And we are deeply concerned that when the department issues a final decision in that tentative final decision, what record it is going to use and how this may even overflow. whether they intentionally want it to or not. It is impossible for us to know.

JUDGE PALMER: This should be confined to this record, and whatever happens in the other would require whatever needs to be done there. Yes, Mr. Vetne? You wish to say something?

MR. VETNE: I do, Your Honor. I think the comments here are essential and relevant to the scope of this hearing.

We are facing a unique situation in this hearing, in that a portion of the Class III and IV price formula was heard on an emergency basis last year.

In July, the department issued a notice that said -- that agreed that we need to

look at the whole formula. So now we are here looking at the whole formula, including that portion that was examined on an emergency basis last year.

What is to be done by the department and the policies it will choose to apply in the future in this hearing, like at every prior hearing, is, in many respects, how have you done it in the past, and what is wrong with that or has gone wrong with that, compared to the future.

Here, the only anomaly we have is that the policy in the past is one that was announced only three months ago. But the whole picture, the whole picture, including that past policy, is at issue in this proceeding. That is how it was noticed.

JUDGE PALMER: But the point. I think, is that it is not a final decision, it is a tentative decision, and you have got your own record from that one that they still have to look at. I don't think they can be looking at **this** one to do anything with the tentative one. Whatever you are saying here is for this particular case. I am going to leave those

statements in there and go ahead.

MR. ROSENBAUM: Could you please continue, Dr. Yonkers.

DR. YONKERS: The current incorporation of the CPDMP on cheese production costs also is in need of an important adjustment. As USDA noted, "The CPDMP study sample of cheese plants is not a random sample. It is a stratified random sample where randomness only applies to strata, size related groupings, of the surveyed plants." Close quote.

And later: "The sample design was intentionally biased to overrepresent large, lower cost plants. The record shows that large plant costs otherwise would have been seriously underrepresented if the survey had relied on a truly random selection of cheese plants." Close quote. 71 Federal Register, Page 67485.

Given these observations, which are entirely accurate, USDA in its tentative decision clearly should have corrected for this intentional bias in the CPDMP survey before applying the survey results to set make allowances for all Class III plants in the

Federal Order system. By using a stratified sample. Dr. Stephenson oversampled larger plants.

Given that larger plants are, other things being equal, more efficient, this meant that Dr. Stephenson was oversampling plants with relatively low costs of processing. If one does not adjustment for the fact that the survey results -- if one does not adjust for that fact. the survey results will significantly understate the costs of processing among cheese plants as a whole. Thus, if one does not adjust for that fact, one will set a make allowance that is too low.

The need to make this correction is particularly great given that the stratified sampling technique employed was chosen for the specific purpose of providing information that could, if properly adjusted, be used to set make allowances.

USDA itself sponsored and partially covered the expenses necessary to conduct the CPDMP survey of the costs of processing and was fully aware of the sampling technique to be used.

Having used a stratified sampling technique, one obviously must adjust for that stratification when using the survey results in determining average costs of processing by all cheese plants.

USDA in its tentative decision noted that, quote, "Even if the methodology used to calculate the estimated make allowance of $0.2028 per pound of cheese was statistically acceptable, the department would not use it as the new make allowance for cheese. The use of different methodologies to establish make allowances for different products would likely result in unintended consequences that could distort the competitive situation between cheese plants and butter-nonfat dry milk plants." Close quote. 71 Federal Register, Page 67486.

The comment misperceives the situation. The use of different methodologies did not relate to CPDMP's calculation of a population weighted average for cheese, but not for the other products, but rather referred to the use of a sampling technique for cheese that was different than the sampling methodology employed for the other products.

The cheese costs of processing survey was developed using a stratified random sample. while the surveys for the other products used a nonstratified random sample There was, thus, an inherent need to correct for stratification with respect to the cheese survey and inherently no need to do so for the other surveys

Having adopted a stratified sample technique for cheese, a methodology different than that employed for the other three products, one cannot fail to take the necessary next step and correct for that stratification, when applying the results to cheese plants as a whole as a necessary result of having decided to use a different sampling methodology in the first place

There was no a priori statistical reason to make a correction to the sample results for dry whey, butter and nonfat dry milk because a stratified sample had not been used

The fact that, as USDA states, quote. "CPDMP did not have similar population data available to do the comparable regression analysis for butter, nonfat dry milk and dry whey." close quote, thus becomes irrelevant

USDA observes that, quote. "It is possible that if the regression methodology could be used for butter, nonfat dry milk and dry whey, that estimated average make allowances for those plants also would be higher than the weighted average costs from the plant samples " Close quote 71 Federal Register, Pages 67486-7

This might be true, but we do not know whether this is true, and do not need to know because a stratified sample was not used for these other products

The reasons why such a stratified sample was used for cheese, and properly so, were recognized by USDA and discussed above Cheese plants cannot be saddled with a make allowance that is too low merely due to speculation as to whether the make allowance -- as to what the make allowance might be for other products had alternative survey methodologies been utilized for them

Therefore, USDA must correct for the intentional sample bias in the CPDMP cheese costs of processing survey and use the corrected population weighted average estimate for this

product's cost. It is, therefore. the weighted average processing costs for cheddar cheese plants outside of California that must be used. The top part of Table 1 of my exhibit, shows the method used by USDA in the tentative decision to determine the make allowances to be used from combining the CPDMP and CDFA data. IDFA believes that USDA should adopt the methodology shown in the bottom portion of the table when considering proposals at this hearing.

Specifically, the population weighted average processing cost for cheddar cheese, as testified to by Dr. Stephenson, should replace the sample weighted average cost used by USDA in the tentative decision by replacing the $0.1638 sample average with the $0.2028 population average.

JUDGE PALMER: Just so that I follow along properly, that number applies to what, a hundredweight, or per pound?

DR. YONKERS: It is the make allowance for per pound of cheddar cheese.

JUDGE PALMER: Per pound. Go ahead.

DR. YONKERS: When the most

recently published CDFA data from Exhibit 10 is combined with the NASS 2005 dairy production volumes for the California and the rest of the country -- the most recent annual data available, the next data will be published in the April 2007 edition of the Dairy Products Annual Summary -- the results of these changes are that USDA should set make allowances at least as high as the following: For cheese. $0.2017; for butter, $0.1214; for nonfat dry milk, $0.1630, and for dry whey, $0.2069. These are the make allowances that USDA should adopt as a result of this hearing.

BY MR. ROSENBAUM:

Q. Dr. Yonkers, before we go on, could we turn to the very last page of your Exhibit 25, which contains Table 1. You can turn back to that. And let people get that in front of them, so that you can be perfectly clear what this table shows.

As you have testified, the top half, called the "Tentative Decision," is your replication of how USDA went about setting the make allowances that are now in effect; is that correct?

A. That's correct.

Q. And you do that separately for butter, nonfat powder, cheese and dry whey, correct?
A. That's correct.
Q. And taking cheese as an example, you start with a total of 2005 U.S. NASS volumes of 3.8 -- is that billion?
A. Million pounds.
Q. Million bounds.
A. Excuse me, billion pounds, that's correct.
Q. Billion pounds. And then you show what the CDFA weighted average costs were coming out of the CDFA survey then in effect, correct?
A. That's correct. The data available at that time.
Q. Which was 17.69 cents, correct?
A. Correct.
Q. Then you have the California NASS volumes of 854,704,000 pounds; is that right?
A. Correct.
Q. As a matter of statistics, that number divided by the 3,812,950,000, gives you California share of NASS of 22 percent?
A. That's correct.
Q. Then you used -- you provide the sample weighted average cost from Dr. Stephenson's

survey, correct?
A. That's correct.
Q. Not readjusted in the way you suggest. correct?
A. That's correct.
Q. And you have now the non-California NASS volumes, the 2.9 million, correct?
A. Billion, correct.
Q. Billion. And the share by the non-California states of NASS being 78 percent, correct?
A. Correct.
Q. You then provide a weighted average of the California and non-California make allowances weighted by their relative portion of cheese production volume, correct?
A. The California and the Cornell research sample averages weighted by the NASS volume. yes.
Q. And that creates the 16.67 cent make allowance, correct?
A. That's correct.
Q. You then add marketing costs on top of that, right?
A. That's correct.

Q. And come to 16.82 cents, correct?
A. Yes.
Q. And that is the current make allowance for cheese, correct?
A. Yes.
Q. Now, in the bottom half of this table -- and you do the same thing for butter, nonfat powder and dry whey, correct?
A. Correct.
Q. Now, in the bottom half of this document. you provide what you think the make allowances. in fact, should be, correct?
A. That's correct.
Q. And the last line, or the last row provides the numbers that are the same as were in the text of your statement; is that correct?
A. That's correct.
Q. With respect to cheese, you have done two things. You have weighted the Cornell data in the manner you think is appropriate, correct?
A. I have actually used the weighted average. the population weighted average that was testified to by Dr. Stephenson.
Q. Then you have also added the updated data from the California Department of Food and

Agriculture as to the cost of manufacture in California for cheese, correct?

A. That's correct.

Q. With respect to butter and nonfat powder, the only thing you have done is to incorporate the recent data from the California Department of Food and Agriculture as to the cost to manufacture those two products?

A. That's correct.

Q. And with respect to dry whey, you have done two things. First, you have incorporated California data, which USDA did not do, and you have done that for the reasons you have stated. correct?

A. Yes. I have incorporated data that was not used in determining the make allowances that are currently in place.

Q. And those were the California -- that was the California data, correct?

A. Correct.

Q. And you have explained in your testimony why you think that should be included, correct?

A. Yes.

Q. And in so doing, you have used the most recent California data; is that correct?

A. That's correct.

JUDGE PALMER: Let me see if I understand how those numbers work. I would like to just go into how this make allowance applies. It won't take me long. I am just a little confused.

The number you have, which is 20 -- or .2017, which is just a little bit over 20 cents per pound --

DR. YONKERS: That's correct, of cheese.

JUDGE PALMER: Okay. Is that the finished product? Does that apply to the finished product or the per pound of milk that is made into cheese? How does that work?

DR. YONKERS: The product price formulas that USDA has adopted since January 1 of 2000 and are currently in place, as modified most recently last month, are all based on a per pound of product basis.

So it incorporates the price per pound of cheese, the cost to convert the milk necessary to make a pound of cheese, and then it factors the yield that you can get from a per pound of component.

JUDGE PALMER: So that applies against a much larger volume of milk?

DR. YONKERS: Yes, this -- the per pound of product prices, make allowances and then it is the yield factors which turn them into a per pound of component, and then USDA uses those to reach its standard. For instance, for butterfat, it uses 3.5 pounds of butterfat to determine the value of butterfat in milk containing 3.5 percent butterfat.

JUDGE PALMER: You are proposing. in effect, a 4 cent per pound of cheese increase. How would that relate back to a producer's price, in terms of -- if this is too complex or needs a little bit of computation. calculation, I will let you defer.

But I am just wondering, how many pounds of milk would that be and how would that affect the hundredweight of milk sold by a dairy farmer or a dairy farmer's representative?

DR. YONKERS: Well, first of all, it is a little less -- it is quite a bit less than 4 cents. It is a little more than three. about three and about a third.

JUDGE PALMER: I stand corrected.

DR. YONKERS: But that is fine. USDA actually analyzed, I believe. Proposal 1 in its Preliminary Economic Analysis, Your Honor. and I do not remember the net revenue. It is in an earlier exhibit.

JUDGE PALMER: It is in the record. All right, go ahead.

MR. ROSENBAUM: I think we are back on page 17. I don't know, Your Honor. at what point you want to take a break.

JUDGE PALMER: You want to do it now? Let's take a short recess. He has finished Proposal 1. Let's take a five-minute recess.

(Thereupon, a recess was taken.)

JUDGE PALMER: On the record.

MR. ROSENBAUM: Dr. Yonkers, we were on page 17 of your statement, with Proposal 2. If you could continue.

DR. YONKERS: Proposal 2. IDFA supports the concept of having USDA conduct an annual manufacturing cost survey of cheese, dry whey, butter and nonfat dry milk plants located outside of California, as contained in Proposal 2.

As stated in my comments on using the most recent data available and in others' testimony at this hearing, make allowances determine the portion of a finished product's value that remains with the processor or, better stated, is not passed back to the farmer or cooperative first selling that milk.

Manufacturing costs change over time for a variety of reasons, both up and down. Maintaining a make allowance that properly rewards farmers and processors, both proprietary and cooperative, while not disrupting the market for end products is one way to ensure an orderly market.

Monitoring the costs associated with producing these products through a regular. annual or or biannual survey of plant costs will provide data to the industry that will serve two very important functions.

First, these results will illuminate trends in plant costs where current regulations are becoming obsolete.

Second, this will provide ready input to future hearings on how these make allowances should be adjusted. This will facilitate a much

more rapid updating of make allowances than has been achieved in the last few years, during which we have, until this month, been living with make allowances based on costs surveys conducted in the late 1990s.

However, IDFA opposes the concept of automatic annual updates to the manufacturing make allowances based on such a survey. We believe that the hearing process provides the opportunity for the industry to provide important input as to the method by which the updated data should be utilized, given the complexities created by the use of stratified samples and the like.

Proposal 3. Proposal 3 would reduce the current make allowances by eliminating the use of CDFA cost of manufacturing data. IDFA opposes Proposal 3 for the reasons described in the section above in support of Proposal 1.

In addition, since USDA first adopted product price formulas for all classes as part of the Federal Order Reform process, it has correctly recognized that costs of processing from the CDFA survey should be included when determining the appropriate level of make

allowances. The CDFA survey provides audited data, collected by trained individuals pursuant to long-standing and well-regarded practices. It would be a big mistake for USDA to turn its back on the CDFA data.

Proposals 6, 7 and 8. IDFA opposes Proposals 6, 7 and 8, all of which propose to adopt changes in the yield factors used in the product price formulas. As noted earlier in my testimony, it is absolutely critical that USDA avoid adopting yield factors that are not representative of actual industry data.

In addition, USDA must consider the entirety of the processing sector regulated by Federal Orders, not merely the most efficient processing facilities.

In April 2003, USDA implemented the final rule resulting from the May 2000 national hearing, the last to consider proposals to change the yield factors. USDA correctly concluded that various factors should be included when setting yield factors, among them including an allowance for farm-to-plant shrink. allowances for secondary products like buttermilk, which has lower value in the

marketplace than nonfat dry milk, and using assumptions regarding butterfat retention in cheddar cheese, which allow for the range of retentions achieved by plants with different processing technology

If anything, USDA should modify the current yield factors to account for within-plant loss of components that reduce the capture rate of whey cream and the reality of the off-grade products that sell at a discount to the market prices as reflected in the NASS survey

The Yield Factor Cannot Be Set at a Level That Ignores Shrinkage Component tests on producer milk are conducted at the farm bulk tank, but processors can only manufacture products from the components that actually reach the plant Along the way, both milk and components are lost, as farm milk is transferred from the bulk tank to the transport tanker and again in the transfer from the tanker to the plant at the receiving area

Others will present actual data on the milk volume and component loss during the process of moving milk from the farm bulk tank

to the plant, but the data presented thus far suggests that the current yield factors are, if anything, on the high side because they reflect the low side of the true amount of farm-to-plant loss.

In addition, shrinkage results from the movement of milk and products within the manufacturing plant. Others will also testify about this loss, not only due to transferring milk in pipelines and other processing equipment, but also as reflected in the small percentage of every plant's output which is off-grade and must be sold at a discount to the NASS survey prices in the marketplace.

These sources of shrinkage are not accounted for in the make allowance or anywhere else in the product pricing formula. The shrinkage should be accounted for in the yield factor. USDA should reject any proposal calling for yield factors that ignore this significant factor, which is a market reality in the dairy industry.

BY MR. ROSENBAUM:

Q. Dr. Yonkers, before you go on, perhaps to clarify the sentence where you say. "These

sources of shrinkage are not accounted for in the make allowance," you are referencing there in-plant shrinkage, as well as off-grade sales; is that correct?

A. That's correct.

Q. The formulas do currently reflect shrinkage from the farm to plant, correct?

A. Farm to plant loss, that's correct.

Q. And your testimony as to that subject is in opposition to the proposals that would eliminate that shrinkage?

A. That's correct.

Q. But you also believe that there should be additional shrinkage built into the formulas, with respect to in-plant shrinkage and off-grade sales, correct?

A. That's correct

Q. Please continue.

DR. YONKERS: Formulas can ignore the reality that secondary products like whey cream and buttermilk have lower value in the marketplace than sweet cream and nonfat dry milk. Secondary products, like the butterfat in whey cream, resulting from the manufacture of cheddar cheese and the buttermilk resulting from

the manufacture of butter, must be considered when setting yield factors for the product price formulas. Adopting yield factors which assume these secondary products have the same value as Grade AA butter in the case of whey cream, and the same value as nonfat dry milk in the case of dry buttermilk ignores the market reality. Other witnesses will be testifying regarding the market value differences between these products.

BY MR. ROSENBAUM:

Q. Dr. Yonkers, we heard already from Mr. Wellington on that subject, correct?

A. That's correct.

Q. And there will be others?

A. There are other IDFA member companies that will be testifying.

Q. Please continue.

DR. YONKERS: Proposal 9. IDFA's Proposal Number 9 is intended to rectify the error in the current Class III formula that results in the valuation of all the fat that is used in cheddar production, but is not captured in the cheddar cheese as Grade AA butter. The specific factor in the current formula that causes this error is the 0.9 factor in the

protein formula This factor is in the part of the protein formula that adjusts for the difference between the fat value in cheese relative to the fat value in butter, the price paid for the Class III fat component

The practical effect of this factor is that 10 percent of the fat is priced at the Grade AA butter value This is an erroneous assumption in two ways First, not all fat -- excuse me, not all fat not captured in cheddar cheese can be recovered And two, the fat that is recovered from the whey stream commands a lower value in the marketplace than Grade AA butter

IDFA member testimony, to be given later in this hearing, will speak to the specific recoveries and to the valuation of whey cream

The protein formula should include a factor to account for the difference between the whey cream value and the Grade AA butter value that is used to price Class III fat and to account for fat losses This should be done with a flat adjustment, similar to the Agri-Mark methodology in Proposal 10, but the adjustment

should be reflective of the actual difference in value between whey cream and Grade AA butter.

Proposal 10. IDFA supports the concept embodied in Agri-Mark's Proposal 10, but as noted above, believes that the adjustment must go beyond the difference in value between Grade AA and Grade B butter values.

Proposal 11. IDFA also believes that Proposal 11, which calls for the reduction of the 3 cent adjustment to the cheddar cheese barrel price to 1.5 cents, does not go far enough. Further elaboration is contained in our support of Proposal 12.

Proposal 12. The 3-cent adjustment to the NASS barrel price is supposed to represent the difference in the costs of processing cheddar cheese in 500-pound barrels, versus 40-pound blocks. Others will also testify and present actual plant data regarding the near zero actual difference between the costs of processing cheddar cheese in barrels. versus 40-pound blocks. Thus, the factual predicate for this adjustment will be shown to be mistaken.

In addition, the Cornell cheddar

cheese costs of processing data used by USDA in the tentative decision to determine the make allowances currently in use, included both block and barrel plant data. Therefore, any difference in the costs of manufacture for blocks versus barrels is already represented in the make allowances used in the Federal Order product price formula for cheddar cheese. Continuation of the 3-cent adjustment to the barrel price would result in double counting this factor.

BY DR. YONKERS:

Q. Dr. Yonkers, let me just stop you there for a minute, because I know this paragraph is perhaps something of a new concept. The current make allowances are based in part on the survey that Dr. Stephenson conducted of the cost of manufacture at cheddar cheese plants, correct?

A. Outside of California, that's correct.

Q. And his survey covered both barrel plants and block plants, correct?

A. That's correct.

Q. And, accordingly, if there is, in fact, a difference in the cost of processing cheddar cheese in barrels versus blocks, he picked that

up as part of his calculations of the cost of manufacture, correct?

A. That's correct. He made no adjustment to either the block or barrel plant costs of processing for the other.

Q. So having included both blocks and barrels in determining the current make allowances, is there any conceptual basis for making an additional 3-cent adjustment to account for the difference between blocks and barrels?

A. No.

Q. Okay. Why don't you continue on, please.

DR. YONKERS: Proposal 14. IDFA opposes the adoption of Proposal 14, which would use a combination of the NASS and CME wholesale product price data in the product price formulas. Proposal 14 would add needless complexities and represents overkill in light of the problem it tries to address.

It is our understanding that an issue the proponents sought to address with this proposal was the lag from market activity to reporting by NASS. In the worst case, a product sale on Monday morning is included in the report filed the following week to be sent to NASS.

where it is reviewed, tabulated and reported the following Friday.

We are sympathetic to the argument that this lag, especially in times of fast-moving or very volatile prices, can create significant divergence between NASS reported market prices, hence the cost or expected cost of the milk input and the actual market price for the product on a given day. Shortening the delay between the sale of a product and the corresponding NASS report would greatly reduce this divergence and its consequences.

We believe options are available to USDA-NASS to reduce this lag. For one, in this age of continuous and instantaneous communication, the NASS survey could be made electronic in reporting, review, auditing and tabulation.

In this way, the price and volume reports could even be available on Monday morning, eliminating four days from the lag. Adoption of such measures is more consistent with past workings of the Federal Order system since order reform and much simpler than Proposal 14.

Proposal 15 IDFA opposes adoption of Proposal 15, which would substitute CME prices for NASS prices for all products except dry whey The product price formulas used to determine minimum milk prices under the final rule are based on the wholesale selling prices of butter, cheddar cheese, nonfat dry milk and dry whey

As a primary building block of Federal Order minimum prices, these wholesale prices determine what handlers pay and producers receive for all milk regulated under the Federal Order program

Therefore, it is imperative that the wholesale selling prices used to determine minimum Federal Order producer prices, represent the wholesale value of the underlying product in the marketplace as accurately and completely as possible

Accurately representing the average wholesale price of these products in the marketplace can only be accomplished by including the largest possible sampling of wholesale prices

For that reason, the product prices

used to determine Federal Order minimum prices must represent actual market sales transactions In addition, the product price data should represent transactions from all areas of the country and not be limited geographically to any one sales region or adjusted to prices in any one region

Finally, such price data should include the largest volume of manufactured dairy products as possible

Currently, only the dairy product prices survey conducted weekly by the National Agricultural Statistics Service of USDA, meets these criteria

Proposal 15 would replace the NASS dairy products prices survey with data from the Chicago Mercantile Exchange, or CME, spot markets However, USDA in the final order -- Federal Order final -- excuse me However. USDA in the Federal Order Reform final rule discussed the many reasons why the CME is not a suitable data source for any of the four purchased products at issue

First, noting that the CME weekly cash butter contract has been used in setting

the butterfat differential, the final rule states. "This price series has been criticized due to the thinness of trading."

With respect to cheese, USDA stated in the final rule, "Criticism of the cheese exchange trading, including inaccurate representation of cheese prices and accusations of market manipulation, reached the point that the National Cheese Exchange," or NCE. "discontinued trading, and cash trading of cheese moved to the CME. The CME also has received some criticism for thinness of trading." Close quote.

While there exists a cash contract for nonfat dry milk at the CME, USDA noted in the final rule that, quote, "There is very limited exchange trading of nonfat dry milk." Finally, there is no cash exchange market for dry whey.

All of the available evidence supports the correctness, both then and now, of USDA's decision in the Federal Order Reform final rule not to utilize CME data. To switch from the NASS data to the CME data would be to switch from a very broad, to an extremely thin,

representation of actual cheese transactions.

The same is true for butter and nonfat dry milk. For the period from January of 2000 to December of 2005, the NASS survey volumes represented 15.4 percent of all U.S. butter production, while CME trading volumes consisted of only 4.6 percent.

Looking at nonfat dry milk over that same time frame, the NASS survey volumes represented 78.1 percent of all U.S. production, while CME trading volumes consisted of only 0.02 percent.

JUDGE PALMER: Where did you get those numbers from? I am not challenging them. I am just wondering if you have a source for the numbers you have.

DR. YONKERS: NASS publishes an annual summary of dairy volumes, of manufactured dairy products, called Dairy Products. They also publish it monthly, but they publish an annual one of those.

JUDGE PALMER: So you looked at those and you found that these were the percentages of the actual cheese transactions and the actual butter production --

DR. YONKERS: I got the production of butter and nonfat dry milk from that NASS publication for each of those years. So each of those years, there is a different annual summary.

And then the data on the CME trading volume, I actually got from a Web site maintained by the University of Wisconsin. called Understanding Dairy Markets, which has all this data available in a summary spreadsheet form.

JUDGE PALMER: All right. Go ahead.

DR. YONKERS: This thinness carries two consequences. First, it raises the very real prospect that the reported prices are not, in fact, representative of finished product transaction prices. But the prices used to set minimum milk prices must be accurate, if the entire pricing system is to function properly.

Second, these markets are sufficiently thin so as to encourage purchasing for the purpose of causing minimum milk prices to rise, if they formed the basis of minimum milk prices.

In addition to their thinness, the CME is not national in scope. In the final rule, USDA noted that, quote, "The scope of the surveys that have been undertaken by NASS, and their geographic representation, appears to be comprehensive." Close quote.

But because the CME spot prices represent transaction prices adjusted to the Chicago market only, the CME spot prices do not satisfactorily capture the national scope of manufactured dairy product markets.

Mr. McCully from Kraft will provide additional testimony regarding how the CME suffers from this shortcoming.

For the reasons I have just explained, the Federal Orders' reliance upon the NASS survey should be retained. In fact, many of the reasons cited for changing to the CME could be addressed, at least in part, by changes in the NASS survey process.

First, USDA should make reporting mandatory for all manufacturers of all products eligible to be reported in the NASS Dairy Products prices survey. This would even further improve the completeness of this data in

representing all eligible sales transactions.

Second, USDA should implement a method to verify that data submitted on the survey is accurate. This could be as simple as requiring manufacturers submitting data to include the names and contact information of their three largest volume customers each week, which USDA in turn could use to conduct spot checks by making certain that the data reported by manufacturers was consistent with what customers reported paying.

Third, USDA could require electronic reporting of the NASS dairy products prices survey data and report weekly data in a more timely fashion. For example, USDA could require that data for the prior week ending be reported by COB Monday, and issue the weekly Dairy Products Prices report on Tuesday.

Proponents of Proposal 15 also claim that the circularity associated with the use of NASS survey prices would be eliminated if USDA instead used the CME spot market prices.

This claim appears to be based on the concept that industry participants commonly use the CME as a reference price, and actual sales

prices for wholesale dairy product transactions occur at a set premium or a discount to the CME price.

Proponents claim that by adopting the CME instead of the NASS survey prices, market participants can merely adjust this discount or premium to account for any higher costs of processing.

This argument ignores marketplace realities. It is very difficult for sellers of homogeneous, nondifferentiated commodities, such as commodity cheddar, to extract a premium from the marketplace. The buyer's alternative is to purchase product from the CME where they will not have to pay the premium or to procure from a competitor that is not similarly increasing prices.

Proposal 16. We oppose Proposal 16 because of both its increased complexity and the distortions that will result from assigning the value of a product, whey, whose yield is dependent upon a milk component that is not highly variable, other solids, to a component that is more highly variable, protein, across breeds.

The current set of regulations represents an intuitive understanding of the components of dairy products. Products with protein, fat, other solids or some combination are priced with those components in mind.

In the case of Class III milk, this means the protein and fat that remain in the cheese are priced based upon the value of the cheese. The other nonfat solids that remain can be dried and sold as dry whey, and their value in the current price formulas reflects this.

As can be seen in the department's Preliminary Economic Analysis, the assignment of the value of whey to the protein component will increase the cost of high protein milk, while reducing the cost of low protein milk.

Since the other solids components of milk do not move parallel to the protein content and are, in fact, relatively constant across breeds, these cost shifts are inconsistent with the whey yield that could be expected from high and low protein milk.

Proposal 17. IDFA opposes adoption of Proposal 17, which would require automatic monthly updates to the make allowances based on

changes in price indices representing costs of electricity and other energy inputs

Monthly adjustments complicate the process of risk management By introducing another factor in the final benchmark price. regardless of how well-documented and known. there is a greater chance that that benchmark price will differ from an actual price to some market participant

In other words, there will be an increase in the basis risk for that participant This addition of risk into the markets for dairy products will retard the acceptance and use of risk management tools for dairy products at a time when risk management is becoming a commonplace part of producer, processor and end-user practices

Proposal 18 IDFA opposes the adoption of Proposal 18, which attempts in some way to use a simulated competitive pay price series in determining Federal Order minimum class prices for milk

The proponents of this proposal have not yet appeared at this hearing, and IDFA may need to return to present further testimony

following such an appearance

However, we do know that USDA abandoned the competitive pay price series known as the M&W price series with the implementation of Federal Order reform amendments in January 2000 That price series had been based on Grade B milk pay prices which had no minimum regulated price requirements

However, over time, both the volume of Grade B milk production and the decline in the number of plants purchasing Grade B milk caused USDA to conclude that it was no longer competitive in any way

In addition, during the Federal Order Reform process. USDA considered a competitive pay price for Grade A milk, but concluded doing so would not lead to a representative competitive pay price for milk

As USDA noted in the April 1999 final decision on Federal Order Reform "Identification of a competitive pay price in today's dairy industry where 70 percent of the milk is currently covered under Federal milk marketing orders, appears to be an unsurmountable challenge After accounting for

state regulations, only about 2 percent of Grade A milk is unregulated, and it is unlikely that even this small amount of milk is not affected by regulated prices. Only about 5 percent of the total milk marketed in the U.S. is Grade B or unregulated, and 42 percent of that milk is located in Minnesota and Wisconsin. The remainder is scattered among 23 states in amounts too small and delivered to too few processing plants to generate a competitive pay price. In areas where alternative markets exist, the price for unregulated milk likely is not below the price paid for regulated milk. since producers would prefer to sell their milk to regulated handlers to receive the higher. regulated price. Thus, unregulated handlers are compelled to meet the regulated price in order to attract sufficient supplies of milk. The circular result is that the regulated price ultimately becomes the competitive price. This process does not lead to a representative competitive pay price for milk." That is at 64 Federal Register, 16092.

Little has changed since the time of that decision, as today very little milk is not

under either Federal Order or state milk price regulation in the U.S.

Proposal 20. IDFA opposes the adoption of Proposal 20, but because the proponents have not yet appeared at this hearing, I will present further testimony on this proposal after they have appeared.

A comment on the use of farm costs of production in determining the Federal Order minimum milk prices. In addition to this testimony on specific proposals, I note that several witnesses have indicated that USDA should consider farm costs of producing milk when setting Federal Order minimum prices for manufactured dairy products. While there are no proposals in the hearing notice directly addressing the use of such data by USDA, I offer the following comments.

As noted by USDA in its October 21st, 2001 recommended decision on Class III and IV product price formulas, quote, "The record of this proceeding contains no new dairy farmer cost of production data that could be used to reflect both the supply and demand sides of the market for dairy products. There is no evidence

in the record that either USDA's Economic Research Service or the CDFA's costs of production have ever been used to price milk.

"If conditions increase supply costs, the quantity of milk produced would be reduced. due to lower profit margins. As the milk supply declines, plants buying manufacturing milk would pay a higher price to maintain an adequate supply of milk to meet their needs. As the resulting farm profit margins increase, so should the supply of milk. Likewise, the reverse would occur if economic conditions reduce supply costs. The price of feed is not directly included in the determination of the price for milk, but rather is one economic condition which may cause a situation in which the price of milk may increase or decrease. A change in feed prices may not necessarily result in a change in milk prices. For instance, if the price of feed increases but the demand for cheese declines, the milk price may not increase since milk plants would need less milk and therefore would not bid the price up in response to lower milk supplies. Also, other economic conditions could more than offset a change in

feed prices and, thus, not necessitate a change in milk prices. The pricing system continued in this decision will continue to account for changes in feed costs, feed supplies and other economic conditions, as explained above. The product price formulas adopted in this rule should reflect accurately the market values of the products made from producer milk used in manufacturing. As supply costs increase with a resulting decline in production, commodity prices would increase as a result of manufacturers attempting to secure enough milk to meet their needs. Such increases in commodity prices would mean higher prices for milk. The opposite would be true if supply costs were declining. Additionally, since Federal Order prices are minimum prices, handlers may increase their pay prices in response to changing supply/demand conditions even when Federal Order prices do not increase." Close quote. 66 Federal Register 54070.

This analysis of this issue by USDA is as correct today as it was then.

I note that proponents have introduced into evidence Exhibit 19, which

provides certain dairy farm costs of production data from a USDA Web site. However, the USDA. ERS Web site cited specifically notes that. quote, "Since cost-of-production data for any particular enterprise are only collected about every four to eight years, estimates for nonsurvey years use the actual survey year as a base and use price indices and other indicators to reflect year-over-year changes. This can cause discontinuities when new survey data replace those nonsurvey estimates. The magnitude of these discontinuities depends on how much technical and/or structural change occurred in the sector between the survey years, as well as changes in the sampling. questionnaire and other data collection procedures." Close quote.

With respect to Exhibit 19, all of the data presented, which purports to cover the years through 2006, was based on a survey conducted in the year 2000. Thus. the more recent years are based on five or six years of index updates and could bear little resemblance to actual costs of production in those years.

Even the updates for changes in

output per cow and number of cows per farm as listed by ERS are not consistent with data on those changes reported by USDA NASS for all of the United States.

For example, the ERS costs of producing milk for the entire U.S. data indicate that was based on a herd with 93 cows for 2000, but only 96 cows in 2005. I note that no such supporting data on herd size and output per cow were provided prior to 2000, an increase of only 3.2 percent. Yet the data reported by NASS shows the average U.S. herd size increased from 87 milk cows in 2000 to 115 milk cows in 2005. an increase of 32 percent or an order of magnitude greater. And, of course, as herd size increases, costs per hundredweight generally decrease.

For output per cow, the story is similar. The ERS costs of production data for the United States on average is based on an output per cow of 19,974 pounds in 2000 and increases to only 20,045 pounds in 2005, a total increase of less than 0.4 percent for the entire five-year period.

On the other hand, NASS reports that

the average milk output per cow in the United States increased from 18,197 pounds in 2000 to 19,576 pounds in 2005, an increase of 7.6 percent during those five years. Again, as production per cow increases, costs per hundredweight generally decrease.

In short, this data is very suspect, even assuming it would, if accurate, provide useful information for decision making at this hearing. And that concludes my direct testimony.

MR. ROSENBAUM: Your Honor, at this point, I would ask that Exhibit 25 be entered into evidence.

JUDGE PALMER: It is received.

(Thereupon, Exhibit 25 was received into evidence.)

MR. ROSENBAUM: Dr. Yonkers is available for cross-examination.

JUDGE PALMER: Well, he covered a lot. I don't know where anybody wants to start. Mr. Beshore, are you going to start?

MR. BESHORE: I will start with one area and I may have some others later.

JUDGE PALMER: Yes, I am

wondering. He gave his testimony on a whole range of proposals. Would it make any sense to take it proposal by proposal?

MR. ROSENBAUM: I think that would end up being less efficient.

JUDGE PALMER: Just go on everything that is in here. All right.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore. Dr. Yonkers, I would like to ask you a question, or maybe more than one. about the comment that you made at the paragraph at the top of page 23 of Exhibit 25, which Mr. Rosenbaum had some supplemented questions highlighted. in essence.

I take it -- this is your first full paragraph on that page.

A. Twenty-three?

Q. Yes. I take it that your point here is that the product prices which should be used in the cheese price formula should match the products that are manufactured by the plants in the make allowance formulas, make allowance calculations? That there should be an identity -- if the costs are based on blocks and

barrels, then both blocks and barrels should be used in the price series?

A. I do believe there should be a comparison. apples to apples comparison, between the data used for make allowance and for dairy product prices that are used, the wholesale dairy product prices used in the product price formulas. yes.

Q. Now, you advocate using the California data?

A. I do.

Q. Okay. Are you aware that that is based on the cost of producing 40-pound blocks only?

A. I am aware of that. I have spoken to people at CDFA who were unable to tell me the nature or by what amount that adjustment made in their cost of processing data. So I don't know what it does.

But I do know that their publications on this say that they have adjusted cost to 40-pound block data.

Q. In other words, page 9 of Exhibit 9, which is the California Manufacturing Costs. Annual 2005 publication, point 4 says, "The volume total includes both cheddar and Monterey jack

cheeses, but the costs reflect only costs for 40-pound blocks of cheddar." That is what you are referring to?

A. That is what I am referring to.

Q. The next point says, these plants processed 500-pound barrels or 40-pound blocks, three plants, packaging costs and packaging labor for 40-pound blocks were substituted for these plants. You are familiar with that?

A. I don't have that in front of me. But I have no reason to doubt what you are reading is correct. Marvin.

Q. So if the resulting -- if the CDFA data is adjusted to reflect only the cost of producing 40-pound blocks and if your point on page 23 is correct, that is the didactic point that there should be an identity between price series and cost data, would you eliminate the CDFA data from the make allowance cost calculations or eliminate barrels from the price series?

A. I guess I would make two points. Number one, this is my second reason for supporting Proposal 12, and I will have one member who will testify about the actual cost difference in blocks/barrels.

The second point I made, I will make, is I am extremely reluctant to abandon the CDFA data. because it is nearly a population enumeration. It represents an extremely large percentage of the volume of those products that are processed in that state.

It is audited data. If at some point in time, we have data from non-California plants that is audited and represents a significant volume, at that point, I would be willing and our members, I think, would be willing to consider not using CDFA data.

But right now, the data that we currently have available from the most recent Cornell survey does not fit that. It is not audited. It does not represent a sufficiently large volume of the production of those products, outside of California.

Q. So the quality of the CDFA data, in your view, and perhaps the costs that it generates, are more important than the point made on page 23 about identity of the cost data and the price series; is that correct?

A. Well, the price series includes data from all across the United States, that the wholesale

dairy price data includes data from all across the United States. So it includes transaction prices from California and other non-Federal Order areas too.

MR. BESHORE: I don't have any other questions at this time.

JUDGE PALMER: Questions? Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. Good afternoon.

A. Good afternoon, Ben. Almost evening.

Q. I want to follow up on that last line of questions of Mr. Beshore, that the -- obviously, USDA has no control over what CDFA puts in their data, right, I mean, what they report?

A. That's correct. I don't believe they do. Maybe they do; I don't know. But my understanding is they have no control over what CDFA does in its survey of processing costs.

Q. But they do have control over what they include in the NASS, right?

A. Now, are you talking about going for make allowances now or to product prices?

Q. I am just talking about product prices.

The product pricing that was reported -- yeah. we are going from manufacturing costs in California to product pricing in the Federal system.

A. I hope they do because I have made some suggestions for improving that NASS reporting process.

Q. If they retain the NASS, they would have the ability to match, for example, just blocks and just price the blocks as opposed to blocks and barrels, right? They could report that?

A. Well, they report that now, they report blocks and barrels separately.

Q. Okay. But they could also exclude California from that survey as well, right?

A. They could, if they decided to.

Q. In fact, in the analysis that was in the economic analysis, its appears they did subtract out the California poundage from the NASS. didn't it?

A. In which economic analysis?

Q. The one they computed the make allowances.

A. I am not following your question. Ben.

Q. Did they not take out of the U.S. population of the pounds, the pounds that were

reported in California for doing the weighted average between CDFA and the Cornell?

A. Take out the pounds? Now, are we talking make allowances or are we talking dairy product prices?

Q. I understand. Let's start again.

The current make allowances are based upon a weighted average between CDFA and the Cornell prices?

A. That's correct.

Q. All right. And to do that, they took pounds of product for CDFA, right?

A. Oh, oh. They took the NASS data on total production in California and not just what was in the CDFA. Now I am with you.

Q. Right. Then they reduced the NASS poundage by the amount of cheese?

A. The way I look at it, they took California and the rest of the country. They divided it up.

Q. California, they used the barrels and then the totals they had for CDFA, because that is what they reported was the barrel cost?

A. Block cost.

Q. I am sorry, block cost?

A. No, they added total cheddar. You know. you are talking about my Table 1 in the data that I have got there.
Q. Sure.
A. And in re-creating that, USDA NASS does not have data on the percentage of cheddar cheese in blocks versus barrels. They only have one cheddar cheese number, so they were unable to do that. I was unable to do that.
Q. Now, we have had -- is anybody going to be able to testify in terms of the financial straits the plants are in in the country?
A. You are asking of my members? None of them have indicated that that was going to be the focus of their testimony. They were going to focus on the proposals at hand.
Q. Okay. How many plants, cheese plants, in the United States went out of business in 2006?
A. I don't know that number, Ben. We don't keep track of that. We don't survey that. I don't have a number.
Q. Wouldn't it be relevant to know whether or not this current system is overpricing the milk to determine the insolvency level of plants that are buying this milk under this regulated

system?
A. Another way of looking at that same issue. I really wish that USDA's preliminary impact analysis would actually address plants and whether plants are making enough money.
But they don't have a model that will do that.
Q. And do you -- a number of your clients are publicly traded companies, are they not?
A. A number? Yeah. A number of them are.
Q. Have any of those reported losses for 2006?
A. I don't think all of them have reported for calendar year 2006.
Q. What about 2005?
A. I don't have that with me, Ben.
Q. The truth of the matter is, is that the processing plants in the country have been profitable the last couple of years; isn't that true. Mr. Yonkers?
A. I don't have any evidence to suggest that.
Q. Do you have evidence to suggest that they are losing money, that they are unprofitable?
A. I didn't include that in my testimony.
Q. I know you didn't. But isn't that relevant coming to the department and asking them to

reduce the costs for their raw product, because you are complaining in here that they are losing money or they are going to lose money with make allowances that are not adjusted correctly, isn't that what you are saying?

A. I am saying that if the make allowances are not set to cover their long-run costs of processing, that plants will not be able to maintain an outlet for a supply of milk.

And my testimony in particular focuses on the data that was collected, which is the only data I have, on what the actual cost of processing is, outside of California, and that was the recently conducted Cornell study.

Q. You would agree, would you not, that for a business entity, regardless of whether you make widgets or cheese or anything else, that they have to have income that exceeds their expenses to continue to survive; isn't that correct?

A. It depends how you define both of those. I have not presented any testimony on the profitability of the industry or individual plants.

Q. Well, will anybody testify to the profitability of industry?

A. I will tell you, I have several members who are planning on testifying. Some were planning on coming this week, but because of other business activities that were going on, had to cancel, and because of the length of the hearing and whether they could get on, declined to come this week.

But several of them are lined up to testify.

Q. And are you aware of any effort to provide any aggregate look at the processing industry in terms of its profitability?

A. I know of no effort to do that.

Q. Now, your Table 1, is that the same numbers that were proposed by Agri-Mark, or is that a different number that was proposed for the make allowances?

A. As I understand Agri-Mark's testimony, they referred and urged USDA to adopt the same procedure that they had submitted in their comments on the tentative final decision on make allowances.

They provided a table that if USDA was not going to do that, that had different numbers than I am showing here.

Q. Are the numbers that are showing here on this exhibit, this table, is that consistent with the scenario that was done, the analysis that was done by the USDA of the Agri-Mark proposal?

A. I don't know.

Q. If the proposals that you propose in Table 1 were to be adopted, what is the total amount of money that would accrue to the benefit of your clients?

A. I haven't analyzed that.

Q. Now, in pages 5 and 6 and elsewhere throughout, you use this example, I think you talk about $1.40 cheese and if they get $1.40 and the make allowance is this and this is what they can pay their producers, and you change the make allowance, but their costs are less than the make allowance, they lose money. That is kind of the tenor of that discussion, right, at pages 5, 6 and 7?

A. Yes.

Q. The truth is, first of all, that most of the products manufactured by your clients are not subject to the NASS pricing; isn't that correct?

A. Yeah, when you say "most," it is -- I would imagine 40 percent is cheese, so it is close. We don't represent our members on nonfat dry milk and butter. Yeah, most.

Q. And then when you talk about cheese, is that most cheese is not subject to the NASS -- I mean, is not a commodity cheddar cheese; isn't that correct?

A. That's correct.

Q. Okay. So the reality is, Dr. Yonkers, that most of the products that your clients or your members make, they can price it any way they want, and it is not going to show up in the NASS; isn't that correct?

A. I don't believe that is an accurate statement, that they can price it any way they want.

Q. They can price it based upon what the competition will allow them to pay; isn't that right?

A. Customers of theirs respond to changes in relative prices in the marketplace, and if they were to increase their prices relative -- and for some, it could be competition with nonfat dry milk and butter as a use, it could be with a

different type of cheese versus cheddar cheese. but you are changing the price relationships and you cannot do that without having a market response, Ben.

Q. Then why -- you are saying then that they are impacted by the NASS price, is that what you are saying, that the NASS price is restricting what a manufacturer of Gouda cheese or specialty butters or cottage cheese, that that is limiting what they can price their milk at?

A. The market establishes, based on supply and demand conditions, the prices for all of those products. And you can compare the relative price of any one of those products you just mentioned to cheddar cheese. There are established price relationships in the marketplace.

When those change, whether they are customers or food service or serving retail. they will look at those changing price relationships and decide whether to buy more of -- less of their product and perhaps more cheddar.

Q. So let me understand your statement then. If a manufacturer of mozzarella cheese, that is

not a NASS reported commodity?
A. That's correct.
Q. And they came to the determination that their energy costs are becoming high and they needed to pass that cost on to their customers --
A. That's correct.
Q. -- that if they passed that cost on to their customers, that the NASS price would capture that and force them to pay that to producers in higher raw milk prices?
A. What I am saying is, it is not simple to pass costs along to customers. It would change the relative prices between mozzarella and other cheddar type, other cheese types or other products in the marketplace.
Q. For the moment, I will accept that statement. The question I have is -- let me ask it this way: Are you saying then that processors, if they do, or are able to pass along extra costs to customers, that those extra costs are not captured in the NASS survey?
A. You are saying "if they are."
Q. If they are able to pass --
A. I am not stipulating that they are.

Q. I understand that.
A. But if they could pass those costs along for mozzarella, it is not one of the products for which NASS collects dairy products prices data.
Q. So if they could pass it long, it would not show up in the NASS?
A. That is what I just said.
Q. In fact, for a majority of the products that manufacture -- that the members of your organization manufacture, that is a true statement?
A. If they could, their prices that they receive for their products are not reported in the NASS dairy products price survey.
Q. Now, you also make a statement at page 6 that there are legally mandated minimum milk prices. Do you see that in the middle of your first paragraph, not the full paragraph, but the paragraph in the middle of the page there?
A. Yes, I do.
Q. It is true, is it not, Mr. Yonkers, that a processing plant that manufactures cheese can and regularly do purchase milk at less than minimum Class III prices in the United States

today?
A. From farms?
Q. From farms and from processors.
A. Well, certainly from other processors.
Q. And from co-ops.
A. If they are Federal Order regulated plants. they can't buy that from co-ops and processors unless they depool that milk.
Q. And that is the other privilege. The plants, the cheese plants that are pooled plants, receive money from the pool for the privilege -- they receive money from the pool to pass on to their producers; isn't that true?
A. Well, that is the concept of pooling.
Q. And if they didn't pool, they would have to pay their producers whatever they could pay their producers; isn't that correct?
A. Which in most cases would be less than other farmers are receiving in the market. This is not an option that they can actually use for a very long period of time.
Q. But they have the option, if the mandated price is so burdensome, to depool, don't they?
A. Ben, I believe when they make that decision, they are basically making the decision

to go out of business, because if they cannot pay a price competitive in the region in which they are in, and of the region they are in, that pool draw is in any way significant to the average price paid to farmers, no. I don't believe they can.

Q. Now, you understand the concept -- we talk about blends and pool blends. But from a processor's standpoint, they purchase milk on a blended price as well, do they not? They have multiple suppliers and they pay maybe different prices, but at the end, there is kind of a blended price for their raw milk price, cost. would you accept that contention?

A. You are talking about the total price they pay or the price they are paying under regulation?

Q. No, the total price that they pay for all their milk.

A. That is a negotiated price between each of their suppliers. They could have one supplier. in which case it would be just one price. They could have multiple suppliers, in which case, it would be a weighted average.

Q. They could purchase milk and do purchase

milk from other cooperatives and other processors at less than the Class III price; isn't that true?

A. I know of no source of data that reports that. Dairy Market News anecdotally reports that in some months when they talk about what the spot market price is above or below class. It is rarely below class on average for the Upper Midwest market. But I know of no source of data that would suggest that they are buying milk regularly below class prices.

Q. What percentage of your manufacturers are pool plants that are regulated, manufacturing plants that are regulated under the Federal Order?

A. I don't know the pool status of all of our member's plants, Ben.

Q. You have processors, members in Idaho?

A. Yes.

Q. Are they regulated?

A. I do not believe they are at this time. But I don't know if at times there are some milk from those plants that are pooled. I don't know the answer to your question.

Q. Are the plants in California regulated by

the Federal Order program?
A. Unless there are some Class I plants that have enough plants that go into Federal Order area, no, they are not, to my knowledge.
Q. And there are plants in the Upper Midwest that are not subject to the pool, they have depooled their milk; isn't that true?
A. On an ongoing basis, I don't know that.
Q. Now, you talk about, over in page 9, the second paragraph, last sentence, I think you are talking about that there may be some cooperatives that are considering voting out the order, right?
A. Yes.
Q. And the reason is, as you state here. "Cooperatives with manufacturing facilities in that order concluded that the product price formulas did not accurately reflect their true cost of manufacture and, thus, doomed them to slow financial ruin."
A. That is what my testimony says.
Q. All right. Should producers be doomed to slow financial ruin, is that the position of IDFA that producers should be condemned to slow financial ruin?

A. IDFA members would not be in business if there wasn't milk being produced in this country, Ben.

Q. And you heard the testimony, for example, today of Gary Genske that showed that a representative of half the milk produced in the United States is, in fact, has been, and is in the process of losing money?

A. I believe he said he had 10 percent of the milk produced in the United States.

Q. He said it was representative of half the milk that was produced.

A. I missed that, Ben. I didn't hear that comment.

Q. Are you aware of any data that shows the producers, on the average and in large quantities, made money in 2006?

A. I don't have farm level data, and I haven't testified to farm level data.

Q. Have you done any analysis to determine whether or not the continued erosion of equity at the American dairy farmers is reaching a point that you are not going to have enough milk for your processors?

A. Your question presumes that there is going

to be a significant change in the long-term trend in milk production, total milk production in this country. No, I have seen no estimates that suggest that that is not going to continue, perhaps not at quite the same rapid pace it did in 2006, when milk production grew at 2.7 percent, but the USDA economic baseline that was just released last week or the week before shows that it is going to continue. So I have seen no analysis that would suggest that that is an issue.

Q. The bottom -- not the bottom. Just before you begin Proposal Number 1 on page 11. And you make this comment, that with high prices, if producers were required to pass on their profits to their suppliers of grain or other inputs that they would be screaming?

A. I agree. I think that is very true.

Q. But --

A. The issue I am making there, Ben, is I don't believe that producers really understand what it means to have a fixed margin that the make allowances in our product price formulas provide to processors, because they are not constrained by that.

Q. But the reality is, Dr. Yonkers, we mentioned the fact that most of your products are not NASS products, and they are not subject to the regulation in many parts of the country, and they do have avenues to obtain milk at less than regulated prices, they are not fixed by margins either, are they?

A. I don't know that all of those members on a regular basis are able to obtain milk at less than Federal Order minimum prices. So I don't agree with that premise.

Q. Let's take another step. We talk about the NASS price. Is that average NASS price the exact price in which every -- let's talk cheese. Is that the exact price every cheese manufacturer sells their cheese for for that month from their plant?

A. Absolutely not.

Q. It is a weighted average, isn't it?

A. Yes.

Q. And if you look at the NASS data that shows you have got the Minnesota, Wisconsin price for blocks and the U.S., other U.S. and you have a Minnesota, Wisconsin price for barrels and another U.S.. right?

A. I believe so.
Q. And there is a wide range in those prices. is there not?
A. Between the one region --
Q. Yes.
A. I expect that, because Minnesota. Wisconsin is one small region of the country. Everyone else is all around it. I would guess there is a huge range of data represented by that rest of U.S. price.
Q. They sometimes have as much as a nickel or 8 cents higher than the rest of the country, the average?
A. I haven't looked at it that closely.
Q. Their regulated make allowance is 16.5 or 16.82, so, in fact, maybe their make allowance is there, they are getting another 8 or 9 cents higher than what your example shows, aren't they? So their margin is really 24 or 25 cents at times?
A. We don't know what they are paying their farmers. I don't know that their margin is that high, Ben.
Q. We don't know really what they are selling their cheese for or what their real costs are.

do we? It is all an average, isn't it?
A. It has to be. I don't know how USDA could enforce a system that put a product price formula on every individual load of cheese that was sold. I don't know any other way to do it. Ben.
Q. I want to take a different line of questioning. There is this expression. I think. that said that a make allowance cannot be too low. Do you believe in that?
A. I don't believe USDA should be overly concerned about setting too --
Q. Too high, I am sorry.
A. Thank you, too high a make allowance.
Q. Too low a producer, but not too high a make allowance.
A. Correct.
Q. Now, and all of your members buy into that argument?
A. The argument is based on the economic principle that if you set too low a make allowance, there is no market mechanism to correct for that. But if you set too high a mechanism, there is a readily available market mechanism and it is called an over-order premium

or, in the case of cooperatives which have processing facilities, that is passed through directly to their members.

Q. Or the possibility is that you are not manufacturing a NASS product and you can seek to sell it for more, or you cannot be manufacturing in a Federally regulated area or you can depool your milk or you can buy and seek to purchase milk at less than minimum prices, right?

A. Well, a couple of those. You know, you just go out -- you used mozzarella earlier. If suddenly the margin on mozzarella was much higher than cheddar, we would see increasing mozzarella production, we would see competition for milk to go into mozzarella. That would raise the price paid.

Q. Okay.

A. So I don't agree with that.

Q. So when we talk about increased margin, if you have -- let's take an example. Let's assume for a moment that there is a plant that can process cheese at 14 cents a pound, has a readily available supply of milk, and more than what it needs, it could acquire more milk readily if it needed it. And the make allowance

is 16 1/2 cents and according to your testimony -- let's use 16 1/2, it is an easier number to say.

And that is the make allowance that a plant that is actually manufacturing at 16 1/2 cents is already at a 2 1/2 cent disadvantage to the plant at 14 cents, right?

A. Um-hum.

Q. So if you raise the make allowance to 20 cents, as your proposal with the population might suggest that we would do, you would have -- the make allowance would now be up to another 3 1/2 cents, right?

A. Yes.

Q. All right. Does that change the competitive relationship -- first of all, does that change the competitive relationship between those two plants?

A. I don't think so. The plant with the lower make allowances will have an incentive to build another plant and take advantage of that and to go out and procure even more milk.

Q. And make even more cheese, right?

A. But take the market away from the plants that aren't.

Q. At a lower price, because they would be able to sell it at a cheaper price?
A. I don't know that the total cheese production is changing as a result of that. You would have to look at the plants that are growing in production versus those that aren't producing anymore.
Q. And that happens on an even basis, you won't have the more production before the lesser production?
A. You may. There also may be more demand. Cheese is one of our bright areas and has been increasing dramatically over the last 20. 25 years. Those plants are also being built because they are demand-driven, there is a demand for their product in the marketplace.
Q. How many of your clients built -- not clients, the members of your organization built farms in the last -- dairy farms in the last year?
A. I don't know of any of them -- well, last year, there is one that came on line last year in Colorado that I can think of. But I don't know; we don't keep that information, Ben.
Q. I am going to change the subject and maybe

even a little bit of the tone here. In some areas we do agree.

In Proposal Number 2, your point there is that we shouldn't be buying, I think the expression used to be, a pig in a poke in terms of these surveys done on an annual basis. We need to know what we are getting to, in fact, decide whether that should be adopted as part of the regulations?

A. Yes, I do. California has been doing this. I mentioned the industry has a high level of confidence, because their data is audited and done by a very professional staff. They don't have an automatic adjuster, they require hearings to make an adjustment, and I believe USDA should do that also.

Q. And the other thing is that the department or CDFA, when it looks at this make allowance. does not automatically index their new make allowances to the changes in their cost data; isn't that correct?

A. They used to, until last year, provide an update using the most recent energy cost indexes, and last year was the first year they withdrew that. I don't believe they are going

to be doing that anymore.
Q. When they do do it, they do the annual cost survey, just because there is an increase in cost, doesn't mean they necessarily will change the make allowances?
A. Well, there has to be a petition from industry to do so. Relatively small changes may not be worth the transaction cost of coming to lovely Strongsville, Ohio for a week.
Q. In your opposition to the energy adjuster --
A. Seventeen, Ben?
Q. Proposal 17 -- you talk about risk management. Now, are you talking -- am I correct -- I mean, I have got them right?
A. Yes. And actually, Mike McCully, when he testifies, will have a little more on this. But the use of futures markets, I mean. IDFA has a position to support anything that is going to improve the liquidity and, therefore, the usefulness of the futures markets as risk management tools.
Q. You are talking about the Class III and IV futures?
A. Well, both Class III and IV futures, and to

the extent that there are any, there are two butter contracts that are out there, there is still a nonfat dry milk contract and there is a new whey futures contract that is going to be introduced this month.

Q. Sure.

A. And one of the things that is required is not only buyers and sellers who are looking to hedge, one of the things that provides liquidity is speculators. And I believe Dr. Cryan even talked about that.

And they have a lot of choices of when they get to the point, I don't know that I will ever get there, but at the point where they can afford to speculate in the futures market --

Q. These are the forgiven sinners?

A. -- that Dr. Cryan talked about. They have a lot of choices on those futures markets to use. The ones that have a less understandable basis or one in which regulatory changes can as much as monthly change that basis. I have concerns about the impact on attracting that speculative investment into the dairy futures contracts.

Q. And having to factor in energy, in fact.

they would be buying two futures, they would be buying an energy futures and a Class III futures?

A. In the opposite direction, yes.

Q. Right. And it is your opinion that the adoption of that proposal would interfere with the ability to increase the liquidity of the futures market?

A. I think it may hurt the existing liquidity of the futures markets.

MR. YALE: I have nothing further at this time.

JUDGE PALMER: Let me just find out who else wishes to question the doctor. Does anybody else have questions?

MR. BESHORE: I will have some more.

JUDGE PALMER: We only have a few minutes. Should we do it tomorrow morning? All right. Let's do it tomorrow morning. Do we feel that Mr. McCully is going to be here tomorrow morning?

MR. ROSENBAUM: He has traveled from out of town, we really need to make sure we complete him tomorrow. He does not have a

terribly long statement.

JUDGE PALMER: Well, let's do this. Let's think about allocating about an hour tomorrow for cross-examination, I think between the two of you, if you think about it hard, anybody else, we can probably finish cross-examination of the witness in about an hour.

MR. SCHAEFER: We have some too.

JUDGE PALMER: We will give you an extra 15 minutes.

(Laughter.)

JUDGE PALMER: And then I think Mr. McCully can come on and I think we will still be able to complete by 12.

MR. YALE: He is the only other witness you have?

MR. ROSENBAUM: For tomorrow, for this week.

JUDGE PALMER: That is the only other witness we have. Fine. We will see everybody tomorrow at nine.

(Thereupon, the proceedings were adjourned at 4:51 o'clock p.m.)

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C E R T I F I C A T E

STATE OF OHIO,)
) SS:
SUMMIT COUNTY,)

I, Binnie Purser Martino, a Registered diplomate Reporter, Certified Realtime Reporter and Notary Public within and for the State of Ohio, duly commissioned and qualified, do hereby certify that these proceedings were taken by me and reduced to Stenotypy, afterwards prepared and produced by means of Computer-Aided Transcription and that the foregoing is a true and correct transcription of the proceedings so taken as aforesaid.

I do further certify that these proceedings were taken at the time and place in the foregoing caption specified.

I do further certify that I am not a relative, employee of or attorney for any party or counsel, or otherwise financially interested in this action.

I do further certify that I am not, nor is the court reporting firm with which I am affiliated, under a contract as defined in Civil Rule 28(D).

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my seal of office at Akron. Ohio on this 14th day of March, 2007.

Binnie Purser Martino, RDR. CRR

My commission expires June 26, 2009.

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