VOLUME XII

BEFORE THE SECRETARY OF

THE UNITED STATES DEPARTMENT OF AGRICULTURE

AGRICULTURAL MARKETING SERVICES

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

National Public Hearing
Tuesday, July 10, 2007
9:00 a.m.
Sheraton Hotel Station Square
300 West Station Square Drive
Grand Station Ballroom I
Pittsburgh, PA 15219

BEFORE: JUDGE VICTOR W. PALMER
U.S. ADMINISTRATIVE LAW JUDGE
UNITED STATES DEPARTMENT OF AGRICULTURE

TRANSCRIPT OF PROCEEDINGS

Reported by:

Vivian D. Macurak
Court Reporter

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I N D E X O F W I T N E S S E S

I N D E X O F E X H I B I T S

EXHIBIT:	MARKED	RECEIVED
75	2592	2746
76	2759	2759
77	2835	2856

P R O C E E D I N G S

JUDGE PALMER: Let's go on the record. We will start with our first witness, John Roetlin, who has testified in an earlier session of this proceeding.

JOHN ROETLIN

a witness herein, having been previously duly sworn, was examined and testified as follows:

JUDGE PALMER: Would you give your name again, sir, and your identification.

MR. ROETLIN: John Roetlin from Twin County Dairy, Kalona, Iowa. My last name is spelled R-O-E-T-L-I-N.

JUDGE PALMER: All right, sir. What is your situation again? Are you an independent dairy farmer?

MR. ROETLIN: No. I own a cheese plant in Kalona, Iowa.

JUDGE PALMER: You testified before and you wanted to add some thoughts.

MR. ROETLIN: The reason is I got the transcript back and I think on page --

can everybody hear me fine -- I think it was 1446, I think there might have been some confusion between what I was saying and what Mr. Yale was saying as far as percentage of butterfat in cheese and milk.

I think in some of the testimony that I had we were talking about butterfat in milk and then again we talked about butterfat in cheese and I'm not sure that he has that right. I'm not able to determine that by reading this, so if somebody has some questions to ask, Mr. Yale or whomever, I would be glad to clarify that.

JUDGE PALMER: I don't know if Mr. Yale was thinking about that right now. What is your point about cheese and butterfat? Are you talking about content or what?

MR. ROETLIN: I'm not sure.

JUDGE PALMER: What was the issue?

MR. ROETLIN: I think Mr. Yale was asking about butterfat, what the percentage of butterfat was in our milk.

JUDGE PALMER: What is the

percentage of butterfat in your milk? Tell me what it is.

MR. ROETLIN: 3.7, 3.8. Then he asked me some questions and we actually drifted into the percentage of butterfat in the cheese.

JUDGE PALMER: What is the percentage of butterfat in cheese?

MR. ROETLIN: Our maximum is 36-and-a-half. I'm not sure if he had a question about that or not.

JUDGE PALMER: Now what you have said, if you read what was said before with what you said now, he will be able to straighten it out. Anything else?

MR. ROETLIN: Not much else. I think the situation is still the same in the business. I think they need to address it and they need to do it. My opinion is they probably have enough information. They have a lot of smart people out here. I think they understand the problem and I think it is time that they address the problem and do it. That's all I have.

JUDGE PALMER: Any questions? Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. I'm trying to call up the page. If I could just borrow that for a second to try to remember what I was thinking.

Let me approach it maybe a different way. There is a ratio of casein or protein to fat; right?

A. Right.

Q. In your vat when you mix, whether you have whole milk or you bring in UF milk or powder or fines or anything else, you still try to seek some kind of a ratio of casein to butterfat and fat because that's how it is going to come out in the cheese; right?

A. Correct.

Q. What is your ratio of casein to fat?

A. I don't have that. Again, we pretty much control it by the FDB or fat on dry basis, so we see if our fat side is too high bringing the FDB up too high, then we reduce the amount

of fat that we put into the cheese fat or --

Q. Add protein.

A. -- add skim or whatever.

Q. Depending on the economics, whether it is cheaper to buy skim or powder or whatever as opposed to --

A. Yes.

MR. BEN YALE: I'm fine.

JUDGE PALMER: Thank you very much, sir. Oh, you have a question, I'm sorry.

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. Good morning Mr. Roetlin. Just a quick question here. There is a proposal in this hearing to eliminate the three cent adjustment to the barrel price when it goes into the formula for protein. Do you support that proposal?

A. I'm not sure. What is it?

Q. In the current formulas when we calculate the cheese price for the formula we add three cents to the barrel price, so you take the block price plus the barrel price and

three cents on that barrel price to calculate your weighted average price of cheese to be used in the formula, and there was a proposal in the hearing to eliminate that three cents.

A. And make them the same you mean?

Q. It would just be however they come out, so the block price would be whatever it is, the barrel price would be whatever it is. There would be no adjustment to those prices.

A. You are trying to keep that three cents or whatever, is that what you are saying?

Q. Whatever the market comes out at, that's what we would use. We would not add a three-cent adjustment.

A. I guess I really don't know. I know one thing. If the spread would be too much, I don't know what the percentage of the barrel price and the percentage of the block price is in your formula, I don't know about that. Is it 60/40?

Q. It varies. I think 60/40 was what it had been. At times it will be one and one.

A. As I understand it, like for example if the price would come out and 60 percent of

that price would come from the block or the barrel, I'm not sure which one anymore, is that right?

Q. Generally speaking there is more barrel production in the survey than there is block production in the survey, so you would add three cents to the barrel price and then calculate your weighted averages.

That's fine. Thank you very much for your help.

JUDGE PALMER: Any other questions? Mr. Yale, do you have another question?

RECROSS-EXAMINATION

BY MR. YALE:

Q. First of all, going back to that last question that I asked you in terms of you look to the dry to fat basis, you look to the ratio to see what the dry to fat basis is and what the ratio of protein to that is, right, in making cheese? Is that correct? I need a verbal answer.

A. I can hardly hearing you.

Q. In the vat you talked about a dry to fat basis. There is a ratio of the casein or the protein to the fat that you need to have in the vat; right?

A. Right.

Q. And you don't know what that number is exactly; right?

A. I do not.

Q. It is a very narrow range, is it not?

A. I would say it would be.

Q. The second thing is of the total fat that comes into the plant, how much of that exits the plant on a percentage basis in cheese?

A. Are you asking me for a number? I guess I really don't know. Probably most of it would go out on cheese because we make full fat cheese, all skim.

Q. Do you sell whey cream?

A. Yes, sir.

Q. You don't know how much of a percentage that is of your sales?

A. I guess I really don't, no. We do

have numbers available. We work with those numbers but I don't have that number.

MR. YALE: All right.

JUDGE PALMER: Thank you, sir. Mr. Wellington.

CROSS-EXAMINATION

BY MR. WELLINGTON:

Q. I have a few questions. Robert Wellington from Agri Mark. How are you doing, John?

A. Very well.

Q. A couple quick clarifications on that three-cent barrel. One point of history, that was added on back in the 1990s when the barrel price tended to be about three cents below the block price of CMA and subsequently for future hearings they changed that and adjusted the moisture and other things, but now they still add the three cents on as if there was a difference between the block and barrel price.

Have you seen that difference in your business that we should be adding three

cents to the barrel price to equate it with the block price or have they been closer in the CMA?

A. I know there is a difference sometimes, okay, but I'm not sure I have given it that much thought, and what effect it would have on us economically I'm not sure. I'm kind of the way I talked to him about it, I don't really know.

MR. WELLINGTON: Okay, thank you.

JUDGE PALMER: Let's not stretch the witness beyond what he really came back to say.

All right, thank you, sir.

Mr. Christ. I have marked Mr. Christ's statement as Exhibit 75 for identification.

(Exhibit No. 75 was marked for identification.)

PAUL CHRIST

a witness herein, having been first duly sworn, was examined and testified as follows:

JUDGE PALMER: All right, Mr. Smith, you may proceed.

MR. SMITH: Thank you, Your Honor.

DIRECT EXAMINATION

BY MR. SMITH:

Q. Daniel Smith, Maine Dairy Industry Association. Good morning, Paul.

A. Good morning.

Q. Before you proceed with your statement could you describe for the record your educational and professional experience.

A. I was educated at Southern Illinois University. I have a master's degree in agricultural economics and I did some additional graduate study at Kansas State University working on a Ph.D. which I never finished, but in that activity I engaged in quite a bit of research related to the dairy industry.

Q. Proceed from your education through your professional background.

A. When I finished at Southern Illinois University I went to work for the federal milk market administrator in Detroit. My service there was interrupted by two years in the Army. In 1964 I worked in the Washington office of what then was the dairy division of AMS.

In 1966 I was attached to the Kansas City Marketing Administrator's office while I was doing research at Kansas State University funded by the dairy division of AMS.

I returned to Washington in 1970 as a supervisory agricultural economist for four years and then I was hired by Land O'Lakes in Minneapolis to do federal order activity. I was called a marketing specialist and a few years later I was promoted to vice president.

My work at Land O'Lakes involved marketing grade A milk during my full 26-year period there and being involved in federal order activities, proposing amendments, defending amendments at hearings and basically trying to operate profitably under federal milk

orders.

Q. How many federal order hearings would you say you have participated in over the years?

A. I never added them up but it would be in the range of at least a couple dozen. If it was anything involved in the Midwest I was there and a lot of times national hearings I was involved, sometimes in a hearing in another area that involved a precedent that Land O'Lakes was interested in, so sometimes I went beyond our own marketing area.

Q. So your work brought you outside of just the Midwest then?

A. Yes, oftentimes, national hearings and sometimes regional hearings.

Q. You indicated that you conducted research for your Ph.D. degree but that you didn't finish. What was the research on?

A. The core project was finding the determinants of the supply of milk on a regional basis across the United States. I had established a number of homogenous regions across the country for milk production and

established the influence of a number of factors that had some effect on the milk supply.

Q. Within that context would you provide a little background on the development of your proposal the MDIA has put forward today.

A. This proposal is sort of a development over a long period of time. When the industry first became concerned about the adequacy of the Minnesota-Wisconsin price I, like many others in the industry, became interested in how do we replace it. I personally have a strong bias in favor of competitive prices for milk.

Q. I apologize, before you get to the substance of it I'm just trying to tie into your background. What I'm trying to get at is that you have been in some sense working in this field in the supply of milk and the competition of milk for a number of years?

A. Oh, yes, at least 15.

MR. SMITH: Your Honor, at this point I would like to offer Mr. Christ as

an expert in agricultural economics in federal milk market order regulation.

JUDGE PALMER: I don't think there is any objection. He is so received as an expert.

BY MR. SMITH:

Q. Okay, Paul, if you want to read your testimony we will follow it.

JUDGE PALMER: This is Exhibit 75. Go ahead, sir.

A. My name is Paul G. Christ spelled C-H-R-I-S-T. I live at 245 Indian Trail South, Afton, Minnesota, 55001. I am a retired vice president of Land O'Lakes, Inc.

In my 26 years' experience at Land O'Lakes I was responsible for the marketing of Grade A milk for the cooperative. As part of that responsibility I participated in the development of many proposals to modify federal milk marketing orders and participated in the appropriate hearings to secure their adoption. Sometimes I was successful and sometimes I was not.

Prior to working for Land O'Lakes I

was a supervisory agricultural economist in what is now the dairy programs activity in the Agricultural Marketing Service. Since retiring from Land O'Lakes in 2000 I have occasionally participated in federal order amendment hearings as an independent consultant for other firms.

I appear here to represent the Maine Dairy Industry Association in their support of Proposal No. 18. Proposal No. 18 would incorporate a factor in Class III milk pricing that would account for any monthly spread between component price calculations for milk and a competitive pay price for equivalent Grade A milk. This testimony puts practical substance to that idea by outlining the development and use of a competitive pay price series to replace the current product formula price for Class III milk.

The "adjustment factor" suggested here would be the adjustment of the other solids price in the Class III formula so that the sum of the component values equals the "basic formula price" or average competitive

pay price.

A variety of competitive pay price mechanisms for pricing Class III milk have been considered in the past including the department's 1994 to 1996 simulated analysis of a competitive pay price referenced in MDIA's proposal. The Department confronted several difficulties with its simulation including that, (1) it could not eliminate circularity, meaning that the influence of regulated minimum prices could not be eliminated and (2) was not necessarily based on vigorous competition among the buyers of milk.

I want to depart from my statement here. I looked at the report again last night and I found some other things that the Department was concerned about. One was they were concerned that it was based on an unusual competitive situation in the upper Midwest which may not be representative of the whole country. I'm not sure that I agree with that, but nevertheless that was in the report.

It did, however, attempt to include the influence of pay prices in California.

What I offer here is a mechanism that builds and updates on this past analysis and that discovers the market driven competitive value of Grade A milk from manufacturing.

It is well known and understood that the market for milk is not the same as the markets for butter, cheese, nonfat dry milk and whey. Prices in each of these markets responds to a unique set of supply and demand factors and they do not move in harmony.

Since the federal milk order system is focused on finding and enforcing effective prices for producer milk, it is likely that attempting to find a competitive price for milk would be more efficient and precise than attempting to discover accurate product prices and discern appropriate yields and make allowances.

With a competitive pay price system the participants in the system decide what margins are appropriate by choosing a particular price to pay for milk. These purchasers are volunteers who pay what they

choose to pay. As volunteers they accept the consequences of competition in both milk and product markets whether it comes from local rivals or more distant rivals in Idaho, California, New Mexico or other areas. If the competitive pay prices chosen by these milk purchasers renders their business profitable or unprofitable is irrelevant so long as they independently choose to pay such price.

Here is an outline of how a competitive pay price for raw Grade A milk would be developed and used:

First, determine the geographic area in which there is significant competition for raw Grade A milk.

Second, exempt handlers who purchase milk in this competitive area from minimum payments to producers in the area.

Third, handlers would not be exempt from minimum payments to producers in other areas. They would pay those producers in the same manner as today.

Fourth, in effect regulated handlers would have two producer payrolls, one for

producers in the competitive price zone and another for producers outside the competitive price zone.

Fifth, producers in the competitive price zone would continue to benefit from the PPD. That is the producer price differential. We propose that a 12-month rolling average PPD be calculated each month and paid to handlers purchasing milk in the competitive price zone. Payments to producers would then be based on the competitive value of milk for manufacturing plus the 12-month rolling average PPD.

Sixth, payments to producers in the competitive price zone would differ from payments to producers outside the zone because the 12-month rolling average PPD would differ from the current month PPD paid to producers outside the competitive price zone.

Seventh, the Market Administrators would collect actual payment data from handlers buying milk in the competitive zone for the preceding month and estimates of payments for the current month. By deducting the value of the respective 12-month rolling average PPDs

they would determine the average expected manufacturing value of milk purchased in the competitive price zone. This average manufacturing value would be the basic formula price.

The basic formula price would become the Class III price for milk transactions between handlers and for determining minimum payments to producers located outside the competitive price zone.

Ninth, the Class III price would still be based on components except the other solids price would be based on the residual value of the basic formula price after the values of butterfat and protein were deducted.

Tenth, a new fund would be set up to receive the value of the current month PPD that would otherwise have gone to producers in the competitive price zone. Payments of the 12-month rolling average PPD fund would be paid out of the fund to enable full federal order values to be paid to producers in the competitive price zone.

Eleventh, most other features of

federal milk orders would remain the same.

Attached to this statement as Appendix B are proposed necessary changes to the federal order language. There are some questions and answers to further elaborate the proposal.

Does competition exist for Grade A milk? Finding a competitive price for Grade A milk depends on the existence of significant, substantial competition for such milk.

The question arises as to how much competition is necessary to render a competitive price. There are two approaches to measuring the degree of decision in a market. The first is the "concentration ratio" which reports the market share represented by the four or eight or twenty largest firms in the market, and the second is the Herfindahl index.

The concentration ratio approach has the defect of not weighing the relative competitive strengths of the individual firms included in the ratio.

For example, one market with a four-firm concentration ratio of 80 percent

could have four equal size competitors. A second market with the same four-firm concentration ratio of 80 percent could have one large firm represent 65 percent of the market and three small firms, each with five percent of the market. Clearly, the first market is more competitive than the second market.

This difficulty is largely resoled by the Herfindahl index. This index is calculated by measuring the market share of each firm in the market, squaring it and then adding up the squared market shares. Here is an example:

What I have listed here is four firms. In the second column I have listed the market share of each of the individual firms ranging from the largest firm of 50 percent down to the smallest firm, the fourth one, with ten percent market share. I squared these four numbers and that is shown in the third column.

For example, the first firm has a 50 percent market share. When you square .50 you end up with .25, so the squared market

share is .25 for that firm.

What this does is it magnifies the weight assigned to the larger firms and reduces the weight assigned to the smaller firms, so it tends to take into account the effect of the more dominant firms in a market and to reduce the effect of the smaller, less significant firms in the market.

The second firm has only a .25 percent market share. When that is squared it gives us a result of .0625.

The third firm shown here has a .15 percent market share and when that is squared it comes out to .0225.

You can see the numbers diminish faster than the market share numbers diminish. Firm No. 4 has a ten percent market share in this example, and when we square that we have .0100.

Adding these four squared market share numbers, we end up with a Herfindahl index and that Herfindahl index in this case is .3450.

What this means is that this market

is more competitive than another market with an index of more than .3450 and less competitive than another market with an index of less than .3450, so a lower number means more competitive, a higher number means less competitive.

This has a conventional mechanism used in antitrust enforcement by the Justice Department to measure how competitive certain markets are.

Whether one uses a concentration or a Herfindahl index to measure competition, it must be related to the relevant market. It can be argued that the market for raw Grade A milk is national in scope. If so, there is plenty of competition as there are hundreds of firms buying milk, resulting in a low concentration ratio and a low Herfindahl index.

I would argue that the competition for buying Grade A milk is more local in nature. The relevant market would include the feasible procurement area of an individual handler's plant, maybe within a radius of 50 to 100 miles.

However, these procurement areas partially or fully overlap those of other handlers, creating a network of competition that extends across the country. Also, there is no data aggregated for any one or combination of procurement areas. Thus, it is difficult to match the number of competitors to a specifically defined market or to measure the intensity of their competitive behavior.

What I propose is conservative, and that is that we measure competition at the county level, which is smaller than the relevant market for raw Grade A milk. I requested data from the Upper Midwest Market Administrator indicating the number of competitors by county and the Herfindahl index by county. The data are presented in Appendix A.

I will just refer generally to the tables in the discussion here. Table 1 lists counties within the Upper Midwest marketing area for which there were three or more milk buyers filing reports to the Federal Order No. 30 Market Administrator.

These data do not include the number of additional milk buyers reporting to other federal order markets on milk purchased in these same counties so the data in this table understate, rather than overstate, the number of competitors in each county.

I did not ask for the same data from other Market Administrators or from the national Dairy Programs office. The last time the national office compiled comprehensive data on sources of milk by state and county was in 2003, making some of the information out-of-date. Also, if significant competition could not be shown for the Upper Midwest market, it was unlikely that it could be shown anywhere in the federal order system.

Tables 2 and 3 show the same information about counties with four or more and five or more milk buyers respectively. With more milk buyers more competition is implied. Even with five milk buyers there is a significant territory in which this much competition occurs.

Tables 4, 5 and 6 show the same

information about counties with a Herfindahl index of 0.50 or less, which is equivalent to at least two equal-sized competitors. The second table shows 0.33 or less Herfindahl index, which is equivalent to at least three equal-sized competitors and a Herfindahl index of 0.25 or less, equivalent to at least four equal-sized competitors. Again, by all three of these measures there is a significant territory in which this much competition occurs.

Figures 1 through 6 are maps illustrating the data from Tables 1 through 6 respectively.

The significance of Appendix A is that it shows that there are a lot of counties in which a lot of competition for raw Grade A milk exists. That is a necessary precondition for the development of a competitive pay price for milk.

Here is what I propose for the territory in which a competitive pay price for Grade A milk is derived:

First, combine the sources of milk

data for all federal milk orders and identify the counties for which the buyers from all markets represent a Herfindahl index of 0.33 or more.

This is an arbitrary choice. It is a question of what level of competition we are comfortable with. The index of .33 means we have at least four competitors for the milk because it is almost impossible to get three exactly equal participants in the market. This means at a minimum there are three equal-sized milk buyers, but as I said it is going to be four or more. In virtually all cases there will be four or more buyers in each county.

Second, aggregate these counties into contiguous groups of ten or more counties. Again, the size of the cluster is an arbitrary choice. I believe that the cluster will include more competitive activity than an individual county, but how large the cluster needs to be, five counties, three counties, ten counties, there is no definitive answer as to what is adequate, but I'm proposing offhand as ten.

If we need to broaden the area in which we find competitive behavior for buying Grade A milk, we might reduce the size of the cluster and pick up areas such as maybe even Southern Idaho.

A cluster of counties is likely to be more competitive than an individual isolated county. There is likely to be several clusters of competitive counties distributed across the federal order system and across a number of states.

Third, define the counties within all of these clusters as the "competitive price zone". You may have seven or eight clusters across the United States, but all of these would constitute competitive price zones. Minimum producers payments would not be enforced within this zone. Thus, the prices paid within this zone would be based on competition among milk buyers and not on regulated milk prices.

How can payments to producers be deregulated? Under our proposal minimum payments to producers in the "competitive price

zone" would not be enforced. However, there are two components of the payments to producers under federal milk orders. The first is the manufacturing value of the milk represented by the value of Class III components, and the second is the producer price differential, PPD, which represents the Class I, Class II and Class IV differentials relative to the Class III price plus all other adjustments in the pricing mechanism.

We propose to deregulate only the manufacturing milk value component of the total payments to providers. There would still be a regulated minimum payment to producers of a PPD but not the same PPD as is paid to producers who are not in the competitive price zone.

In order to make timely use of the competitive pay price it must be available before reports of receipts and utilization are filed and before the pool is calculated. Therefore, the PPD for the current month will not be known before the competitive pay price is known so the PPD paid to producers in the competitive price zone must be determined in

another manner.

We propose that the PPD paid to producers in the competitive price zone be the 12-month rolling average PPDs for the market in which the handler is regulated. This rolling average PPD would be paid by the Market Administrator to each handler buying milk in the competitive price zone as soon as the pool is settled so the money could be used to pay producers in the current month.

For example, when the June 2007 pool was settled, and it isn't yet, and the June PPD is determined, the Market Administrator would calculate a new 12-month rolling average PPD. The MA would then pay this amount to each handler buying milk in the competitive price zone for the estimated volume of milk that the handler will purchase in the month of July in the competitive price zone.

The timing of the payment would be coordinated with the expected date of payments to producers in the competitive price zone.

For example, we propose that on or before the fourth of the month, say July,

handlers buying milk in the competitive price zone report to the Market Administrator how much they paid for the first half of June and how much they expect to pay for the second half of June. This implies that payments for the first half of June would be paid on or before the fourth of the following month. Thus the Market Administrator should pay the 12-month rolling average PPD to competitive price zone handlers by about the first of the month. Whether this payment should be in one installment at the time of the first half payment to producers or two installments at the times of each payment to producers is an open question. It is probably best as two installments.

Handlers who buy milk in a competitive price zone have the ability to pay both the manufacturing value of producer milk as determined by them and a 12-month moving average PPD. Over the period of a year producers in a competitive price zone will receive as much as producers outside the zone because the average competitive price paid to

them will equal the Class III price paid to regular pool producers. However, there will be differences in individual months. In particular, the PPD will vary more for regular pool producers than for competitive price zone producers.

How will a handler decide the manufacturing value of milk purchased? A handler buying milk in the competitive price zone would make decisions in the same manner as a participant in any unregulated relatively competitive market.

The handler will evaluate the forces of supply and demand, the degree of competition in both the buying and selling markets including that from California and set a price expected to maximize profits in the long run.

The handler will consider the value of alternative product mixes. It will consider manufacturing costs, plant capacity utilization, product prices, trends in milk production and consumer demand, transportation costs and other factors affecting the ability to make a profit.

Many of these are subjective factors peculiar to the individual handler and cannot be comprehended by a product formula like the ones currently in use. The price the handler decides to pay will represent the best estimate of the value of milk to the handler for manufacturing.

How will payments and reports be timed to make the information useful? We propose that payments and reports be timed similar to the timing of the old Minnesota-Wisconsin Grade B price survey.

First, all handlers, whether they buy milk in the competitive price zone or not must report their producer payroll to the Market Administrator by the 22nd of the following month. We would require the handler to report separately for producers in the competitive price zone and producers outside the zone. This may not be necessary because the Market Administrator could sort out producers in the two zones by their mailing address or physical location.

Second, the Market Administrator

would aggregate all the payments to producers in the competitive price zone and deduct the value of the 12-month rolling average PPD. The residual would be the manufacturing value of milk in the competitive price zone. An agent of the Secretary, probably one of the Market Administrators, would then accumulate this price and volume data from all markets and calculate an average competitive manufacturing milk price. This would be the "base month price".

Third, each handler buying milk in the competitive price zone would be required to report on or before the fourth of the following month the volume of milk and the total payments for it for the first half of the month and the amount expected to be paid for the second half of the month.

This compilation of this data after deducting the value of the 12-month rolling average PPD would be compared to the base month price. The difference would be added to the base month price, resulting in the Basic Formula Price, BFP. This timing would conform

to the needs of pricing producer milk outside of the competitive price zone.

How does California factor into this plan? California is not part of this plan because the Secretary of Agriculture cannot compel California to conform to it. If California would conform to it and identify the competitive areas of that state it would enrich the pool of data on which the basic formula price would be based.

In any event, handlers buying milk in the competitive price zone would have to consider the competitive effect of California competitors in both milk markets and dairy product markets when they decide how much to pay producers in the competitive price zone.

Will this proposal result in higher or lower price to producers? We don't have a definitive answer to this question, but I suspect that the competitive basic formula price will be higher than the current Class III price. The reason is most of the competitive price zone is likely to be in the Upper Midwest. In this area vigorous competition has

for many years resulted in pay prices to producers, (mailbox prices) well above the uniform prices rendered by federal milk orders. The same vigorous competition is likely to show up in the competitive price handlers pay for milk in the competitive price zone.

However, if competitive areas can be found in the Northeast or Northwest or Southwest, pay prices in those areas could dilute the effect of the Midwest. Of particular value would be a mechanism for discovering competitive pay prices for California.

This completes my statement. I would like to refer to Appendix B, which has what I think is the necessary changes to order language. There aren't a great deal. Maybe if I go through them quickly we'll see that you don't need to make a lot of changes in the existing language to accommodate this proposal. It would require amendments to both the general provisions, Part 1000, and to individual orders across the country. I used the Northeast order as my template, but similar provisions exist in

each of the other orders.

Okay, the general provisions would identify the competitive price zones which would be a list of counties. Payments to producers in those counties would be treated according to the plan presented here.

The second change would be in part 1001.30, reports of receipts and utilization. It would require the handlers to file a separate report for milk received from producers in a competitive price zone. It just makes it convenient for the Market Administrator.

Payroll reports, that would be Paragraph 31. Payroll reports would require a separate report for producers located in the competitive price zone.

The fourth change would be in Paragraph 50 of the general provisions, and it just identifies the basic formula price which is not now in the general provisions. It would also change the method of calculating the Class III skim milk price, which is it would be the basic formula price for milk containing

three-and-a-half percent butterfat less three-and-a-half times the butterfat divided by .965. Basically it just corrects the Class III skim milk price based on the basic formula price.

Here is the fundamental change. The only significant change in the whole component pricing system that would be associated with this proposal, we would change the method of calculating the other solids price.

The other solids price would be the residual value of the basic formula price after the value of butterfat is deducted, that is average pounds of butterfat in the basic formula price times the butterfat price and the protein value is deducted, which is the average percentage of protein in the basic formula price times the pounds of protein.

The residual value then would be divided by the average content of other solids, so instead of using the whey price to determine the other solids price we would determine the other solids price from the residual in the competitive pay price we have accumulated.

That is the only fundamental change in the component pricing system. Everything else stays the same.

In the next section, Part 1000.53 we just identify the basic formula price as one of those that has yet to be announced.

Producer price differential, this gives a mechanism for computing the 12-month rolling average PPD. You would simply take a weighted average of the preceding 12-month PPDs and average them together. Part 1000.62, Announcement of Producer Prices, the Market Administrator would announce the 12-month rolling average PPD.

Producer-Settlement Fund, this is part 100.70. This would simply require the Market Administrator to set up a separate fund to receive the current month PPD for the milk that is in the competitive price zone and accumulate the money there and then from that fund he would pay out the 12-month average PPD.

1001.71 just instructs the Market Administrator to pay out the 12-month weighted average PPD to handlers buying milk in the

competitive price zone. That is in Part 1001.72.

Part 1000.73 would simply require handlers who are not in the competitive price zone to be paid in the same manner as they are now being paid.

That's a quick review. I'm not sure I'm exactly correct in the changes in our language, but I think I have encompassed probably 95 percent of what needs to be done.

That completes my statement and I would be glad to answer questions.

JUDGE PALMER: Dan, do you have any more questions submitted?

MR. SMITH: Your Honor, how do you want to proceed? We have all the direct statements in the record at this point.

JUDGE PALMER: I think we may as well complete this witness and go on. Who has questions?

MR. SMITH: I do have some follow-up questions.

BY MR. SMITH:

Q. First, Paul, preliminarily, you made

some additions to your testimony. I just wanted to clarify for the record. Essentially the testimony that you submitted is the testimony that would go into the record; is that correct?

A. Yes, but I made small modifications based on reading the --

Q. If I could just highlight, these are probably in your report, I don't know if you made any notes on your statement, but at the top of page 2 you made reference to some analysis of the impact of the Midwest.

Page 4 and 5 you discussed in a little more detail the Herfindahl index, and on page 6 there was a more extended explanation of the competitive price zone.

A. That is just an elaboration of what I really had in the report. It is not essential to the testimony but it may make it more clear.

Q. Just to clarify for the record, the changes to the statute listed in Appendix B you would want to go in verbatim?

A. Yes, I would like that to go in

verbatim. It needs to be carefully reviewed to make sure I covered all of the necessary bases but I think it is virtually complete.

Q. If we could go back and flush out a few things to expand the record.

With regard to the competitive price zone, on page 2, your No. 1 introduces this as determining the geographic area in which there is significant competition for raw Grade A milk. That is in a sense the competitive price zone but it is not really a geographic area. The competitive price zone even though it is one zone covers all of your clusters of counties throughout the country; is that correct?

A. Yes. It would cover I hope a number of clusters over a broad range of geography, but still it is a geographic area but not necessarily contiguous.

Q. Can you just identify maybe with a little more particularity the states you think would end up in the zone.

A. As I mentioned in my statement, I only asked for the data in the Upper Midwest

and the response I got is more conservative than we would find if we looked at all orders because in this Upper Midwest marketing area there are handlers from other federal orders who are buying milk, so we find more counties than were identified here.

I did look at the reports from the Market Administrators of receipts of milk by state and county and I tried to identify the number of counties that had at least 25 producers, and those counties I suspect would have a significant amount of competition.

I have a way to verify that. For example, I expect both Michigan and Ohio to have clusters of counties. For example, Michigan has 33 counties with more than 25 producers. Ohio has 27, Indiana has 11 so those are possibilities. New York and Pennsylvania are strong possibilities of having clusters of counties where competitive competition is very vigorous. It is possible that southwest Missouri we may not get ten counties there but we could probably get six counties there, so I believe there are areas

that we would find where we meet the criteria that I set out in the statement.

If we wanted to broaden the potential geographic area where we find competitive behavior we would relax the criteria say from maybe .33 as we suggested for Herfindahl index to maybe a .40 or something like that.

Q. The statement is not pegged necessarily to the arbitrary numbers of the ten counties or the .33 calculation of the HHI index?

A. No. These are subjective responses and I think that they would be conservative in clearly indicating strong competition. If we as an industry were comfortable with maybe just three handlers in a county we could lower that Herfindahl index, or raise the Herfindahl index, I'm sorry, and get more counties in this competitive price zone.

Q. The organizing principle is to find vigorous competition in clusters of counties?

A. Yes, and that's a subjective issue about how much competition is enough

competition.

Q. Would you expect that there is latitude in that calculation that might bring in the Southwest or the Northwest part of the country?

A. I couldn't find a source of milk data for either Florida or Arizona. The Texas market maybe. Maybe in Idaho it is possible, southern Idaho that we would have a cluster of competitive counties.

Q. If you were to aggregate it, do you have a professional estimate of how much of the Class III milk across the country that is pooled currently might be included in the competitive price zone calculation?

A. I didn't look up the numbers. I think there are 47 billion pounds of Class III milk in the federal order system. The competitive price areas will be the areas where there is a lot of manufactured milk processed and I would guess half to two-thirds would be included in the competitive area.

Q. Could you relate the operation of this competitive price zone dynamic to, you

have some reference to the M-W in one of the calculations, but given that there is some lineage in your background in working with this and how the two are related.

A. This proposal is not much different than the old M-W mechanism. Under the old Minnesota-Wisconsin system usually it was the same handlers who were buying both Grade A milk and Grade B milk. Two payrolls, one for the Grade A milk and one for the Grade B milk. The National Agricultural Statistics Service would collect from these handlers buying Grade B milk what they actually paid for milk the preceding month and from a smaller sample they would collect what they expected to pay for the current month.

We are duplicating that same process. The Market Administrators would collect through the payroll reports what these plants actually paid the preceding month and then would get a separate report with their estimate of what they expected to pay for the current month and they would maintain two producer payrolls just like they did under the

Minnesota-Wisconsin process, one for producers in the competitive price zone and another for producers outside. In the past it was one payroll for Grade B producers and another payroll for Grade A, so many, many similarities.

Q. Jumping around just a little bit, but in that regard in your statement you discuss in some detail procedures for assembling information. I'm wondering about the similarities with the old M-W there or how it would mesh from that old system to the current process.

A. I suggested a system for collecting data which would be pretty efficient because the Market Administrators are now collecting this similar information and they have the reporting relationship with these handlers.

Under the old M-W system the agent of the Secretary was the National Agricultural Statistics Service. The Secretary of course could choose any agent he wants to collect and assemble and announce these numbers, but I just presumed that the Market Administrators would

be able to do it efficiently.

Q. If you could just track through how that information is obtained by the Secretary and then how the calculation is made for the announcement of the Class III price.

A. Each Market Administrator would get reports from producers buying milk in the competitive price zone and each could then transmit that information about how many dollars were paid and how much milk was purchased and what the component tests were to some agent of the Secretary and he could consolidate them into one price for all of the milk in the competitive price zone. This would be the national basic formula price.

Q. Is there any impact on the Class IV price or other classified prices in the system?

A. No. This would not affect any other mechanism in the federal orders. Class I, Class II and Class III, advanced, advanced III, advanced Class IV, all would be done exactly as they are now. The only substantive change would be the mechanism for determining the other solids price.

Q. What would be the impact on the calculation of yields or make allowances under the current Class III prices?

A. This would have no impact on them at all. Whatever make allowances or yield factors are chosen based on whatever the Secretary has available to him, that would stay the same with the exception of the other solids price. Nothing else would change.

Q. Going the other way, how would the producer price be calculated under this?

A. The producer price to farmers in the competitive price zone would be chosen by the people who buy milk in that zone based on how they evaluate their own competitive situation.

As rational buyers of milk they will try to make some long-term profits. That also means paying enough to maintain a milk supply, so they will decide and that information will then get built into the basic formula price, which will in turn affect how producers outside the competitive price zone are paid.

They are now paid basically the Class III price plus the PPD, and the Class III

price would be the same as the basic formula price and that would be the protein price as determined by the Secretary, the butterfat price as determined by the Secretary under the federal order rules times the pounds of butterfat times the pounds of protein, and the only departure would be that they would pay for the other solids based on the residual other solids price. That would be the only change.

Q. The primary impact the producer would see, the direct impact the producer would see in producing milk is in the calculation of the other solids price?

A. Yes, that's correct. Any departure from what we now do would show up in the other solids price.

Q. Just a little follow-up on the correlation with the California pricing system being outside of the federal order system. Your statement indicates that you anticipate a higher on average producer price arising out of the competitive pay price calculation.

A. Yes.

Q. How would you expect that that price

would respond in relation to the California pricing series which might then be understood to be lower if developed under the California component pricing?

A. If I was a handler buying milk in a competitive price zone in Michigan or Ohio, New York, Pennsylvania, Minnesota, Wisconsin, I would be very concerned about competition in finished product markets from California. I would be very concerned. I would evaluate that before I would decide how much I could afford to pay for milk. This is part of the competitive environment in product markets. Therefore, it has to be factored in when one decides how much he can afford to pay for milk.

There are other factors such as local competition, local trends in milk production, national trends and demand. Those sorts of things would also be taken into account.

Q. Two final questions about in the calculation that the handler has to make in the competitive decision. More specifically how would the calculation account for hauling

subsidies and over order premiums in the market?

A. The calculation as it stands would ignore both of these. Hauling subsidies exist in the Upper Midwest and they are fairly large. I would estimate roughly half of the hauling cost is subsidized.

If hauling subsidies were taken into account as payments to producers, that would raise the basic formula price at least to the extent that it includes milk from Minnesota and Wisconsin. It probably wouldn't make any difference in other parts of the country.

On the other hand, over order premiums, to the extent that there is money left over after service costs are paid, that would enhance the ability of a handler to pay for milk. If you took that out it would reduce the effective pay price to producers or manufacturing values, so you have offsetting effects.

I think that the effect of over order premiums is pretty small. First, in the Upper Midwest at least a very small percentage

of milk goes into the bottle, 15 to 20 percent, and if that over order premium is divided by five or six it gets pretty small at the farm level and it gets a lot smaller a lot faster when we take into account how much is eaten up by service costs of getting milk into the fluid market, so there is not much money left over for producers and when it is divided up by all producers, it amounts to a very small amount of money.

MR. SMITH: I have no further questions of this witness.

JUDGE PALMER: We are going to continue for a bit, but I thought at 10:30 we would take a 20-minute recess. Who wants to ask questions first? Mr. Rosenbaum.

CROSS-EXAMINATION

BY MR. ROSENBAUM:

Q. Steve Rosenbaum, International Dairy Foods Association. Let me start with some what I will call mechanical questions as to how this would work. Let's focus on a zone that has been deemed to be a competitive zone by

whatever Herfindahl index requirements or contiguity of requirements that have been established, if that's the right word.

Farmers within that area may end up negotiating different prices from one another with respect to what they receive for their milk; correct?

A. They could receive different prices because it would be several buyers in the market. Whether that is a result of negotiations or not, it is not common for individual farmers to negotiate. It is common for their cooperative to negotiate.

Q. To switch then from farmer to cooperative, how much a cooperative receives for its milk would depend in those areas upon the negotiations that take place between them and the potential buyers; is that the mechanism you have in mind?

A. This issue was not addressed fully in my testimony, but most federal orders treat cooperatives as producers and they are paid the blend price, but the cooperative in fact is the entity, the handler who pays the producers, and

I would not modify the mechanisms or the amounts that the cooperatives are paid when they in turn would participate in this competitive price area mechanism for paying producers.

Q. Let me back up. Within the competitive price area there is no longer a regulated price for Class III milk; is that right?

A. There is no regulated price for Class III milk, but there is a regulated minimum that they must pay at least the 12-month average PPD. They have to pay that much, but any additional amount is voluntary and would represent the manufacturing value.

Q. The 12-month PPD is made up of what with respect to farmers or cooperatives located within a competitive area?

A. That would be the PPD that was generated on the volume of milk in the competitive price area in each of the 12 preceding months and then average. It is a weighted average and then that weighted average is paid out to the handlers who buy milk in the

competitive price zone.

Q. Does that PPD include what is being paid for Class III milk?

A. No. The PPD is made up of all the adjustments and differentials in the federal order that are beyond the Class III price.

Q. Let's leave the PPD out of it for the moment and just focus on the Class III pricing.

A. Okay.

Q. With respect to that, how much a cooperative receives for milk going to a Class III use will depend in a competitive zone area on the negotiations they enter into with their buyers; correct?

A. Not correct, because again I would treat the co-op as a handler buying milk in a competitive zone. Any transactions between handlers would be at the regulated minimum prices including the regulated minimum Class III.

Q. Let's start with a simplified example. We talked about independent farmers. Let's leave the co-op out of it for now. With

respect to that transaction between independent farmers and a handler, let's say a noncooperative handler for now, the price that was paid to that farmer with respect to milk going to a Class III use would be a matter of negotiation between the farmer and the handler; correct?

A. Yes. I guess in principle, yes, but in fact very little negotiation occurs.

Q. The agreed upon price?

A. Yes, the agreed upon mechanism for being paid.

Q. That agreed upon mechanism may vary from farmer to farmer; correct?

A. It is possible, yes.

Q. And may vary among handlers; correct?

A. Yes. Handlers often will offer different package deals. One handler may have one package deal. Another one may have another.

Q. Within the competitive pay zone that set of agreements will not be subject to any minimum price requirements?

A. That's correct.

Q. You are not proposing to do this for Class IV milk?

A. No.

Q. Why not?

A. We are focusing on one issue and that is how do we develop a workable competitive pay price for raw Grade A milk. We could go through the federal orders and find a number of things that could and maybe should be modified. We chose in this case just to focus on one issue, and that issue was is it possible to develop this competitive price for milk, and our proposal implies that, yes, it is.

Q. Obviously raw Grade A milk is also used for Class IV purposes, so I'm not sure why your answer dictates the result of not having a proposal that covers Class IV milk.

A. You are correct in implying that this is not exclusively milk purchased for Class III purposes. The vast majority of it would be milk purchased for Class III purposes, but it is possible you might find a butter plant, for example Southeast Pennsylvania, that

might influence what the cheese makers would pay for theirs. That would be part of the competitive environment just like the California situation would be part of the competitive environment.

Q. But my question really, that leads me to another mechanical question. Let me address that first and then go to the question I was trying to get at a minute ago.

When you are calculating Herfindahl indexes or counting the number of buyers for purposes of determining what counties will be included in a competitive zone are you including only Class III purchasers in making those determinations or are you including all purchasers?

A. I'm including all purchasers of milk for manufacturing. Any transactions between handlers as I said would be at Grade A minimum prices. The only transaction that would be exempt from minimum prices would be that between the first buyer and producers who produce milk in this competitive price zone.

Q. When you are calculating the

Herfindahl index and deciding whether or not the competitive zone includes or doesn't include a particular county, if there are buyers who are buying for Class IV purposes are they included in calculating the Herfindahl index under your proposal?

A. Yes.

Q. That was my mechanical question. Let me go back to my broader question, which is under your proposal, even though the transaction is taking place within a competitive zone, if the purchase is for Class IV purposes it is subject to the minimum price regulations applicable to Class IV milk; is that right?

A. Not so. All transactions between regulated handlers buying from producers who produce milk in the competitive zone would be exempt from minimum pricing and you can argue that even a bottling plant would be exempt on that portion of their payment for milk.

Q. You testified a couple minutes ago that with respect to an independent farmer selling milk to a Class III handler in a

competitive zone, that transaction would not be subject to minimum requirements?

A. Yes.

Q. So now I'm asking you let's assume that the transaction is between an independent farmer and a Class IV handler in a county that has been deemed to be part of a competitive zone. Is that transaction subject to minimum price requirements?

A. That transaction would not. No transactions between regulated handlers and producers in the competitive price zone would be subject to minimum payment for the manufacturing portion of the price.

Q. Then could you explain how that is handled mechanically given the changes to the regulation as I read them that you are proposing only -- let me back up. The price paid by that Class IV handler would be reported to USDA?

A. Yes.

Q. And it would be included in making the adjustment to the other solids price for Class III purposes?

A. Yes.

Q. But the minimum Class IV price for areas outside the competitive zones would be entirely unaffected by what a Class IV handler within a competitive zone was paying?

A. That's correct, as long as we maintain the present component system for pricing Class IV milk, that's correct.

Q. So under your proposal in effect the minimum price for Class III milk in areas outside the competitive zones is being set by the competitive price being paid for Class III milk and Class IV milk within the competitive zones; correct?

A. That's right. The manufacturing value collected from plants that buy milk in the competitive zone.

Q. But, unlike the situation with respect to Class III milk, with respect to Class IV milk you would have handlers in a competitive zone who would be free from price regulation and paying a competitive price and handlers outside the competitive zone buying Class IV milk paying whatever price is dictated

by the product price formulas now in existence; correct?

A. Correct.

Q. Let's talk about the competitive zones themselves. You have actually only presented evidence today that has identified competitive zones in the Upper Midwest; correct?

A. That's the only documentation I have at this point. I would argue that this is more conservative than we would find if we did it on an all market basis because I know that there are federal orders outside the Upper Midwest who procure milk in the same Midwest area so there would be more buyers than indicated in the tables I have presented.

Q. You did say, and I quote page 9 of your testimony, that most of the competitive price zones are likely to be in the Upper Midwest?

A. That's correct. The largest conglomeration of counties and largest volume of milk is almost surely to be found in the Upper Midwest.

Q. Let's assume if one were to determine there were other competitive price zones, how do you propose the prices being paid in various zones to be aggregated for purposes of determining what the overall competitive price is for purposes of making the adjustment to the other solids price?

A. What I would recommend is a weighted average based on the volume of milk in each of these areas.

Q. Am I correct that one of the factors that determines how much a handler is willing to pay for its milk is -- let me phrase that a little differently. A handler among other things looks at what it can sell its end product for and that helps determine how much it can pay for the milk?

A. That's correct. That's the revenue side of the statement.

Q. It is true that the value of the manufactured price, let's use cheese as an example, is impacted by the proximity of the manufacturer to consumers; correct?

A. That's right.

Q. It has been historically the case that the Upper Midwest, given its relatively close proximity to the eastern United States, has been thought to have an advantage in that respect over cheese production in for example the Pacific Northwest; is that right?

A. On the volume of manufactured products that move from the Pacific Northwest or from California to eastern markets, the transportation costs would be a burden that would not be borne by Midwest handlers. Not all of the product from the West Coast moves East but some of it does, so transportation costs would affect the competitive ability of California and Midwest processors.

Q. It is fair to conclude that, regardless of the possibility of identifying additional competitive pay zones outside the Upper Midwest, once you do a weighed average the competitive pay price is going to come to be dominated by whatever is being paid in the Upper Midwest.

A. I agree with that. The greatest volume of milk is there and also the greatest

conglomeration of counties would be there.

Q. So let's assume you are a cheese plant located in the Pacific Northwest. You are now being required to pay as a minimum regulated price the price that is being garnered by producers in the Upper Midwest; correct?

A. The large influence would be the amount paid to producers in the Upper Midwest.

Q. And what is being paid to those producers in the Upper Midwest is being influenced in part by the fact that the purchasers of that milk are located closer to the consumers and therefore can afford to pay more?

A. That would be one of the competitive factors they would be able to take into account, but there are other competitive factors such as hauling subsidies which would not show up in this price which would mean that the Midwest price would be lower than it would be without this distortion.

Q. But you have no doubt but that the prices in the Upper Midwest would exceed?

A. I agree with that. The prices in the Upper Midwest, pay prices have exceeded federal order minimums by a great deal .50 to a dollar for many, many years. This is not a new phenomenon. This is a phenomenon of almost a generation going back to the early eighties.

Q. The difference here though is that for the first time you would now be requiring handlers in the Pacific Northwest to pay as a minimum price the value of milk in the Upper Midwest?

A. That's correct, and that was also the case in the old M-W system.

Q. One difference of course was the old M-W, and I wanted to get to that, the M-W system was based on what the Grade B milk price was; correct?

A. That's correct.

Q. And the Grade B -- well, just to set the stage, it used to be, let's back up even more. The Grade B milk price was an unregulated price; correct?

A. Correct.

Q. What was being paid for Grade B milk

was surveyed by USDA; correct?

A. Correct.

Q. And that set the minimum Class III price, correct, in the federal order system?

A. That's correct.

Q. It was the Class III price; correct?

A. Correct.

Q. Of course the Class III price was the price that handlers were having to pay for Grade A milk; correct?

A. Correct?

Q. Because by definition only Grade A milk is regulated by the federal order system.

A. That's correct.

Q. Grade B milk had a price that was observably less than the price of Grade A milk in the Upper Midwest; correct?

A. I would argue in the latter years of the M-W price that was the case. As the amount of Grade B milk declined it was usually in smaller, more remote farms and the cost of assembling Grade B milk became higher.

Q. It may have been .50 to a dollar less than what was being paid?

A. I can't remember how much difference there was in terms of the basic manufacturing value between Grade A and Grade B milk.

JUDGE PALMER: We are now a little bit past 10:30. Let's take a 20-minute break.

MR. ROSENBAUM: I don't think he was finished with his answer.

A. I can't give you a definitive answer. I would probably agree that in the latter years the Grade B price was lower.

JUDGE PALMER: We will break now until ten minutes of the hour.

(Recess taken.)

JUDGE PALMER: Is Mr. Christ still here? We are a little bit over the time so I think we will start.

BY MR. ROSENBAUM:

Q. Mr. Christ, to follow-up on the issue we were talking about before the break, to the extent that the Grade B price in the Upper Midwest at the time when that was separate from the Class III price was less than the Grade A price in the Upper Midwest, the

practical reality was that a purchaser of Grade A milk for Class III purposes in other parts of the country was buying milk at a price less than the price of Grade A milk in the Upper Midwest if it was only paying the minimum regulated price?

A. The handler outside the Upper Midwest would be paying a price for Grade A milk based on I would argue the depressed price of Grade B milk, which may or may not, I doubt that it really reflected the value of Grade A milk in the Midwest area, but he would be paying less. He would be paying Grade B value.

Q. That play would not exist under your proposal?

A. No.

Q. Because the minimum price outside of the Upper Midwest would be set or at least dominated by the competitive price for Grade A milk in the Upper Midwest; correct?

A. That's correct, but the competitive price in the Upper Midwest would be modified to the degree that he would find competitive areas outside of the Upper Midwest.

Q. Are there areas outside the Upper Midwest where the Herfindahl index from the buyer's side might qualify the area as competitive but Herfindahl index from the seller's side would not?

A. The transaction I'm dealing with here is a transaction between independent farmers and the first buyer of milk. The Herfindahl index would be related to the buyers of that milk, not to the farmers. It would be a rare, I think almost impossible, situation to have fewer producers than buyers, so the Herfindahl index would be related to the buyers in that area who buy direct from the farmers.

Q. Your effort by using Herfindahl index is to identify areas where the price was being set by competition; correct?

A. That's correct. The amount of competition is somewhat subjective but I have made a proposal for .33. If the Department or Secretary was comfortable with something higher than that, it would probably work.

Q. Take a hypothetical area where there is one cooperative who is selling all the milk

in the county on behalf of its members, okay? Now there may be multiple purchasers for that milk but the pricing being paid would be influenced by the offsetting power of the seller; correct?

A. That is correct, and that would not be a competitive price zone because in that case where there was only one buyer in the cooperative the Herfindahl index would be 1.0.

Q. So you would exclude that from your competitive zones?

A. Yes. If there were four or five cooperatives relatively balanced, then it would be included in the pricing.

Q. What if those cooperatives had joined together in a joint marketing effort? How would that be handled?

A. My understanding is the Capper-Volstead Act exempts co-ops from joining together to market agricultural products, but it does not exempt cooperatives from colluding in paying prices to dairy farmers. My belief is that cooperatives are not permitted to do that.

Q. How much the cooperatives can afford to pay the dairy farmer depends on what they have gotten from the purchaser of the milk; correct?

A. That's correct, in part.

Q. In part, and to the extent that the cooperatives have joined together in forming a joint agency --

A. Common marketing agency is the language.

Q. -- common marketing agency, they are potentially able to extract from the market monopsony prices; correct?

A. They hope to be able to. Maybe in some cases they do. They share in the returns from those prices but they do not share equally because usually the over order premium prices are broken down into two pieces. One piece goes directly to the co-op seller to help cover service costs, and the second piece is distributed on the basis of the producer of milk controlled by each cooperative.

Q. Regardless of how they ultimately use the money they have more money to pay their

P. Christ - Cross by Mr. Wellington

farmers?

A. There is more total money. Over order premiums do affect their ability to pay, but as I argued in my direct statement it probably is not a big deal in the manufacturing areas.

Q. Have you looked at what the over order premiums are being paid?

A. No, I haven't, not recently.

MR. ROSENBAUM: That's all I have for now. Thanks.

JUDGE PALMER: Questions?

CROSS-EXAMINATION

BY MR. WELLINGTON:

Q. good morning, Paul.

A. Good morning, Mr. Wellington.

JUDGE PALMER: Please identify yourself for the record.

MR. WELLINGTON: Bob Wellington with Agri Mark Dairy Farmers.

BY MR. WELLINGTON:

Q. Paul, doesn't your proposal factor in the Class III minimum price and the local

market situation that determines over order premiums already? Isn't that really the purpose of this?

A. The purpose of this is to find a price for manufacturing milk that reflects the competitive market for milk, not the competitive market for individual products, and so that is what we are trying to do is get a competitive price for milk.

Q. So if there is an over order premium in the Upper Midwest where farmers are getting paid more than the Class III minimum, that would likely be factored in to this proposal?

A. It would be factored in in the Upper Midwest and in other areas that might be in this competitive price zone, but we also pointed out that there is another flaw for example to the degree that farmers get hauling subsidies that would understate the price.

Q. Wouldn't manufacturers though in areas outside the competitive zone, let's say New England, which it is unlikely that we would have a competitive zone in New England, even in Vermont I don't think we would have one, but

wouldn't they be paying competitive premiums twice, once for the competitive premium in the Upper Midwest and then twice for a local competitive premium to procure a supply of milk?

A. That's a tricky question I haven't thought of. If part of the competitive pay price in the Midwest reflects over order premiums that would be built into the Class III price experienced by Vermont buyers of milk, they may choose to behave in a competitive manner beyond that by paying premiums again, but they would not do that unless it was in their own best interest.

Q. Yes, but doesn't it occur at times that when plants are in a tough, very strong competitive situation that they will often pay even more than the milk is worth in the short term to procure a supply?

A. In the short term it is sometimes rational to pay a price that does not reflect all of your costs, but this is not a sustainable strategy because eventually you either have to cover your fixed costs or you

have to go out of business, but in the short run it is possible that will occur.

Q. Hasn't that happened in the Upper Midwest at times?

A. I believe it has. There are periods like 2006 when probably most of the cooperative buyers of milk at least in the Upper Midwest did not make money, but as I mentioned earlier this practice of overpaying the federal order minimums has been with us since probably 1983, and to me in 24 years in between is the long run, not the short run, so the industry has sustained itself. It still has the capacity to process the milk available. The milk supply sometimes goes down and sometimes goes up, but this a practice that has persisted and the industry hasn't disappeared.

Q. Haven't some cheese plants in the Upper Midwest disappeared?

A. Oh, yes, there have been a few plants that have closed and a few organizations. I guess I can't recall any specifically that went bankrupt, but there has been some consolidation.

Q. There are times when Class III and Class IV prices can differ significantly. I want to give an example. Let's say for example Class IV pricing was a dollar under less than the Class III price. If you had that situation would Class IV handlers buying milk in the competitive price zones receive that dollar difference from the pool?

A. They would not receive the dollar difference from the pool. They would pay the dollar difference into the pool.

Q. I'm saying they in fact have a Class IV price that is less than Class III.

A. Okay, the reverse.

Q. Do you see what I'm saying? Would they still receive that from the pool so their effective class is a Class IV minimum price?

A. That's correct. The handlers would pay as they do now the differential values into the pool whether it is Class I or Class IV.

Q. Even if they are buying milk from a competitive zone?

A. Yes.

Q. Did you do any type of economic

impact of this proposal?

A. No, I didn't do any economic impact on producers, but clearly the most significant impact would be whether it renders a higher price or a lower price to producers outside the competitive zone. Producers inside the competitive zone are already getting prices reflected in the competitive environment. Producers outside may end up getting a higher price, the basic price, the Class III price, and that would be my guess as to the immediate impact.

Q. Could USDA choose such an economic impact now based upon the information that is available?

A. I guess I would argue not. There is a circularity problem. As long as you have a regulated minimum price, that would probably influence what is actually paid, and it is difficult to predict if there was no regulated minimum whether they would be that same price or not. I believe that it wouldn't be too far off, but it would be unwise to try to predict that.

P. Christ - Cross by Mr. Wellington

Q. Do you think that one alternative to this proposal would be for the USDA to do this in two steps, the first step being designating these competitive price zones where the minimum prices for manufacturing milk do not apply but you keep the milk in the pool and you basically collect a price series, and then the second piece is once you have that price as near as in place for some period of time, a year, two years, then you hold a hearing and you consider an implementation of that series?

A. I would agree with you if I thought you could get a clean, competitive price series by doing a two-step approach, but I don't know how you can get a clean, competitive price without exempting minimum producer payments in a competitive price zone.

Q. I'm saying you would exempt them.

A. Oh, okay.

Q. But they would still be part of the pool? The only thing you are doing is saying there are no minimum prices applying in these particular counties.

A. The only minimum price that I would

exempt is the payment to producers on the manufacturing portion of their milk. Everything else is the same, and I think you are suggesting the same idea. In effect you are saying you are adopting the proposal.

Q. Not quite. What I'm saying is wouldn't you have concerns to have this major of a proposal go into place without knowing what the price series shows?

A. It would be useful to know in advance what it would show, but I personally don't know how we could get that information without actually implementing the practice.

MR. WELLINGTON: Okay, thank you.

JUDGE PALMER: Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. John Vetne for proponents. Mr. Christ, I'm grateful for your efforts in thinking outside the box. Many of us are intrigued.

A. Most of the time they keep me in the

box.

Q. I'm looking for some conceptual illumination in my own thinking and some follow-up questions on that. In response to a question from Mr. Wellington, he asked, and I think you confirmed, that the minimum price would not apply to manufacturing of milk within the competitive zones?

A. That's correct.

Q. Elsewhere I recall your saying that the minimum price would not apply to anybody buying milk in the competitive zone for that milk?

A. That's correct. Minimum producer payments would not apply in a competitive zone no matter which regulated handler was buying in that zone.

Q. And no matter what use they made of that milk?

A. That's correct, and that's in order to avoid circularity.

Q. Class I, Class II, it doesn't matter what the use allocated for that milk is, the minimum producer price would not be enforced?

A. That's correct. The manufacturing portion of the producer price would not be enforced. The handler would still pay the Class I differential into the pool or the Class IV differential.

Q. Or draw from the pool as the case may be?

A. Yeah.

Q. Within this competitive zone that you propose there are buyers and there are sellers. In response to a question from Mr. Rosenbaum you appear to constrict the population of buyers and sellers as follows: To transactions between independent farmers and the first buyers of milk.

A. Okay, maybe I would modify the word. Individual farmers might be members of a cooperative, and to that degree I wouldn't call them independent. Conventionally we call farmers who are not members of a cooperative independent. What I mean is all producers dealing with a cooperative or dealing with an organization that is not a cooperative.

Q. Okay, so any farmer regardless of

cooperative affiliation would be a farmer whose competitive transaction is measured?

A. Yes.

Q. So we have included all farmers. Let me ask a few questions about --

JUDGE PALMER: I'm confused by that. A farmer dealing with a co-op, how would you know what he was paid without getting into what co-ops are paying farmers?

THE WITNESS: The federal orders do not enforce that transaction today. Co-ops can reblend under federal milk orders, so in effect that would not change that relationship.

However, under this proposal the Market Administrator would collect as he now does how much is actually paid to each individual farmer, so that information is now available, would continue to be available, but in the future it would be used to help develop this competitive pay price.

JUDGE PALMER: But you only want the portion that is paid for the Class III?

THE WITNESS: The manufacturing portion of the total payment.

JUDGE PALMER: How would you figure that out?

THE WITNESS: The Market Administrator would pay to these buyers of milk in the competitive area a producer price differential.

JUDGE PALMER: You would divide it up among the farmers?

THE WITNESS: Yes, and deduct that amount from the money that is actually paid to the farmers and the residual is how much is paid for the manufacturing value.

JUDGE PALMER: You leave out a reblending for premiums or whatever else?

THE WITNESS: Yes. All of that is part of this competitive payment. Their ability to pay is determined by the PPD and what they are able to sell, either the milk or the products of milk.

JUDGE PALMER: So the Market Administrator would be able to obtain that information?

THE WITNESS: Yes, he gets this information today.

BY MR. VETNE:

Q. When you say the manufacturing value paid you do not mean for that to be synonymous with that milk being used in manufacturing?

A. No.

Q. My statement is correct?

A. Yes, it is correct. The milk might be used other than in manufacturing if it is purchased in a competitive area.

Q. All milk purchased within the system has --

A. Within the competitive area.

Q. Let me ask my question before you answer. All milk purchased of necessity has a component that is a manufacturing value whether it is used for Class I, Class II?

A. That's correct.

Q. Let me get to who is a buyer for purposes of determining this competitive area under the Herfindahl index to which you referred where there are three or more buyers.

Where there are different buying

entities who have combined such as for marketing agencies in common to set prices or negotiate prices, for Herfindahl competitive indexing purposes are those entities treated as though they were separate or are they treated as one entity?

A. They will be treated as separate entities. The members of common marketing agencies will be treated as separate buyers of milk because there is no antitrust exemption on that side of the business.

Q. Your perception is that under Capper-Volstead cooperatives are not permitted to get together to decide how producers are paid?

A. That's my understanding.

Q. How about parent subsidiary relationships where there is a subsidiary of a parent buying and maybe that parent has more than one buying entity operating within the competitive counties and the parent can control the actions of the subsidiaries; would that be treated as one buying entity or two?

A. That's really a good question. As I

had first thought about this, anybody that is identified as a handler by the Market Administrator would be considered an independent entity. A handler could operate several plants. I guess I don't think the Market Administrator would consider that as being separate handlers.

If there is one decision making body then that should be treated as one handler in terms of purchase prices of milk, but I hadn't thought about that. I think that is probably the right answer. The decision making entity is the handler in this case.

Q. The parent handler?

A. The parent? I'm trying to think of an example of that. I can think of handlers who operate multiple plants, that would be one handler, but I can't think of an example of a handler who owns another handler, both of whom buy milk in the same area. I don't have an answer to that question.

Q. There are a number of joint enterprises out there for example in which one of the enterprising contributors makes

decisions?

A. I'm aware of joint ventures in the dairy industry where the milk supplier is one partner in the venture and the processing partner is another partner, but there is only one decision maker for buying the milk and that would be the milk supplying partner.

Q. What about a situation for example in which the entity that controls a marketing agency in common, the decision makers are the same individuals that decide what cooperative members receive?

How about this example? A cooperative is allowed under the Capper-Volstead Act to market up to 50 percent but not in excess of 50 percent of nonmembers.

A. That's correct.

Q. The cooperative in that instance decides the price that that independent market through the cooperative gets as well as the producers who are cooperative members?

A. That's correct. Market Administrators allow the cooperative to pay nonmembers for whom they market the milk.

P. Christ - Cross by Mr. Vetne

Q. And there are examples of marketing agencies in common or federations through which independent producers are pooled and marketed in which the folks that run the cooperative agency in common at the same time decide what cooperatives, at least some cooperative components of their organization pay to their members.

Is that one buying entity or two? You have a cooperative as a handler and the agency as another handler?

A. I would argue that the party that pays the producer, writes the check to the producer, would be the handler under this proposal and would be exempt from minimum producer payments.

Q. I'm talking about not who is exempt but who is contributing to, competitive for Herfindahl purposes. If the same individuals are involved in or control decision making of two entities and they are separate entities for reporting purposes but the same people decide, how is that to be treated under the Herfindahl index?

A. As mentioned earlier, the decision making entity would be the one of interest in this particular example. I have trouble coming up with an example where it is not also identified as a separate handler. I used the term handler to identify who is exempt and you are posing examples where the decision maker may be the same for more than one handler.

Q. Yes.

A. In spirit the decision maker should be the entity of interest. I'm just doubtful that there are many or even any examples where there is one decision maker for several handlers in one particular geographic area.

Q. Well, let's see. Dairy Marketing Services is a handler in many markets; correct?

A. I'm generally aware of them and I know that my own organization is involved in that, but I did not get involved in any of the decision making.

Q. Dairy Market Services as you are aware markets milk of independent producers.

A. Yes.

Q. As a collective the cooperatives who

are dominant in Dairy Market Services decide what those independent producers get paid at least at federal minimum --

A. I think the decision making entity there would be DMS.

Q. The principals that are involved in DMS also decide what their own cooperative members get paid?

A. Yes. Each principal would decide for its own members, but the principals together constitute a new entity, DMS, which decides how much the independent producers. There is some overlap about who the decision makers are, but they do constitute separate entities.

Q. It is your understanding I take it that that overlap in that decision making is not the kind of relationship between cooperatives in setting minimum prices that you believe violates Capper-Volstead?

A. Yes. DMS would be a separate entity and co-ops, as are private organizations, are free to set up whatever independent entities they choose.

Q. The price data under your proposal proposed to be collected and reported as the competitive Grade A price is what you are looking for; right?

A. Correct.

Q. The competitive Grade A price will not include hauling subsidies?

A. Simply because we don't have accurate ways at this time to capture that information.

Q. Hauling subsidies are fairly common in the Upper Midwest?

A. Yes.

Q. And you are familiar with hauling subsidies?

A. Yes.

Q. There is a broad range of the amount of haul that is subsidized from organization to organization?

A. That's my belief. I don't know the books of individual organizations.

Q. When you were working for Land O'Lakes would there be a broad variety of subsidies from area to area?

A. That's what we believe. We made an attempt, and I got a lot of injuries from trying to sell the idea, we eliminated hauling subsidies at one time and we angered a good share of our membership by doing that.

Q. Ordinarily the price that is regulated by USDA is a price paid to producers or co-ops delivered at the plant?

A. Yes.

Q. The producer of the co-op is responsible for getting the milk there?

A. Yes.

Q. That is part of the producer cost?

A. Yes, the assembly cost.

Q. So when hauling subsidies are paid it is in effect an indirect additional compensation?

A. That's correct.

Q. What is to prevent, what can be done to guard against under your proposal simply shifting monies to the hauling subsidy or away from the hauling subsidy to influence the direction of the measured Grade A premium that you propose?

A. I don't think there is any control to petition the total payment between hauling subsidies and manufacturing values. I think it could vary by handler and it could vary over time. There is nothing in the proposal to deal with that.

Q. You agree though that a handler buying milk in these competitive zones, if he elected to shift money to or from hauling subsidies it would shift the measured competitive price?

A. Yes, that is correct.

Q. I want to refer to it as the PPD-2 --

A. The 12-month average.

Q. The 12-month average PPD. The PPD since federal order reform has been a volatile number?

A. Yes.

Q. Sometimes very large and sometimes negative?

A. That's correct.

Q. You observed that the PPD-2 would be less volatile?

A. That's correct, because it is a 12-month average. A sideline benefit is it would discourage depooling.

Q. So the PPD that would otherwise be payable to these producers in the competitive zone would go into a fund?

A. Correct.

Q. Because of the volatility of the regular PPD there may be occasion, particularly within the first 12 months but maybe even beyond that, in which there is not enough money in the PPD-2 reserve to pay that 12-month rolling average. In fact, you need 12 months before you can even start.

How do you propose to deal with that when a very large chunk needs to be paid out in order to meet the regulatory obligation?

A. I agree during the transition period there is a question of adequate funding. It would be possible to calculate a 12-month average without having the money in the fund, but if you had the case of a uniform PPD on a year-round you would be paying in the same amount that you are taking out. Only to the

degree that the PPD would vary would you run into the situation of running short of funds where the PPDs going in would be smaller than the 12-month average coming out. You could have a two- or three-month rolling average that was uniform paying in x dollars and taking out the same x dollars at the same time.

The problem could arise, and if that were the case there are ready provisions in the order that when there isn't enough money in the fund the residual is prorated among the recipients.

Q. So you don't propose any mechanism to catch up so the competitive zone producers get what they bargained for?

A. I haven't proposed anything in the proposal itself. In one set of circumstances where there is a series of low PPDs going in you could deplete the fund. You get a series of high PPDs going in, then you have an abundance of money.

Q. Under the same scenario with volatile price, regulated price differences from month to month there could be an occasion

in which the PPD-2 reserve is sufficient to pay for example in the Upper Midwest market but insufficient to pay in the Pacific Northwest or Ohio or the Northeast.

You do not propose any combination of PPD-2 reserves between the markets?

A. No. In fact, the risk of depleting the fund would be greater in the low utilization markets like the Upper Midwest simply because the PPD is smaller. In the other markets where the PPD is larger the risk of depletion would be less.

Q. The low utilization markets, the Northwest for example is characterized by quite a bit of Class I formula and sometimes there is a negative PPD there when there is positive PPD elsewhere in other parts of the country.

A. That is possible.

Q. Regardless of whether there is lower utilization in the market.

A. I have not looked carefully at the flow of PPDs in the Pacific Northwest but I doubt very much on an annualized basis that it would be negative.

Q. You indicate that the proposal is designed so that only the other solids price would change.

A. Correct.

Q. Everything else, the protein prices and butterfat prices would be based on a first step, essentially what we are doing now, the component price manufacturing?

A. That's correct. This is designed to make an initial change and maybe with experience we may choose other changes but we are not proposing anything right now.

Q. What about situations as has occurred in the past where the other solids price is effectively negative, would that be translated?

A. You would have the same phenomenon in our proposal. It is possible that all the value of manufacturing milk was eaten up by butterfat value and protein value and the residual is negative. Well, then you would have a negative other solids price.

Q. How would that be reflected in pay prices either to PPD-1 producers or PPD-2

producers?

A. Let's say PPD-1. PPD-1 would be people that still had regulated minimum prices. That would be reflected exactly the same as it is now with negative other solids price. That PPD or the Class III price would be the composite of a positive protein value and a negative other solids value just as it is now.

It would be irrelevant to the producers in the PPD-2 pool in the competitive price area. They would simply be paid however the buyer chooses to pay them, whether he chooses to reflect it as protein, butterfat and other solids or chooses to pay them at a per hundredweight. It doesn't matter. They are free to pay in any manner they choose.

Q. Mr. Smith asked you a question something like this: Would there be any changes in the other prices, to which your answer was, no, there is no change in the mechanism for other prices. Elsewhere you answered, yes, you do believe that there would be a change in the level of other prices.

A. There would be a change in the level

of other prices to the degree that they are influenced by the Class III price. Recall we are not changing the advanced Class III price or advanced Class IV price which is used for Class I pricing. That would still be calculated as it is now.

Q. In the so-called competitive counties there would ordinarily be, at least in many of them, some nonexempt transactions. For example, producers who are selling milk to a different market, a producer in southern Wisconsin sells milk to Indiana for example and is pooled in the mideast quarter, that transaction would not be exempt even though a similar transaction between a southeast Wisconsin producer and an Upper Midwest handler is exempt; am I correct?

A. I think I would disagree. My intent was that any regulated handler buying milk in a competitive price zone would be exempt from minimum producer payments.

Let's say there are five handlers, three of which are in one market, the fourth comes from a second market and the fifth comes

from a third market. All five of these would be exempt from minimum producer payments, so within the territory where the competition occurs everyone is exempt.

Q. One reason for doing that is to avoid to the extent possible the effect of circularity?

A. That's correct.

Q. You would agree with me that the price paid in one county in the milk shed is influenced by the price paid in the next county?

A. That's why we suggested conglomerations.

Q. At the edge of whatever conglomeration there is there will be a county that is not exempt that will influence the price within an exempt county nearby?

A. That situation exists today. In the first case we have several handlers from several markets buying milk in the same county and minimum blend prices are different. We have contiguous counties in which producers are paid by and regulated by different orders and

sometimes the PPD can be as much as a dollar different depending on the orders, so we have those significant variations today and I don't think the situation there will change.

Q. That situation is a direct result of regulation; correct?

A. A large degree of it. To the extent that the pay price is influenced by minimum federal order price, then it is an artifact of regulation.

Q. And there aren't many counties in which producers are regulated, different producers are regulated by different markets?

A. That's correct.

Q. And have different PPDs?

A. That's correct.

Q. That influences the decision and competitive need of a handler who receives milk under the lowest PPD to pay more out of packet to be competitive with producers who are nearer the milk shed that are getting more because it is being shipped to other markets?

A. That's true only if the buyer with the high PPD chooses to pay a high

manufacturing value as well. Such a buyer could choose to pay a high PPD and a low manufacturing value, which would be easier to compete with if you have a low PPD.

Q. My question related to past practice not under the proposal. It is true now and has been for many years that there are places in which already highly variable PPDs and handlers receiving milk under a low PPD have to compete with the high PPD producers?

A. That's correct. It creates a competitive problem because they have a minimum payment required by the order.

Q. You referred in response to I think questions from Mr. Rosenbaum about the ability of cooperatives to reblend and you said that this would not change that, so I want to ask a couple questions about that.

Ordinarily a membership agreement between a dairy farmer and a cooperative is for a period of time, a year?

A. Typically a year.

Q. During that time the producer commits to sell to the cooperative and receives

compensation as the cooperative decides to pay that producer?

A. That's correct.

Q. Within these competitive zones a cooperative can decide for any month to reblend money from other regions, the market or regions of the country to producers into the competitive zone to upwardly influence the Class III price or to take money from producers in the competitive zone to negatively influence the Class III price?

A. That situation would not change from the present situation.

Q. But in the present situation that kind of decision making is not reflected in a regulated price applicable to everybody else. Under your proposal it would be.

A. That's correct, because we are not measuring the competitive value of milk today, we are measuring the competitive value of the products of milk.

Q. Do you believe that where a cooperative moves money from other parts of the market or the country into a competitive zone

for the decision making purpose of increasing the regulated price that that reflects competition within the competitive zone?

A. That would be reflected in the competition in the competitive zone, but I think it would be a self-defeating mechanism, that they would be doing damage to the members outside the competitive zone in order to help the members in the competitive zone.

Q. If that in effect raised the price temporarily throughout the country for everybody, members in the aggregate would be advantaged?

A. That depends on whether the organization is processing its own milk or selling it to outside buyers. If it was processing its own milk it would use this mechanism to increase its own costs. You would have offsetting gain and damage. If it were selling the milk to outside entities, then it might help the organization.

Q. It would be a bit like for a short period of time bidding up the cheese price on the CME?

A. I would say conceptually that's correct. In practice I don't think either would be practical, either bidding up the price on the CME or bidding up the price in the competitive zone.

Q. You can't conceive of a situation where it would be in the short-term interest of an entity to do either one?

A. Again, conceptually, yes. I can think of buying cheap cheese off the CME and selling it on the CME.

MR. VETNE: That's all the questions I have for now. Thank you.

JUDGE PALMER: I have one about your proposal that says you wanted a survey of plants located in nine states including California to develop the competitive price series, but then in your testimony I think you said that there is no way to really get data for California.

MR. CHRIST: That's correct. The proposal was originally formulated hoping to get a wide base of area to apply this competitive price. When I started to look into

it to try to find where we were likely to find enough competition, it was a narrower field. That's the only difference. It would be better to have the wide field that was originally proposed.

JUDGE PALMER: Is there any data that you can get from California under the present circumstances?

MR. CHRIST: We can get regulated minimum prices. I don't know if we can get actual pay prices. We do get mailbox prices from California and I don't know all the intricacies of that calculation, but the mailbox price is heavily influenced by the regulated minimum price. Again, how do you isolate the competitive factors from the regulatory factors that influence the price?

JUDGE PALMER: One effect is you have modified your proposal to eliminate California at this time.

MR. CHRIST: That's correct, we have, reluctantly.

JUDGE PALMER: Questions from Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. For clarification, I think that John Vetne was asking you questions about DMS, Dairy Marketing Services. You made I think the statement, if I got it right, my organization was affiliated or is affiliated with DMS.

You were not referring to the Maine Dairy Industry Association, were you?

A. I was talking about my history as an employee of Land O'Lakes. I guess I have a tattoo or something on my back that says I still belong to them in some respects.

Q. Do you have a view of approximately what portion would be the right portion the universe of milk being priced by the federal order system that should be in the competitive pay zone in proportion to the total system?

In other words, is ten percent right? If you get to a certain point in terms of total volume of milk in the competitive pay zone you got the tail wag of the dog I guess.

A. That's correct. We have only a

small amount and we ran into the same difficulty with the Minnesota-Wisconsin price where the Grade B milk fell below ten percent and got down to five percent. We concluded that as an industry that was no longer an adequate base. I would hope we could get at least a third of the manufacturing milk in the competitive zone. Less than that would still work but we would want it to be very representative of the total volume of manufacturing milk.

Q. The total volume of manufacturing milk in the federal order system?

A. That's correct.

Q. So a third would be your target?

A. Yes, I would hope so, but I have no idea at this point whether we would meet that threshold. I think we would, but I have no measurement that would tell me we will.

Q. What would be the concern if it was less than that? 20 or 25 percent of the manufacturing milk would still be quite a substantial --

A. 20 or 25 percent would be a huge

volume of milk and probably would be adequate. All through this proposal we have been conservative to protect ourselves against lack of competition and that sort of thing. These arbitrary measures could be relaxed and I think they would still be adequate.

MR. BESHORE: Thank you.

JUDGE PALMER: Jim Chad.

CROSS-EXAMINATION

BY MR. CHAD:

Q. Good morning. My name is Dennis Chad, C-H-A-D. Good morning, Paul.

A. Good morning Mr. Chad.

Q. How are you?

A. Good.

Q. Just a couple of questions on clarifications. As I understand the competitive pay zone areas that you are defining, the co-op to the producer would be an unregulated transaction?

A. It is now through the reblending privilege and it would also be under our proposal. Our proposal would simply extend the

exemption from minimum producer prices to anyone and everyone who is a regulated handler buying in the competitive pay price zones.

Q. You probably just answered the second question. That would apply to an independent handler in that area as well?

A. That's correct.

Q. However, what you are saying, the co-op as it acts as a handler to sell to another handler, that transaction would continue to be regulated; is that true?

A. Yes. All transactions between handlers would be at minimum federal order prices no matter what the class. If the co-op buys milk from farmers in a competitive area and sells the milk to a cheese manufacturer it would be at the regulated Class III price.

Q. If we put some names on the ground in the Upper Midwest, if Land O'Lakes sells milk to Saputo Cheese, that transaction would be at the minimum regulated price?

A. That's correct, the minimum regulated Class III price.

Q. But if Saputo had independent

producers then their transaction and payment to their independent producers would not be regulated?

A. That's correct, as long as it was in the competitive pay price zone.

Q. The same would be true of a transaction between Land O'Lakes and Dean's Foods?

A. That's correct, it would be at the federal order minimum price.

Q. If Dean's Foods had independent producers in the Upper Midwest, that transaction would not be regulated?

A. That's correct.

Q. Do you believe that that would encourage handlers to develop independent supplies in order to circumvent regulated minimum pricing?

A. That motive would arise only if they thought they could buy the milk cheaper. As long as the competitive pay price reflected the value of manufacturing milk I don't think they could get it cheaper. It would be the local competitive manufacturing milk compared to the

average basic formula price and they would be able to have to predict that local milk was going to cheaper or more expensive than the average.

Q. Another question. Shifting gears, as I understand it, you are proposing no change to the advance Class III prices?

A. No.

Q. So Class I prices would not be changed at all nationally because of your proposal?

A. With this proposal there is no change proposed for anything else.

Q. The third thing is just if you could explain the contradiction that I kind of feel. Since the Department, the USDA promulgated the orders for 3A at least in my opinion it seems like the Department has tried to associate the price of milk that a processer pays for with the values of the end product that the processer gets.

It will take me a little while to set this up. The BFP and M-W, because it was Grade B milk and because my last memory of BFP

showed that 95 percent of the milk was cheese and only five percent to butter-powder, what you were reflecting were class prices that basically in the 3A you were reflecting the price of milk used to produce butter-powder, the BFP reflected the price of milk used to make cheese.

There is a contradiction there because the results it seems to me of what you are going to come out with is a price that may not be at all your basic formula price that you set up, may have no relationship to any product, any classified pricing. Could you address that?

A. I will try to elaborate on that. The competitive pay price that would be collected would be the manufacturing value embodied in all the uses of milk by the handlers who buy milk in this competitive price area.

I believe that where we have the competitive environment is also the areas where we will find a preponderance of cheese manufacturing. It is not going to be

100 percent pure cheese or 95 percent pure cheese but that it may be in the same order of magnitude, it might be 85 to 90. I suspect that it will represent mostly cheese although it will include the manufacturing value as expressed by Class IV manufacturers and Class I manufacturers who may be in the same buying area.

Q. But if a competitive pay zone defined for Pennsylvania for instance, and I think that it could be ten counties?

A. Eastern Pennsylvania, that's correct.

Q. All the way through Pennsylvania I would expect, in Pennsylvania you probably have a 15 to 20 percent Class III utilization?

JUDGE PALMER: You are giving us a lot of testimony. Do you want to rephrase the question?

Q. What would be the effect if Pennsylvania was added into and declared a competitive pricing area?

A. That area would be similar to any other area that was in the competitive price

zone. The prices that were extracted from that area would represent what the buyers of milk felt the manufacturing value of that milk was.

Q. If there was very little Class III in the counties of Pennsylvania, would you agree with me that the impact of pricing Class III there would have very little impact?

A. In that particular portion of the total competitive price area maybe the weight would be heavier away from cheese.

Q. Just a last question. In your testimony you used the word volunteers. Would in these competitive price areas a dairy farmer or a handler or anyone else have the opportunity to opt out of the disruption of minimum pricing?

A. Not under our proposal. They are either in the competitive price zone or they are not. The word volunteer was used to identify the decision maker. He is not compelled by regulatory minimums when he pays money to producers.

MR. CHAD: Thank you very much.

JUDGE PALMER: Before we get on let me get a show of hands. How many people wish to ask questions of Dr. Christ?

MR. CHRIST: I would like to correct, it is not Dr. Christ.

JUDGE PALMER: We are going to do is we are going to break for lunch and we will be back at 1:00 and resume.

(At this juncture, a luncheon recess was taken.)

JUDGE PALMER: Mr. Brown.

CROSS-EXAMINATION

BY MR. BROWN:

Q. Michael Brown with Northwest Dairy Association. Did you have a good lunch, Paul?

A. Yes, I did.

JUDGE PALMER: Now you are going to spoil it for him.

Q. Paul, I had several questions, just more or less clarifications. I guess the first one is you talked about mandating competitive price zones. Say for example it ended up being Minnesota-Wisconsin. What if they voted out

the order? What would we do?

A. Under this proposal only regulated handlers would be affected, so if they voted out the order only regulated handlers buying in this competitive area would report the payment information.

Q. One of the things that we have seen, and this is a quick comment and Paul knows this, is the dairy farmers in Idaho which did vote out the order, and we have seen a lot of variation in price, very wide between handlers, would you expect to see some of that variation compared to the current system? Just your best guess.

A. You mean if we simply deregulated payment to producers or under the order?

Q. Within a competitive price zone as you defined it would you expect to see more variation?

A. Yes, I think so, because there would be less regulatory guidance that the handlers might take advantage of. They would only have the 12-month PPD to work with and the rest of it would be guesswork in terms of what my

competitors might do. A lot of the information they would have available needed to make a decision like what is happening with the supply and whether the markets are improving, not improving, that sort of thing.

Q. One of the tenets of a federal order is it provides what we call orderly marketing. We hear that term a lot. Within these zones are you concerned about disorderly marketing? Do you think it could be managed?

A. I'm not concerned about disorderly marketing provided you have a competitive environment. That was the first feature of the proposal was to define the territory in which you have a competitive environment.

Q. Another question, under your program premiums are included, so for example if it was a quality premium it would be reported as part of the price as I understand it; is that correct?

A. That's correct. I would expect that the handlers would report total pounds of milk, total pounds of protein, total pounds of fat, et cetera.

Q. From your experience as a buyer of milk and dealing with different handlers does quality have different values to different users of milk depending on how they use it?

A. I'm not sure how much differences there are in values but there are differences in what they pay. They may be providing an incentive that they hope will be more attractive than what their competitors offer.

Q. A new premium we are seeing is for rBST free milk certainly in the northwest and some midwest and some eastern markets, and that's for someone who is willing to do as you know a specific production practice. How would you handle a premium like that?

A. Our proposal would not encompass any kind of payments that are not now part of the regulatory system. RBST free milk is not differentiated within the present system so we would not differentiate it either.

Q. What you are saying then is if someone was paying a premium for rBST you would not expect them to report that but it would be part of their mailbox pay price?

A. Total dollars, total pounds of milk, total pounds of protein, et cetera, nothing about attributes that are not included in the regulatory scheme.

Q. Quality isn't included in a lot of regulatory schemes. Some orders have it, some don't. That's a premium you would count though?

A. That is part of total dollars. People buying milk in the competitive area may or may not pay for quality, but that would be built, to the degree they do pay for quality, that would be built into this basic formula price.

Q. But yet they wouldn't for BST? You pay that. For example, us as a handler and I know other handlers in this room pay --

A. It would show up in the total dollars paid but it wouldn't be attributed to any particular attribute.

Q. That is a premium that basically is some kind of a pass through.

Again, back to my question. In the case of a premium such as that where you may

not, you may have the large volumes of milk that don't have that attribute in other markets, it is very specific, would you not be a little concerned including those kinds of premiums for specific production practices in this case shouldn't be part of regulated minimum price?

A. It is a payment for something other than basic milk. It is a payment for a service and you could argue that organic milk would be in the same category, it is a payment for a service, but it is outside the regulatory scheme at the present time. I would leave it outside our proposal for the basic formula price.

Q. Organic, same thing, you would leave it outside?

A. Yes.

Q. One thing that again we see nationally, and we know this from looking at the NASS data, is returns from sales of products where we have for example cheese where we have an M-W price and the rest of the U.S. price which we believe is heavily weighted

to the West Coast, especially cheese.

The difference is for example in 2006, just a simple weekly average of block cheddar, Minnesota-Wisconsin averages 6.35 cents higher than other states average, meaning that for commodity products the revenue stream is greater in the midwest as you would expect, probably because of transportation?

Of course USDA, again correct me if I'm wrong, they use a national weighted average NASS price when determining current formulas. I have two questions related to that.

The first is when you are looking at your regional competitive areas are you concerned based on local marketing conditions and value of commodities, how that would impact, that pay versus other areas may not enjoy the same level of commodity price?

A. That's a question of regional differences and manufacturing values. There is some evidence, particularly in the Cornell model that shows you can justify some regional differences in manufacturing milk values.

I go back to the academic study

committee that looked at placing the Minnesota-Wisconsin price. They were fairly adamant that the price should be uniform. I think what you are leading to is if this thing is heavily, the competitive pay price is heavily weighted to the midwest, then maybe not appropriate for the West Coast.

I think it is another issue for another time to decide whether we need regional differences to manufactured milk prices. At the present time we haven't dealt with this for 40 years probably.

Q. A couple more. A related issue, again different parts of the country produce different products, and again we under the current federal order program are using commodity products to determine our manufacturing milk values, in fact to determine all milk values.

If you are in a region, again which I think first of all I asked in the northeast and the midwest, would you agree that a greater percentage, particularly of cheese milk and cheese, is used for non-commodity products

versus the West?

A. I believe that and that's based on conversations with primarily academicians. Wisconsin claims a large percentage of the cheese production now, specialty cheese, so I think that is occurring.

Q. Is there a potential concern there that a comparative survey based on specialty cheese could generate a different value for milk than in markets where cheese is primarily a commodity?

A. I don't know how to answer that question. Specialty cheese not only would render a higher price but would also incur higher costs, so the net of the two I can't comment on. I don't know.

Q. When you talk about the pool draw you talk about a 12-month rolling average, so if you pool the differentials and you take that 12-month average you are going to get paid back.

Again just for my own clarification, if you are a Class IV manufacturer and say the difference between Class III and Class IV is a

dollar --

A. Which is higher?

Q. III is higher than IV. This is so I understand the mechanics and the average PPD is 35 cents, if you are a Class IV plant are you going to draw $1.35? If you are going to pool that Class IV difference in value, are you going to pool -- how will that work?

A. On a monthly basis you will pay into the pool the differential value of what you do with the milk, so on a monthly basis you would take out that dollar. You would still receive the 12-month average to enable you to pay the manufacturing price, the competitive manufacturing price.

Q. In effect what you are saying is under this system if again there was a dollar difference and you were a Class IV plant basically you are going to get a PPD to make up that difference in III, IV relative value?

A. You will actually get it on a current basis because you will pay into the pool the differential relative to the Class III price and if it is negative you will take money

out.

Q. Are you concerned again because we are going to have a pool draw that is a 12-month rolling average, could there be some distortion of that relative value of III, IV when you are looking at a 12-month rolling versus the current difference?

A. Well, if the Class IV value or the value of the products made in Class IV were a dollar less than the value of products made in Class III, that would enable you to pay a competitive equivalent Class III price so you would be on par with your Class III competitors.

Q. Over time?

A. Over time.

MR. BROWN: That's all my questions. Thank you.

JUDGE PALMER: Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. Good afternoon. Ben Yale for Select, Dairy Producers of New Mexico and

Continental Dairy Products.

First of all, I want to commend you for an excellent effort to get us outside the cage.

A. The box.

Q. It is more of a cage. You are aware that dairy producers were supportive of the competitive pay price as opposed to the end product price?

A. I don't remember that concretely but I knew that it was on the table.

Q. I have a few just specific questions I want to ask that deal with your testimony. First off, there is a lot of talk here about the difference between Class III and IV, but in an unregulated market if you have two manufacturing plants, one that is making cheese and one that is making butter-powder, ultimately the value of the milk is the same, is it not?

A. That's correct. There is a principle called factor price equalization. The factor of production would have the same value in the range of outputs. If they don't

have the same value the factor will migrate into the product as a higher value, so in an open market situation you would expect the factor price to be equal.

Q. During the development you were very active in the dairy industry at the time, but when we went from one manufacturing price of Class III to at that time the IIIA it was not in response to the market but in response to another regulated price elsewhere in the country, was it not?

A. I remember participating in those hearings and I think California was blamed in part for the problem.

Q. You are not going to say whether appropriately or not?

A. No.

Q. That is an oratorical question. At the bottom of the first page you talk about two of the issues. You mentioned a third one later, but I only want to deal with the two you have there. The Department was concerned about circularity and the lack of vigorous competition among the buyers.

How do you define circularity?

A. Circularity is the amount of influence that a regulated price has on the prices actually paid. It is hard to avoid that influence when there exists a regulatory minimum price. In order have a clean competitive price it is necessary to somehow eliminate the influence of the regulated price.

Q. The problem is, is it not, however, that the regulation begins to, almost begins to dictate what the competitive price is rather than the other way around or has that risk?

A. That risk exists, especially on the down side. It is very difficult to pay less than the regulatory minimum, at least for a proprietary handler, but it is not real difficult to pay more.

Q. You are aware, are you not, of the situation with the nonfat dry milk and the NASS reporting and how much of the NASS or, I'm sorry, the nonfat dry milk is marketed or contracted for?

A. I have seen references to the situation where a small number of firms are

reporting nonfat prices that a large percentage of it is in the hands of one firm.

Q. Are you aware that some of that nonfat dry milk is priced using the NASS price itself?

A. No, I was not, because these firms can use whatever input they want in negotiating prices. I don't know what inputs they use.

Q. But if you have a situation where the NASS survey is used as the reference price and then that ultimate sales price is reported to NASS you begin to have another form of circularity, don't you?

A. I think it is possible. It depends on whether prices are set prospectively or after the fact when the NASS price is announced.

Q. In the other part you talked about the vigorous competition. Again, I want to talk about the nonfat dry milk. You mentioned that there is one group, large volume that is in one hand and a little bit in other hands.

I don't know if that misstated your testimony. Maybe I need to ask it. You are

talking about the market power or competitive distribution within milk producers or buyers of milk from producers. How do you see that in the nonfat dry milk today?

A. I guess I want to just not answer the question because I have never bought and sold nonfat dry milk and I'm really not familiar with that market.

Q. Okay, that's fair. You also mentioned this issue of the ten counties. I noticed when you look out here in the East and you see the size of the counties it is easy to think in terms of that, but when you go out to the West they have some very large counties, like New Mexico and the like. Is that really a fixed number? Is there another way to describe --

A. A county has a convenient political identity where we can identify people as being either in the county or not in the county. It is convenient. If you have a small county with a smaller number of farms you are less likely to reach the threshold that we proposed. If you have a large county with a large number of

farms it is more likely, so to that extent using a county is not the perfect measure.

The question is what is the relevant market, and as I argued in the paper it is a procurement area for an individual handler, which is usually many counties but we don't have any data on that basis, so the next best thing is to go to a lower level, the county level, which is more conservative than we would like.

Q. I think you suggested what, ten contiguous counties?

A. Just as an arbitrary number. It could be smaller. It has to do with the comfort that vigorous competition does occur within this territory, however large it is.

Q. I want to go back to an earlier question I had regarding unregulated markets. What are the rules of the buyer and seller in the setting of the price?

A. I guess in the abstract you could say the buyer and seller negotiate and they negotiate on the basis of evidence of value.

Evidence of value would be product

markets like the Chicago Mercantile Exchange or product prices reported by the national or Dairy Market News Service. Both look for evidence of what the product is worth and try to come to a conclusion.

In fact, over time most firms in the dairy industry enter into long-term arrangements where both parties become comfortable with the production standards, the quality standards, et cetera, and they devise some sort of formula related to these evidences of value.

Q. You are talking about from the producer of milk to the processer?

A. No, I'm talking about between processors and their customers.

Q. I was ambiguous in my question. I apologize. I want to talk as if we were in an unregulated market and you have producers and processors. Do the producers have a role as a seller of that milk in setting the price?

A. They have a small role. They are not price makers as such because they come close to meeting the definition of being

participants in a competitive market, but their influence is felt based on whether they choose to stay with their existing buyer or to find a new buyer when the contract expires. If they are unhappy with the terms of trade with one buyer they will move.

Q. That can shift the value of the milk within the market one way or the other?

A. That's right. If someone is paying better than another, they will end up with more of the milk and that will be reflected in the local price.

Q. That is what you are hoping to capture?

A. We should capture.

Q. Under the current formulas we have NASS survey prices and make allowances and yields; right?

A. Correct.

Q. Is there any participation in any way by producers in any three of those factors?

A. Not directly. Indirectly the composition of milk produced by the producer would affect yields but not directly.

Q. When producers come either formally at this hearing or outside the hearing in other public or even private things and express frustration in the system, that they are not able to participate in the setting of the price, there is some legitimacy to that complaint; right?

A. I also teach economics, and part of what I teach is market structure. Agriculture has many of the features of the perfectly competitive market, which means the participants are price takers. It is an unfortunate artifact of that kind of market structure.

Q. But they would have more say in your proposal than what is currently? They would be more of a participant in the pricing as opposed to the current structure?

A. I don't see that they would directly participate any more than they do now. They would still have the choice to shift from one buyer to another as their contracts expire and presumably they would shift to the one that has the better terms.

Q. I want to simplify your proposal. You are talking about, fundamentally what you are doing is trying to price the other solids in the Class III?

A. Other solids is simply a mechanism for transmitting the information that has been captured in the competitive price zone into the federal regulatory scheme with the least amount of disruption.

Q. You said that the other value --

A. It is the residual that makes the two, brings the two into harmony.

Q. The way that it would work though, in many ways what is set as yields or make allowances become less relevant because the market would begin to dictate what that other value is, and if the yields and make allowances make too high a price than that other value would get smaller or if it made it too low a price that other value would get higher in the competitive market; right?

A. That is probably true but only in a competitive market, but it would get reflected indirectly in the basic formula price.

Q. And that's the goal of your proposal?

A. Yes.

MR. YALE: I have no other questions.

JUDGE PALMER: Questions? Yes, sir.

CROSS-EXAMINATION

BY MR. ROSENBAUM:

Q. Steve Rosenbaum. I have a few follow-up questions about how your system would work. I will just run through a couple different arrangements, and these are all directed to situations where the transaction is within a competitive pay zone.

If it is a sale from an independent farmer, by that I mean a non-cooperative farmer, to a regulated handler, proprietary handler, then that sale would not be subject to minimum pricing regulations; is that correct?

A. That's correct.

Q. If the farmer is instead a member of a cooperative and if that cooperative is deemed

the handler for regulatory purposes, then the transaction between the farmer and the cooperative would be free of minimum price regulations; correct?

A. That's correct.

Q. Now the cooperative in this case let's say then sells the milk to a Class III processer, but that is an unregulated transaction under the current system and would be unregulated under your testimony as well; correct?

A. To a Class III processer who is not a handler?

Q. Yes.

A. Cooperatives are prohibited from selling milk at less than order prices, so to that degree it would be a regulated transaction.

Q. Let's assume you are right about that. Are you suggesting that in the sale by the cooperative to the Class III processer minimum regulated pricing would apply under your scenario?

A. The language in the law, if co-ops

are going to enjoy privileges they are prohibited from selling at less than order prices.

There is some flexibility in that. For example, is the milk priced at the origin or the destination? If it is priced at the origin you could be above minimums or if it is priced at destination it could be below minimums because of transportation costs.

There is also the issue of sometimes on a spot basis milk will move for less than order values simply because it is distressed, but that provision is in the law and I expect it is enforced where necessary.

Q. But under your proposal even though this transaction is taking place in the competitive pay zone it would be subject to minimum price requirements?

A. It would be subject to the language in the legislation prohibiting co-ops from selling at prices below our minimums.

Q. The fact that your proposal has been adopted would not change that?

A. No.

Q. I guess to put it bluntly it seems to me this is a problem with your proposal because you are no longer really establishing competitive pay prices. Obviously in that scenario what the cooperative can return to its own farmers is really dictated by the minimum prices, the regulated prices that the cooperative is now receiving from the ultimate processer of that milk.

A. The federal order would dictate what the cooperative, the minimum that the cooperative would receive, but it would not dictate what the cooperative would have to pay its members.

Q. It may not be a legal obligation with respect to that payment, but its capacity, financial capacity to pay would be dictated not by its competitive relationship with its farmers but rather by the minimum pricing structure posed on its customer.

A. In part. It would dictate the minimum revenue that the co-op might extract from its customer, but then whether the co-op pays that money to local producers or retains

it for profitability or pays it to producers in another area, that is within the flexibility that a co-op can exercise.

Q. Long-term a co-op can't pay out more than it receives for the milk; right?

A. That's right. The co-op will fail.

Q. And in this scenario what the co-op is receiving for its milk is based on federal minimum pricing, not competitive prices?

A. That is largely correct. I think that is correct.

MR. ROSENBAUM: I think that's all I have. Thank you.

JUDGE PALMER: Any more questions? Mr. Rower.

CROSS-EXAMINATION

BY MR. ROWER:

Q. Good afternoon, Paul.

A. Good afternoon.

Q. Paul, have you considered how broadly distributed on a geographic basis this set of competitive zones would have to be to reflect national rather than regional marketing

conditions?

A. This is a dilemma with the proposal. Ideally it would encompass all the major milk production areas in the United States. When I looked at the sources of milk data that I collected from the Market Administrator's office there are big areas in the country where there are not enough producers or buyers of milk to be competitive by my definition, so I thing that's an unfortunate aspect but I don't know how to correct it.

Q. The clusters that you mentioned that may exist in Michigan or --

A. Ohio.

Q. Ohio or Texas may or may not be sufficient to reflect national marketing conditions better?

A. They may be sufficient. The question is are marketing conditions in these relatively uncompetitive areas, a small number of buyers, small number of producers, is that what we want represented or do we prefer that we represent the competitive environment we find in these clusters?

I think the competitive environment we find in these clusters may be more representative of what would occur if the whole universe were competitive. Again, there could be localized situations that are not adequately reflected in these clusters that we will be able to find.

MR. ROWER: Thank you.

JUDGE PALMER: Mr. Schaefer.

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. Henry Schaefer with USDA. Mike Brown mentioned some unregulated portions of Idaho where there is a significant quantity of Class III milk and Class IV milk.

Do you anticipate those areas being included because theoretically that would be competitive, there is no federal order regulation there?

A. I would like to see unregulated areas included. Again, as Mr. Rower mentioned, that expanded universe of data, that would be helpful.

The proposal as I have presented it is embodied within the regulatory scheme and I didn't extend it and I didn't discuss it with my clients as to how it would extend into unregulated areas, but first and foremost you would need to have a competitive environment and, second, a mechanism for collecting the information, and those two things I can't determine from data I have available.

Q. When you talk about really the only changes in the Class III and other solids, when you talk about the pool as I understand the proposal, all of the handlers, both those that are buying milk in this competitive pay price zone and outside of it, all of that milk would participate in the pool?

A. All of that milk would participate in the pool, but the PPD would not be paid, the current PPD would not be paid to the producers in the competitive price zone. It would be paid to producers who are not in the competitive price zone. Mechanically the other features would function just as they do now, just a difference in how the PPD is handled

between the two groups.

Q. Along that same line then all the class prices that are calculated today in addition to the BFP or your new Class III price calculation would be used to calculate that pool each month?

A. That's correct, in the same method it is now being done.

Q. Do you have any provision of what the Market Administrator of the Secretary would do if there was significant quantities of milk not pooled in these competitive areas?

A. If it were not pooled the milk would no longer be subject to any kind of regulation and would not be eligible to receive the producer price differential, but I think that the chance of that happening would be very slim if we used the 12-month rolling average BFP. I don't think we have had a 12-month period where the PPD has been zero or below zero. We have had plenty of months where it has been below zero but not on an annualized basis, but I haven't checked that out to make sure that that is correct.

P. Christ - Cross by Mr. Shaeffer

Q. The future's market, the CME Class III future's market currently settles on our computed Class III price. How would you envision this change impacting their settlement and what they might do or have to do to stay in sync with our pricing?

A. I would expect that the dairy committee at the Chicago Mercantile Exchange would adopt the new basic formula as the settlement price. They made that switch when we switched from the M-W to the component formula, so I think they would probably make the switch again.

Q. Back in 2000 they had the start of the forward contract pilot program and so proprietary handlers in particular did some forward contracting at that time.

How would you envision the proprietary handlers, particularly forward contracting, and how that might impact your competitive price?

A. Okay, forward contracting can generate income or losses, and as such it can affect a handler's ability to pay and so it may

cause them to pay less or may cause them to pay more but it is no different than any other business transaction. It may generate more income or less income, but it would affect the financial health of his organization, which in turn would affect his ability to pay.

Q. Would you then incorporate those forward contracts into the competitive price?

A. The answer is no. It is like the other influences that were brought up like a payment for a premium for rBST free milk or for hauling subsidies.

There are a whole bunch of flow of funds that could influence pay price. I don't know if we can capture them all. That flow of income I don't think should be taken into account, so these I don't call them extraneous flows of income, they are related, but I would not include them in adjusting or modifying this reported pay price. I would just take the number as it comes until we have a significant amount of experience and then look for distortions.

MR. SCHAEFER: Thank you,

Paul.

JUDGE PALMER: Anybody before Mr. Smith? Yes, Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. Thank you, Judge Palmer. I forgot to ask, are you familiar with the term 13th check?

A. Yes, I am.

Q. That is a payment of revenues at the end of the fiscal year to members of the cooperative that have not been paid out in the ordinary month of payments.

A. That's correct.

Q. How if at all would your proposal capture the payment of a 13th check?

A. Our proposal would not. This is a rebate of profitability of the organization to the member, the co-op member. It wasn't considered in the old Minnesota-Wisconsin price series and we would not consider it here either.

Q. Do you agree with me that a

cooperative might elect to pay more on a monthly basis and thereby have less left to pay the 13th check?

A. That's one of the choices that they have. A prudent member of a co-op would evaluate the total returns from being a member, including the 13th check.

Q. Of course the converse is true --

A. Yes.

Q. Pay less on a monthly basis and more on a --

A. Yes, that's true.

Q. The Herfindahl, is there enough competition analysis? You described that as it applied to buyers. Do you also propose to apply it to sellers?

A. You mean individual sellers?

Q. No, I mean sellers within a county. Let's say there is a co-op that represents 80 percent of sellers and 20 or 30 independent farmers. It would make a difference, wouldn't it?

A. First, when you take that into account the answer is no. This proposal is

focused on the transaction between farmers and the first buyer. The second transaction between the first buyer and his buyer is outside the range of what we are proposing here. That transaction would be handled just as it is now at the same federal prices.

Q. You distinguished between a transaction between a producer and its cooperative or the cooperative to which the producer is a member and a transaction between a cooperative and the handler buying milk from the cooperative.

A. Yes.

Q. Assume with me for a moment that there are cooperative associations who have elected for one reason or another not to be handlers.

A. That's correct, bargaining co-ops.

Q. You are aware that there are such co-ops --

A. That's correct.

Q. -- who negotiate for and receive payments from handlers and then distribute that money back to the producer members. In that

case your proposal would capture the transaction between the cooperative and the handler as an exempt transaction; am I correct?

A. Not correct. If the cooperative is paying the producer, I believe they would show up as the handler for that milk. They would be paid by their buyer and then in some cases they could account to the pool and in some cases they would not. I will get into that.

My understanding of bargaining co-ops as I observed them in the Midwest, they negotiate some terms of trade with the buyers but the say cheese plant buyer will pay the producers directly and then the member will pay dues back to the cooperative. I don't know of any situation where a co-op pays producers and is not a handler.

Now in some and maybe all the orders the settlement price between the customer of the co-op and the co-op is blend price, it is not class prices, and we would not change that. We talked earlier about settling with the pool. The person who accounts at class prices settles with the pool. The co-op would receive the

blend price and, well, it probably would not receive the PPD part of that.

This is a sticky area which I had not considered, where the co-op would be paid the blend price, would they include the PPD portion of that or would they have to rely on the 12-month average PPD. I would prefer that they rely on the 12-month average PPD.

Q. Milk that is reported as diverted to a non-pool plant, be it a cooperative handler, diversion is a term of art in the federal order system.

A. Yes, but I understand it.

Q. In the context that we are talking, that diversion could be a contractual commitment of a co-op to make a sale to a cheese plant which is not itself a regulated plant?

A. That's possible.

Q. On that transaction the co-op must account to the pool in your proposal at a Class III price?

A. That's correct.

Q. But the co-op may sell to the buying

handler that receives the diverted milk at any price the co-op wants to charge for it?

A. Okay, that's a legal question which I'm not prepared to answer. I know the language of the law prohibits co-ops from selling below order price, but is it just other order handlers or unregulated handlers? I'm not prepared to answer.

Q. You said that your proposal would be superimposed on the existing system of a component private pricing.

A. That's correct.

Q. And that there would be no change?

A. Other than the other solids price.

Q. Other than the other solids price. Does your testimony apply equally to the component pricing system adopted as the interim final rule effective February 1 in exactly the same way as it would apply to a final rule that is different that came out of this proceeding?

A. I have to admit I have not read the interim final rule. I presume the structure of component pricing will not have changed, maybe the parameters will have changed, and in that

respect this proposal would apply to both.

Q. In saying that there would be no change you are not advocating either for or against component prices?

A. No.

Q. The proposals at issue in this proceeding?

A. No.

Q. No, it is correct that you are not?

A. It is correct that I am not advocating any of the component pricing proposals.

JUDGE PALMER: Mr. Smith.

REDIRECT EXAMINATION

BY MR. SMITH:

Q. Dan Smith. Two follow-up questions. Statutory correction is one. Paul, this is essentially the first time you have had the opportunity to present this proposal in this type of forum much less present it very much at all.

From the presentation of your statement and the questions that you received

how would you describe the strength of your proposal as it fits within the existing component pricing system?

A. The strength of the proposal is that it relies on the competitive market for milk rather than the competitive market for any or all products of milk, and therefore it is a more precise measure of the value provided at the farm and so I think it is an improvement in precision in the regulatory system.

Q. Would you say at the same time the proposal does not purport to tip over the whole structure of component pricing at the same time that it introduces that?

A. No, there is no intent or effort to significantly modify the component pricing system as it now exists other than the other solids price.

Q. If you could take off your milk industry hat and put on perhaps your former USDA alumni hat and even your senior adviser to this group, not senior in the sense of chronology but respect --

A. Senior with respect to decrepitude.

P. Christ - Redirect by Mr. Smith

Q. That's from you, not me. Might you have a suggestion as to how this proposal can be moved forward in the process based on your experience with this regulatory process over the many years you have worked with it?

A. Okay, first let me mention how we got here. I had presented a crude outline of this at the Dairy Economists meeting in Charleston in April simply because I have an interest in it. Then I learned that the Maine Dairy Industry Association is promoting a competitive pay price to adjust a component pricing system without much detail. Well, we got together and I decided to develop more detail.

I don't consider this to be absolutely complete at this point. I think it is a workable proposal in its present form. However, there is a lot of information that would be useful to make it better understood and more precise and in particular determining everywhere where we can find these competitive price zones. The Market Administrators have that information. Maybe the Market

Administrator has information about some of these other factors that may influence the pay prices for milk, for example hauling subsidies, premiums, maybe even rBST free, something like that. How many distortions in the so-called competitive price might exist out there and how big a problem are they?

What I would like to have had before this hearing is that kind of background information that I personally don't have access to, so I would hope that members of the Department would maybe focus some effort in getting some more data and more analytical study of how this would impact the system and the industry.

I certainly don't feel that it should be ignored or removed from this proceedings because I think it is a really important alternative to coming up with an improved system for getting the basic formula price for milk.

If such data could be developed it would be of interest to the Department, it would be of interest to people in the industry

so they could have a better feel for what the impacts would be.

We had a day of informal proceedings associated with the other proposals. It might be useful to have something similar related to this idea of competitive pay prices. This proposal, because it does deserve some more information and analysis, could be on another track relative to the other proposals just as we have already had an interim decision on some of the proposals. We could have a final decision or recommend a decision on this proposal that is not timed exactly like the other proposals.

I would encourage some flexibility in both the regulatory process and maybe a lot of flexibility in terms of helping develop data from which we could draw better inferences about how this would work.

Q. Let's correct the statutory error.

A. In the proposed federal order language changes that I have I would go to page 11. In the center of the page there is a Section 1000.50M, which refers to the nonfat

solids price.

That is an error. The intent there was to refer to the other solids price which is Paragraph O, so scratch the M and insert O, and then scratch the first word "nonfat" solids or "nonfat" and put the word "other" in, so it would now read "other solids price".

Again in the next sentence the second word is "nonfat". Scratch "nonfat" and enter the word "other", so it would read the "other solids price per pound round to the nearest 100 cents," et cetera. This was simply an error on my part.

MR. SMITH: I have nothing further, Your Honor. Thank you.

JUDGE PALMER: Any questions? You are excused, sir.

Let's take another witness for about a half hour. Is everybody ready to do that? Dr. Stephenson, if you would come forward, sir.

MS. TAYLOR: Your Honor, could I move that Exhibit 75 be received into evidence?

JUDGE PALMER: Oh, yes. Thank

you very much. It is received.

(Exhibit No. 75 was received into evidence.)

MARK STEPHENSON

a witness herein, having been previously duly sworn, was examined and testified as follows:

JUDGE PALMER: Doctor, you are under oath. Who wants to start examination of the doctor? Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. John Vetne for Equimart. Dr. Stephenson, good afternoon.

A. Good afternoon.

Q. Your testimony, which is marked Exhibit 72, builds upon a prior study and prior testimony marked as Exhibits 75 and 76 at a hearing in Ohio last year; correct?

A. I don't recall the exhibit numbers but, yes, sir.

Q. In this round you updated some of that information for many of those plants to

reflect more current data; correct?

A. That's correct.

Q. In the September study and testimony the plant cost data for cheese makers included 16 plants in a stratified sample of which five plants were very large and the remaining eleven plants were not large or not super large; correct?

A. That's correct.

Q. In this particular round you surveyed costs of eleven plants that process cheese; correct?

A. Correct.

Q. Of those eleven there are three plants that were not included in last September's data; is that correct?

A. That's correct. I did have three plants that had data questions that weren't resolved by the time of the hearing but the data came in later.

Q. So those three plants participated in the last survey, but the results were not included in the survey results because you had questions?

A. Correct.

Q. And those questions have since been resolved and they are now included for the update?

A. That's correct. Those three plants are included in this updated study.

Q. There are eight plants in the updated study whose cost data was fully included in the last survey and is fully included in the current survey?

A. Yes.

Q. The current survey, however, unlike the last survey, is not one in which large and small plants have been stratified?

A. There was no attempt to do that. I didn't have the time nor the opportunity to solicit plants that had not done the study before or to think about taking draws out of the list of plants that I had, so I contacted the operations who had previously participated in this project and invited them. Not all participated again but many of them did.

Q. For your prior testimony you were asked to do the study and were compensated for

your time by USDA; is that correct?

A. Correct.

Q. For this updated portion you were asked to do the update by my client, Equimart, NDA and others who are proponents of make allowance changes; is that correct?

A. That's correct.

Q. You expect that my clients will compensate Cornell University for your time?

A. I have very much hopes of that, yes.

Q. Are you personally receiving any extra remuneration as a result of this work?

A. No, I'm not.

Q. This is captured in your ordinary salary from Cornell?

A. Yes, that's correct.

Q. Going back to the cheese plants and the differences, the plants that are not included this time that were included last time, are they in the category of the larger plants or smaller plants from the last survey?

A. Most of those plants would have been in the small category, the ones that didn't participate this time that did last time.

Dr. Stephenson - Cross by Mr. Vetne

Q. Of the plants that are included in this survey in which you gave testimony yesterday could you give us an indication of the range of annual cheese production of those plants for example from greater than x million pounds of cheese to in excess of x million pounds.

A. Of all of the plants?

Q. Yes.

A. The range was greater than 30 million pounds of cheese annually to greater than 100 million pounds of cheese annually.

Q. The three plants that were new this time around in the survey results, where in that range do they fall? Are they in excess of the 100 million pounds?

A. They all are in excess of the 100 million pounds, that's correct.

Q. In your testimony in Strongsville, Ohio in September 2006, Exhibit 75, you discussed a correlation between cost and size of a plant, that is size meaning volume of cheese produced.

Did you observe a similar

relationship this time among the costs that were reported to you with the eleven plants?

A. I didn't do the same regression on this data to have reestimated the cost function. However, it certainly was true that the largest of these plants that hadn't been included last time came in with quite low costs that would have been corroborated by the cost function we had last time.

Q. Do you have any reason based on your observation of the eleven plants this time to believe that the formula you provided last time on correlation between cost and size is not valid?

A. No. I think it probably is well within the range. I mean, certainly not every plant last time fell precisely on the graph that was indicated or line that was indicated. Some were above the line, some below, and this would have been true of the additional plants this time, but they were well within that area, that range. They were larger plants though.

Q. Did you make similar observations that there is a general relationship between

the size and cost for plants producing three products, whey and butter and --

A. Yes.

Q. Has that been your observation in prior surveys?

A. In every one of the cost studies that we have done whether they have been fluid plants or whey or butter or cheese operations we have always observed a large number of plants that there is quite an economy of scale in these operations.

Q. I want to ask you some questions about cheese plants and whey plants included in the survey. Your testimony in September was that the whey plants included in the cost survey were a subset of the cheese plants that were also included in the survey.

Is that also true for the survey on which you presented testimony yesterday?

A. That is true. Only whey plants that were associated with cheese plants are included in this survey.

Q. Of the seven whey plants does that mean they were included, the seven whey plants

were a subset of the eleven cheese plants?

A. Yes, that's true.

Q. So it is not just associated with any cheese plants, it is associated with these particular ones?

A. It is associated with these particular ones. However, I might as an addendum say some of these plants processing whey were processing more of the whey that was produced in that cheese plant.

Q. That was my next question. By that you mean that they were receiving whey sold by other entities or within an organization from another plant?

A. I do, yes.

Q. With respect to such transactions let's say sold by another entity, is there any line or column either on the cheese plant or the whey plant cost summaries, which are Tables 1 and 2, on which the cost of condensing, loading and transporting and unloading condensed whey from a cheese plant to the receiving plant where those costs would be captured in Table 1 or 2, Table 1 being cheese

costs, Table 2 being dry whey costs?

A. No. We have considered a plant that manufactures condensed whey and sells that product to another plant, to have achieved their costs of doing so in the sales price, and so we are not interested in following that cost at that point because it is not a product of interest for us.

Q. You make an assumption with respect to the cheese plant that it does not incur additional costs, it doesn't have a cheese cost attributed to that, and it is revenue to the sales equal to the cost of getting it to the receiving whey plant?

A. That's correct. We sometimes do that sort of thing with enterprise accounting in different operations when the cost of doing so may be a relatively small portion of total receipts for the plant.

Q. With respect to the four cheese plants included in the cheese plant survey that did not have whey operations, did some of those cheese plants condense and transport the whey to other plants operated by the same

Dr. Stephenson - Cross by Mr. Vetne

organization?

A. Yes, one of them did.

Q. With respect to that kind of transaction where there is no sale price there is a cost at the cheese plant end for condensing and unloading or condensing and unloading the whey onto a truck. Am I correct that that cost at the cheese plant end was not captured in your reported costs for making cheese?

A. The cost of condensing was not incorporated as a cost of processing cheese. We do have a line in there to collect costs on whey disposal or transportation, but we don't explicitly capture the costs of condensing in a plant to move to another plant for further grind.

Q. For that kind of operation included in your survey were those condensing, loading, transportation and unloading costs included on any line of the whey processing, at the whey processing end for the internal kind of transaction?

A. For the internal transactions? No,

they aren't. We expected the product comes into the door and at that point you begin your transformation of the product, grinding, whatever, to incur your cost. We don't have any price of product if you will in the survey, so we don't gather prices for milk that was purchased. We don't gather information about products that were sold from the plant, the prices of those products.

Q. Let me move for a second to butter and powder plants. To the extent that butter is produced in a plant that is separate from a condensing and drying plant, do the lines and columns appearing in Tables 3 and 4 capture costs of transporting cream from a drying plant to a butter churning plant on any line or column?

A. We had one operation that had considerable transportation costs from drying plants to a churn and those transportation costs were included in there. Generally speaking, I mean, we do have a line area where that could be done, but generally speaking cream sales from a plant aren't recognizing

transportation costs.

Q. You said in one case that was included. That would have been at the butter plant end?

A. In this case the butter plant incurred the costs.

Q. With respect to that butter plant where there were buttermilk byproducts of the churning, that in turn would in turn have to be dried and sent back to the powdering plants.

Would those costs have been included of loading and transporting it back to the powder plant?

A. If we had that hypothetical situation, I guess if we had thought enough to catch it we would have tried to include that within the organization. I don't believe that that was done, however.

Q. At the time of your testimony in September with respect to butter plants you expressed discomfort with the reliability of the results that you observed and reported in September.

A. Yes.

Dr. Stephenson - Cross by Mr. Vetne

Q. Can you comment on your confident level with respect to the costs reported in the current survey.

A. I feel much better about these. An economist I guess or statistician would normally like to have two different things that they are looking at when they are trying to understand the quality of the information they might have. One is how many observations do you have.

With the butter plant the first time around and this time around there are fewer than I would like to have in a sample like this, but in the first collection that we had of data and information there was also a lot of variability in the calculated costs of processing, so those two things, relatively few observations and quite a bit of variability between the plants that we had seen, made me give the remark that I was not as comfortable with butter data as I was the other data.

I should also tell you that I did make a correction to the table that was reported in testimony yesterday and I have

copies in the back of the room of that.

The only line on that table that was incorrect, which was Table 3, processing costs for butter plants, was the line that said last time weighted average.

I made a copy and paste error from a previous table in the chart and I didn't update that last time weighted average line. They were in fact the cheese numbers that we had from Table 1. That has been corrected. It has been asked that I read these values in.

Q. Yes, please. You have that corrected page 8 in the back of the room?

A. It is, and I have additional copies here.

MR. VETNE: Your Honor, can we mark that?

JUDGE PALMER: That will be 76.

MR. VETNE: It is a one-page exhibit on both sides.

JUDGE PALMER: I will receive it too.

(Exhibit No. 76 was marked for

identification and received into evidence.)

BY MR. VETNE:

Q. Just to hammer home let's read that into the record as you read that line for the record yesterday.

A. Table 3, processing costs for four butter plants, the numbers from the September testimony were average pounds of butter, 31,400,511; labor costs, 2.81 cents per pound; energy, 1.14 cents per pound.

Ingredients are included over in the repairs and depreciation and other columns.

Packaging was 1.04 cents per pounds.

The repairs, depreciation and other costs were 5.41 cents per pound.

General and administrative costs were .64 cents per pound; return on investments was 1.08 cents per pound for a total cost per pound of 11.08 cents per pound.

Q. Your testimony in reading this through, you made reference to the fifth column, repairs and depreciation, twice, used the repairs, depreciation and other.

Is it correct that the column

Dr. Stephenson - Cross by Mr. Vetne

includes other miscellaneous costs equivalent to the line in the CDFA reported survey of nonlabor processing costs?

A. CDFA California has a line that is called nonlabor processing costs and in that nonlabor processing costs they typically are including everything that is in this repairs, depreciation and other column as well as energy costs. This year I believe they broke energy out, which is the reason I have chosen to do it here.

Q. In the survey reported last September seven plants participated or eight plants participated in the nonfat dry milk survey and seven this time. Are the nonfat dry milk plants in this survey a subgroup of the eight that participated last time or are there some differences?

A. No, they are all the same plants that participated last time.

MR. VETNE: Those are all the questions I have at the moment. Thank you very much.

JUDGE PALMER: Any other

Dr. Stephenson - Cross by Dr. Cryan

questions?

CROSS-EXAMINATION

BY DR. CRYAN:

Q. Roger Cryan. I'm making my first appearance this week, but I have appeared in previous sessions. I'm going to ask Dr. Stephenson some questions based primarily on discussions I previously had with him so we can go over some numbers.

Last fall in Cleveland at my request you broke out energy costs for each of the four products between fuel and electricity.

Did you provide that same breakdown with respect to the survey?

A. I have those numbers. I can provide them if you would like.

Q. Would you read them for the record please.

A. For the cheese plants the average electric costs over the time period for the plants was .52 cents per pound and the fuel costs were 1.05 cents per pound.

Q. Say that again.

A. 1.05 cents per pound. That was on a monthly average volume of 9,892,611 pounds of cheese.

I would like to just tell you that these numbers I would consider to be a little bit preliminary. I did break them out rather quickly and I would like to make sure that they are numbers that, a couple of them are a tenth of a cent different from the totals that I reported in the tables but they are pretty good numbers.

Q. If you have some corrections to make will you make those available? These will be pretty close?

A. Yes.

Q. I will point out in September Dr. Stephenson made similar on the fly calculations that he concluded were correct in the final analysis; is that right?

A. Yes. For whey the electric costs averaged 1.35 cents per pound and the fuel costs 3.01 cents per pound. That was on an average volume of 4,893,538 pounds per month.

For butter the average electric

costs were .44 cents per pound; average fuel costs .98 cents per pound, and that was on an average volume of 4,802,234 pounds per month, and for nonfat dry milk powder the electric costs averaged 1.29 cents per pound and the fuel costs were 3.46 cents per pound on the average volume of 5,845,205 pounds per month.

DR. CRYAN: I would like to ask that notice be taken of two pages in this same hearing that we have been discussing from last fall in Cleveland. Pages 133 and page 134 represent the cross-examination during which Dr. Stephenson offered the same numbers that corresponded to his previous study and I ask that notice be taken of that.

JUDGE PALMER: So noted.

BY DR. CRYAN:

Q. Mark, you and I also discussed data for the purposes of establishing a base for some of these costs. We discussed volume data for the purposes of establishing some sort of base.

Based upon your paper, your statement, there is a table that shows a

distribution of plant month, a plant month distribution, page 4 of Exhibit 72, which demonstrates that most of your surveys were based on the four quarters of 2006.

Is the volume concentrated in those same months to your knowledge for those same quarters?

A. Without having done a calculation, I would imagine, yes. This is the biggest volume of observations, and to the extent you have some difference month to month for products processed in plants it could be different, but I wouldn't expect it to be much different.

Q. Is it possible that you could provide a more detailed breakdown by product of the pounds in each survey for the record?

A. Within the confines of confidentiality I'm willing to do that. I wouldn't report a plant's volume if it is the only operation in a month, or two plants as far as that goes, but to the extent I can display it like this, yes, I would be glad to.

Q. I would appreciate that.

DR. CRYAN: With respect to

this data I would ask that energy pricing that is released on a monthly basis by the Bureau of Labor Statistics discussed in previous sessions, that the data be recognized in its updated form through the close of the hearing record.

Those two series are the producer price index for industrial natural gas, Series No. WPU 0553 with a base equal to December 1990, and the producer price index for industrial electricity, Series No. WPU 0543 with a base equal to 1982. I would ask that those both be recognized for the record.

JUDGE PALMER: We will take official notice of it.

MR. CRYAN: Thank you very much. I have no further questions.

JUDGE PALMER: Mr. Rosenbaum. Actually, I'm looking at my watch. I'm trying to be a little more regulated here. It is actually 2:30 so let's taking a 20-minute afternoon recess.

(Recess taken.)

JUDGE PALMER: Let's try

Dr. Stephenson - Cross by Mr. Rosenbaum again.

CROSS-EXAMINATION

BY MR. ROSENBAUM:

Q. Stephen Rosenbaum. Good to see you again, Mr. Stephenson. Just to orient ourselves, you performed two surveys. One you testified to in September 2006 and the other to which you testified yesterday and today; correct?

A. That's correct.

Q. Just to simplify things, I will call the first one the September 2006 survey and the second one the July 2007 survey if that's okay.

A. That's fine.

Q. I know that's not actually the case. When you performed the September 2006 survey there were 138 cheese plants in the population; is that correct?

A. If I recall correctly. I could look that up, but I believe that's right.

Q. You divided those cheese plants into two strata; is that correct?

A. Yes.

Dr. Stephenson - Cross by Mr. Rosenbaum

Q. One strata that represented the top ten percent of plants as measured by annual production; correct?

A. Yes.

Q. And the other strata that represented the other remaining plants; correct?

A. Yes.

Q. The strata in the top ten percent of plants had 13 plants in them?

A. Yes.

Q. You selected five of those 13 plants at random to actually participate in the survey; correct?

A. Yes. It was stratified. We wanted to make sure that we had some of the larger operations in the study, and on sample draws that were not stratified we found that, just because of the large numbers of small plants still in existence, we were drawing very heavily from small plants and not often from the large.

Q. Do you know what the average production -- let me back up. The five plants

Dr. Stephenson - Cross by Mr. Rosenbaum

that you selected from the upper strata, the plants with the ten percent highest production, did all five of them actually participate in the survey?

A. Let me try to recall. No, we didn't have all five of them participate in the survey. I believe it was three plants that we had here who participated this time or got qualitative data or had data that I had questions about last time, enough questions that they weren't included in the study, so we did have a couple of large plants included in the survey last time, but in the summaries that were given at the time of the testimony in September 2006 we didn't have all of those plants in the survey.

Q. Let me try to get all the details set forth. You selected five plants out of the top strata; is that correct?

A. That's correct.

Q. You selected 15 plants out of the bottom strata; is that correct?

A. Correct.

Q. For a total of 20 plants to

participate in the survey?

A. Correct.

Q. But the data from only 16 plants were included when you actually reported data in your testimony; correct?

A. Yes, although, as I said, we did have some plants that had submitted information that were not included in all of the -- we had 16 plants that had good information that were listed in here. We had a few plants that had not given information or that hadn't answered enough questions to be included.

Q. Of course we are talking here so far just about the cheese survey, correct, just to make sure we are on the same page?

A. Yes.

Q. As you just described, you included 20 plants in the survey, five from the top strata and 15 from the bottom strata, but the data from only 16 were included when you reported the data results in your testimony, so there were four dropouts so to speak; correct?

A. That's correct.

Q. Of the four dropouts how many from

the top and how many from the bottom?

A. Three dropouts from the top strata.

Q. And therefore one dropout from the bottom strata; correct?

A. Yes.

Q. So in terms of the data that actually got included in the report of costs, there were two plants from the top strata and 14 from the bottom strata; correct?

A. That's correct.

Q. Let's switch to the July 2007 survey, which is the one covered by your testimony in Exhibit 72, which is your testimony you gave yesterday. There are eleven plants covered by that survey; correct?

A. That's correct.

Q. If I understood your testimony, you went back to the same 20 plants you had gone to in your September 2006 survey; correct?

A. That's correct. Well, I should back up. I went back to the same group of 20 with the exception of the plants who refused to participate, not for data quality reasons but for just a reluctance to actually involve

themselves in the survey. In other words, there were a couple of plants who simply said, no, we don't want to be involved in this.

Q. These were plants that had been involved in September 2006 but told you they didn't want to be involved in July 2007?

A. No. When we asked plants in the first stratified draw we had two plants who said, no, I don't want to be involved in the study at all.

Q. Were these cheese plants?

A. One of them was.

Q. You testified a few minutes ago that you approached 20 plants to complete the survey and only six of them actually provided data that was used in the report that you made.

Was this one plant that refused to participate one of the four that explains the difference between 16 and 20?

A. Yes.

Q. Was that a plant from the top strata or the bottom strata?

A. I don't recall that. It wasn't an exceedingly large plant but it was a good size.

Dr. Stephenson - Cross by Mr. Rosenbaum

Q. There are eleven plants in the July 2007 survey; correct?

A. Yes.

Q. How many of them are in the top strata and how many of them are in the bottom strata?

A. I would have to go back and look at the cut line on that, but I believe that four of them are in the large strata.

Q. Which would mean seven in the bottom strata?

A. Yes.

Q. Is it fair to conclude that the results of the July 2007 survey are more skewed towards larger plants than had been the result of the September 2006 survey?

A. It certainly is. You can see from Table 1 in here that the average plant volume process between the last survey and this one indicates that the average volume processed in cheese plants was nearly doubled, so we did lose a few of the plants this time from the smaller sample that didn't participate, chose not to, and we had more with quality data this

time from the large subset, so we lost a tail on one side of the distribution and gained it on the other.

Q. Well, correct me if I'm wrong, but you went from 14 plants in the lower strata participating in the September 2006 survey to seven plants in the July 2007 survey that came from the lower strata; correct?

A. I believe that's right without looking.

Q. So you lost seven plants from the lower strata?

A. Yes.

Q. And you lost one plant from the upper strata but gained three additional plants in the upper strata; is that right?

A. I had one plant from the upper strata who chose not to participate this time.

Q. That was all set by the fact that you had three plants in the upper strata that did for the July 2007 report purpose report data in time for you to include it in your report; correct?

A. Yes.

Dr. Stephenson - Cross by Mr. Rosenbaum

Q. Three plants had not had their data included in July 2006; is that correct?

A. That's correct.

MR. ROSENBAUM: Your Honor, I would like to ask that Exhibits 75 and 76 as presented by Dr. Stephenson in his testimony on or about September 14, 2006 be admitted into evidence by reference. These are the work product that make up the September 2006 survey. They are explicitly referenced by Dr. Stephenson in Exhibit 72, which is his current testimony.

JUDGE PALMER: Were those the exhibit numbers in 2006, 75 and 76?

MR. ROSENBAUM: Yes.

JUDGE PALMER: That's a different 75 and 76.

MR. ROSENBAUM: It's confusing. I will call them the September 2006 Exhibit 75 and the July 2007 Exhibit 76.

MR. VETNE: Your Honor, they have been marked as part of this record as Exhibits 36 and 37.

MR. ROSENBAUM: They have not

been accepted yet.

MR. VETNE: They have been marked and there was a ruling of limited usefulness in the absence of Dr. Stephenson.

JUDGE PALMER: We will receive them now.

MR. ROSENBAUM: So that is 36 and 37.

(Exhibit Nos. 36 and 37 were received into evidence.)

JUDGE PALMER: If there is a problem with the numbering somebody will let us know.

BY MR. ROSENBAUM:

Q. Dr. Stephenson, I'm sure you will recall back in 2006 -- do you have copies of these?

A. I do, yes.

Q. Exhibit 75 was your actual oral testimony that you read in the record if you recall. You discussed there the need to make adjustments in the results of a stratified brand of sample in order to come up with a number that was representative of the weighted

Dr. Stephenson - Cross by Mr. Rosenbaum

average cost of production for the population as a whole; correct?

A. That's correct, or I suggested that that would be a reasonable thing to do.

Q. Specifically do you recall that if you only looked at the plants that have been included in the sample you did back in September 2006 the weighted average cost of production was 16.38 cents? Do you remember that?

A. Yes. I think that was right.

Q. However, you testified that once you adjusted for the fact that you had performed a stratified sample the weighted average cost of production was 20.28 cents?

A. Uh-huh.

Q. Say yes or no for the record.

A. Yes, I recall that.

Q. Do you recall testifying that you believed that that was the best number in terms of the actual weighted average cost of production for commercial cheddar cheese plants located out of California, namely 20.28 cents?

A. I actually didn't reread this, but I

Dr. Stephenson - Cross by Mr. Rosenbaum

recall that I did talk about whether or not you wanted to cover something like 80 percent of the volume of cheese in this country because it is not a single number that would come off of a graph like that or 80 percent of volume or 50 percent or something like that.

Q. I asked you a question, and let me just quote it for you from the hearing last time and ask you whether you still submit to it or agree with what you said previously. My question is from page 82 of the transcript of the previous hearing back in September 2006.

QUESTION: "If USDA were to conclude that the starting point for determining make allowances should be the weighted average cost of producing for commercial cheese, a cheddar cheese plant located outside of California, then 20.28 cents is the number they should use. Is that correct based upon your work?

ANSWER: "If only one number could come out of my lips that would be the best I could give."

Is that still your view?

A. I did not do the refitting of the

regression with this new data. I believe that these new plant data fall very well in line with what was on here, but I would not want to say absolutely until I redid that work.

Q. Is it still your view that that kind of refitting produces the best number?

A. I think that it probably does because the last time we had an oversampling of smaller plant in the survey. This time I think we have an oversampling of larger plants in the survey. If you really want to get something representative of the population, then you need to make a statistical estimation of that.

Q. The results of your July 2007 analysis would indicate that based upon the plants that are included in the sample the weighted average cost of producing cheddar cheese plants has declined by roughly half a percent per pound; correct?

A. Yes.

Q. However, you also note that when one simply examines the change in the cost of processing for the eight plants that participated in both the September 2006 survey

Dr. Stephenson - Cross by Mr. Rosenbaum

and the July 2007 survey the costs of processing have increased by 1.5 cents per pound; correct?

A. That's correct.

Q. 1.76 cents per pound, excuse me. Is it reasonable to conclude that the half cent decline in weighted average as shown in Exhibit 72 as presented today is in all likelihood a reflection of the fact that the sample is now more heavily weighted toward larger plants as opposed to their actually having been a decline in processing costs?

A. I had hoped that I made that clear in my testimony but I'm glad to clarify that, yes, I think that's the case.

There are a couple of things going on in this report. One is a different set of plants that we actually have in here even though it was drawn from the same group that we had last time, but the same plant to plant comparison indicates that some of the real costs of processing have increased over that time period.

Q. Is it fair to say that the most

reasonable conclusion to draw from your July 2007 report is that the costs of processing for cheddar cheese plants has increased by 1.7 cents per pound?

A. I think that that is the strongest conclusion that can be drawn from the data. We do have more observations now at the large end of the scale and I think that makes me feel better, the full length of plan observations that we had.

However, looking at -- if the question is how have costs changed for plants over this roughly year and a half time period, I think that 1.7 cents a pound is approximately the correct number.

Q. As we discussed a few minutes ago, you had testified that in September 2006 that you saw it appropriate to make an adjustment for the fact that you had performed a stratified sample for cheese; correct?

A. Yes, that's correct.

Q. You did not perform a stratified sample for the other dairy products; correct?

A. I didn't have enough information on

the population of plant volumes to be able to do that.

Q. There was no need or even hypothetical way to perform an adjustment for those other products because you hadn't done a stratified sample to begin with?

A. I didn't have the information to do that.

Q. Does the fact that you didn't have the information to do that for other dairy products change the conclusion that you testified to both in September 2006 and today that it is appropriate to make such an adjustment to the cheddar cheese data given the fact that you did do a stratified sample for cheddar cheese?

A. As an economist I guess I would think that we ought to use the best data that we do have available and draw the best conclusions. With more information about this population of cheddar plans I think you can make a stronger statement. With less information available, then I think you have to take the information that you have.

Dr. Stephenson - Cross by Mr. Rosenbaum

Q. Given the information you had about cheddar cheese both in September 2006 and today, you had the ability to do a stratified sample; correct?

A. I did at that time and now I still have the information. It is a little bit older and may not reflect the volumes in those plants today but it was approximately right.

Q. Once again, making an adjustment that you engaged in stratification remains from an economist's perspective the best way to handle the cheddar cheese data; is that right?

A. I think that it is.

Q. In Exhibit 72 your testimony for today on page 7 you talk about the whey data. At the bottom of page 7 you state, "The total costs have increased by less than half a cent per pound. The same thing is shown by same-plant comparisons."

Do you see that?

A. Yes.

Q. What I want to focus on is what you meant by the same thing. Do you mean a half a cent per pound? What is it you are saying?

A. That's exactly what I mean. There are a couple more digits that could be added there that would be a little bit different, but we are dealing with data that probably is not as precise as four digits would suggest. When I said about the same I did mean a half cent per pound.

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

JUDGE PALMER: Mr. Yale.

DR. CRYAN: Can I follow-up on that before you begin?

JUDGE PALMER: Go ahead.

CROSS-EXAMINATION

BY DR. CRYAN:

Q. Roger Cryan with National Milk.

As a follow-up to the last set of questions I just wanted to clarify something that you did point out, which is your original regression of the relationship between plant size and the cost size per pound that your study in September was based on, you did a regression of participating plants; is that

Dr. Stephenson - Cross by Dr. Cryan

correct?

A. That's correct.

Q. You applied the resulting equation to the volumes in your original larger sample of plants by size?

A. That's correct.

Q. Obviously there has been a big change in the plant sizes from your participating sample in the average plant size; is that correct?

A. That's correct, in the reported numbers here, that's right.

Q. Would it be reasonable to assume that there has been some analogous change in the plant sizes in the stratified sample in the original samples, in the original list that you drew from?

A. Do you mean that those plants are not processing the same volumes or that are not the same list of plants?

Q. The smaller ones are out of business and some of the larger ones are bigger?

A. That is almost entirely, I would imagine it would be a true statement. However,

all of the plants were still in business that I had originally asked to be involved in this study.

Q. I understand, but if you were to apply the results from this study, if you were to take results from this study and do a regression analysis and apply that equation with the population difference to an updated population, it is not really predictable what the result would be?

A. That's correct. I think that there are two things that can happen and undoubtedly have. One of them is that that line would have shifted upward by about 1.7 cents at the point of observation we talked about before and the entire line would have shifted to the right to indicate a slightly larger average plant size.

MR. CRYAN: Very good. Thank you very much. That's all.

JUDGE PALMER: Mr. Yale.

CROSS-EXAMINATION

BY MR. YALE:

Q. Ben Yale on behalf of Select Milk

Producers, Continental Dairy Products and Dairylea Producers of New Mexico.

Good afternoon. How are you doing?

A. I'm fine, thank you.

Q. Let's start with that line. I want to take it a different way and I appreciate Dr. Cryan's assistance because he saved me a bunch of inept questions.

The volume of cheese that reports to NASS -- first of all, in your exhibit that you presented yesterday you had a total volume of cheese at the plants of which you have cost data; right?

A. That's correct.

Q. That volume was twice as much as we had before; is that right?

A. That's right, very nearly.

Q. How much is that for a one-year period?

A. These are annual data, that's correct, a 12-month time period.

Q. How much cheese was reportable to NASS? First of all, let me ask this question. The data that you received is for producing

product that is reportable to NASS; is that correct?

A. Plants have to make at least the product that is reportable to NASS. Otherwise, I wasn't interested. Most of the plants are processing something else that isn't.

Q. Are the volumes listed on page 5, Table 1 all NASS reportable cheese?

A. No. These include, at least the total pounds of cheese in here would include products that are similar to cheddar, would have incurred some of the costs in there but are pounds of the entire products of cheese in this plant.

Q. For example, cheese that could be used for aging?

A. Yes.

Q. Or cheese in which other flavors would be added, like pepper?

A. They could be, yes.

Q. Are the costs associated with making these other products, are they differentiated from these numbers?

A. They are in a very small sense.

Again, as I indicated in my direct yesterday, we distribute costs according to the pounds of solids in the products, and so to the extent that a cheddar cheese might have 38 percent moisture and another cheese might have 40 percent moisture the costs would be distributed slightly differently on a per pound product basis, but we are assuming that most of the costs, I mean, we don't have enough information to split it much finer than that.

Q. You were here I think during Paul Christ's testimony today and he indicated that when there are different types of cheese normally there may be added costs as well as the added value for special cheese. Do you agree?

A. I think that that is correct. However, these plants are all plants that are producing a majority of cheddar style cheese and they are also plants that aren't producing any product that is grossly different. In other words, we don't have mold ripened cheeses in these operations.

Q. Are all of these sold in 40-pound

blocks, six 40-blocks or 500-pound barrels?

A. All that are reported in here, yes.

Q. That total of 118 million pounds is only for cheddar that is sold in 40-pound blocks or barrels?

A. Yes.

Q. There is no cut and wrap?

A. No.

Q. No loaves?

A. No, there are no loaves in here, at least the ones that you are representing in this. We do have operations that move product out of the plants and do cut and wrap somewhere else. There were a couple of operations that did some cut and wrap, but those costs aren't included in here. The labor is taken out. To the extent we could identify energy that was done in one operation, we removed that.

Q. Do you know offhand what the total volume of cheddar cheese produced in the United States was last year?

A. I didn't look at that. I certainly can, but, no, I don't know off the top of my head.

Q. Do you know what percentage this 118 million represents outside of California, the percentage of cheese that is produced outside of California?

A. I would presume it is a fairly large percentage.

Q. Would it be more than half?

A. I don't know. I am not going to make a statement on that without my looking at the data. I presume you have the number.

Q. Page 6 when you did your initial draw out of a hat or a box or whatever, maybe a computer random number, you picked out five large plants; right?

A. Yes.

Q. The definition of large plant was what?

A. We drew the line at the number of plants with the largest end of the scale that comprised about ten percent of the volume of cheddar cheese in the country.

Q. Out of that there were 20 plants that comprised that and you drew out five names?

A. No. We wanted to take a total of 20 plants and we took five plants out of the large size category and 15 out of the other 90 percent of volume in the country.

Q. Of those five one of them said no thanks?

A. Yes.

Q. And three of them said I'll take care of you later, this in 2006.

A. Yes. We had plants that had data questions, I had data questions on that weren't resolved at the time of the testimony.

Q. And then one gave data; is that right?

A. Yes.

Q. Out of the five? It is off that that you produced that stratificational analysis that came up with the 20-some cents that you suggested for an average test; is that right?

A. Yes. It was out of that data that we mapped a cost function and then applied that to a sample of plants.

Q. Now you do it again in 2007 and the

one that did say yes and did it on time did it again; right?

A. Yes.

Q. And three of them came in later; is that right?

A. We had three of them that have done it for this time period, this newer period, different data.

Q. It is different data, different period, okay?

A. Yes.

Q. Based upon the testimony you indicated there was a shift of 1.7 cents in general across all plants; is that correct?

A. That is what I observed with the eight plants that were in the survey both times.

Q. By the way, the difference of the 58 million pounds of cheese in Table 1, is all of that represented or is the bulk of that represented by these three plants?

A. The bulk of it would be, yes, the four large plants.

Q. The four large plants?

A. Yes.

Q. Well, you had the one large plant included last time; right?

A. I did, yes.

Q. Assuming that the same people that gave you the data in 2006 gave you the data in 2007, no additions, no subtractions, it would have been roughly in the same number? There might be some up or down, but you wouldn't have seen a significant change in the amount; right?

A. If we had all of the same plants in there I would assume it would be roughly the same number.

Q. I think you testify that there were, what, four small plants that did not agree to participate this time for whatever reason or five, four?

A. I think it was five.

Q. Okay, so if we now take those five out, their volume out, then there is even less that, of the 60 million that was in 2006 its going to be, whatever those five plant volumes are are not going to show up in 2007; right?

A. That's correct.

Q. So the addition of the three large plants is really more than 58 million pounds; right?

A. It probably is. You're right. I indicated before that we lost some plants off the smaller end of the scale and we gained plants on the larger end of the scale. We didn't just gain plants on the large end of the scale.

Q. Had the three plants reported to you in time for your testimony in 2006, based upon the data you have now it is fair to say, is it not, that the average plant costs that would have shown up in your report in 2006 would have been lower than the one that you actually reported; right?

A. Which costs are you referring to?

Q. I'm talking about your total cost for produced cheese, the weighted average.

A. I would expect that the weighted average number would have been less. However, when I would have mapped that back to the population of plants I wouldn't have. The population of plants didn't change but the

sample did.

Q. I asked this the last time in 2006. I want to ask you again today. Who has reviewed your study? Has this gone through any peer review?

A. This is a confidential survey and, no, I believe I told you last time that other people hadn't reviewed it with the exception of my colleagues who have looked at the information but not in a peer review way.

Q. And no one from the Department has reviewed it?

A. No.

Q. And there has been no cross-checks with the Department or any other data to determine whether the plants have reported the right numbers?

A. I have no audit authority, Ben, and I can't go into plants and compel them to open their books up.

Q. They didn't provide you, for example, any other regularly produced financial statements to compare with the data that they gave you; is that correct?

A. No, they didn't. I do of course have the audited data from CDFA publications and I'm able to take a look at comparisons here and see if we are tracking about the same or are roughly in the ballpark. I believe the CDFA reports a slightly lower total cost number and a slightly larger average volume on a number of products.

Q. Do you have the ability to recompute for the period that you used in 2006 using the three large plants that reported this time?

A. Two of the plants have given me their data from that time period with the corrections that I think should have been there. One of them didn't clean the data up.

Q. Who has talked to you about the data? Has anybody from any of the plants talked to you about the data and your study?

A. Their data?

Q. Yes.

A. Yes, virtually all of the plants have.

Q. Have any of them called back and discussed with you that they thought that the

costs that you were reporting were too high or too low, that they needed to be adjusted?

A. None of the plants have seen the results of this testimony prior to yesterday, so I can tell you that none of them have had an opportunity to say, oh, my plant has larger expenses than that or smaller. This is completely independent.

Q. In 2006 you provided a high and a low and a range for prices and you did not this time. Is that because of the lack of time to do so?

A. To some extent, but there are also fewer plants here, and when you get into do I have enough plants to be able to really report highs and lows with butter is a good example, no, you would have had two plants in each of those, and if I respect the rule of three I couldn't do that.

Q. But you could have done it like before with the cheese?

A. I could have split the cheese plants five and six as a high and low, but I didn't have the time to do that.

Q. Going back, the implication by the questions of Stephen Rosenbaum and yourself, Dr. Stephenson, was you said it was 20.8 cents was what you thought the price would be in September and now you have 1.7.

Are you suggesting that the price that would cover the average production of cheese in the United States ought to be at 22.5 cents?

A. With the testimony that I'm submitting here -- I don't know what USDA used out of my last testimony if anything to make a decision about changing make allowances. All that I'm trying to indicate here is that of those same plants that participated both last time and this time I observed a 1.7-cent increase in their costs.

Q. But you have not recomputed that stratificational analysis?

A. No, I didn't. If I were going to do that I would want to reestimate the cost functions.

Q. Right, so that at the end of 2006 you have a cost per pound of .170026 plus and

then you have a formula, right, to graph out based on the pounds processed?

A. Yes.

Q. You would have to recompute those factors?

A. I would, yes.

Q. As Dr. Cryan pointed out, you would need to know the new pounds and everything else?

A. I do have the pounds for the plants that participated so that regression could be done, but if you wanted to map that back to today's population I would assume that the population has changed a little.

Q. I kind of want to shift focus here to a little more practical thing. As an economist would you expect that a plant that negotiates prices with producers for a long term would do so at a price at which it can profitably make cheese? Is that a fair assessment?

A. That's beyond the bounds of what I really came here to testify about. I came here to testify about the results of the cost study.

Q. That is a pretty straightforward economic analysis; the expectation is that they would.

A. You wouldn't expect in the long run that anyone would negotiate milk prices that would not allow them to make a profit.

Q. You have, and you have not provided, and I appreciate that, the confidentiality of these individual plants, but you have seen some very large plants in your study?

A. Yes.

Q. Would it be within the range of those plants to be purchasing milk using a formula similar to that of USDA's but with a make allowance of 10 cents or 11 cents?

A. I really can't comment on that. I would have to take a look and see what their formulas are. As I understand it, many of the plants are not using NASS numbers. I don't think that I could possibly make a sweeping statement like that.

Q. Can you give us the range between the highest and the lowest in terms of cents per pound in make allowances of the study you

have done for cheese?

A. I can give an idea about the lowest and the highest. Again, I will try to couch this in a reasonable range here as opposed to specific numbers. At the low end we did have a couple of plants that are right about at the 10 cents per pound range.

Q. And the high range was --

A. The high range was above 25.

Q. I appreciate you giving us that. I want to I think at this point shift for a moment and let's talk about nonfat dry milk, butter-powder plants.

On page 6 of your testimony just before the last paragraph before the processing cost results you make a comment about, "A butter-powder plant that sells a large amount of cream or skim milk, or even condensed product, can overstate the indirectly allocated expenses for those products and thus underestimate the true costs" --

A. Excuse me, can you clarify this.

Q. Page 5.

A. You said page 6.

Q. I need better glasses than I have. It is page 5. It is just above Processing Cost Results. It says, "Plants that sell a significant"; do you see that paragraph?

A. Yes, I do.

Q. All right. You have done a study specifically on butter-powder plant costs and fuel; is that correct?

A. Quite a number of years ago I had done a butter-powder cost study.

Q. In that study you came to learn that in those plants they produce more than just butter and nonfat dry milk; is that correct?

A. Yes, although at that time when we were choosing plants for our cost studies whether they were cheese, cheddar operations, butter-powder, fluid, we made a real attempt to select plants that produced only the products that we were interested in or as close to that as we could get because we didn't want to have to do enterprise accounting at that point in time, so I think you will find there is a statement to that effect that we did try to find plants that produced only the final

products.

Q. You are aware in your statement that butter-powder plants today are not just butter-powder but cream or skim or condensed or buttermilk or any number of things; right?

A. Certainly.

Q. Are you aware that for some uses nonfat dry milk or skim condensed can be interchanged in the use for that product? Are you aware of that?

A. Certainly.

Q. Cheese being a common one; right?

A. Sure.

Q. The cost to produce the skim condensed is not going to include all of the energy that is necessary for the nonfat dry milk; is that right?

A. No, it isn't I wouldn't assume. I know that it doesn't in the plants. However, it is more expensive to transport and it is not as storable a product, so there are additional costs that have to be considered.

Q. Between buyer and seller they kind of go through arbitrage to see which is the

best solution between the two; isn't that correct?

A. Most of the time I would imagine that is true although sometimes there are a functionality of differences that just would cause one plant to prefer one to the other.

Q. Assume that there are no functionality differences. Let me take another piece before we talk about that.

The indirect costs that you talk about are the depreciation, management and those costs, is that right, associated with that operation?

A. Well, any of the costs that are allocated indirectly, if that's what you are talking about, can be any costs that are not specifically assigned to a product.

As an example, some of the costs, any of the costs that we have on one of the final pages which certainly would include value of assets is one line but even clerical among other things can be assigned to a particular product line of the plant as that information. If they don't, I have to allocate it

indirectly.

Q. When a plant in its side of the equation decides to move say from the nonfat dry milk to condensed, those indirect costs, they internally may be moving those over to the condensed because that's part of their equation to determine whether or not that is a profitable sale or not; is that right?

A. I would imagine that they make a real attempt to understand their costs of all products in the plant including the sale of skim milk rather than going as far as condensed. They may incur a little more than the cost of unloading, storage, separation and reloading.

Q. Was there any distinction made between the different types of powder between extra grades?

A. No, no attempt was made to distinguish between high heat, low heat or anything else.

Q. Are the energy costs higher for high heat as opposed to low heat?

A. I don't know that.

Q. In this period of time in the powder situation, again we are talking about nonfat dry milk and we see a change in costs, we don't know whether there has also been a shift in costs in terms of what is done internally in the plant first of all between whether they are making powder or condensed; right?

A. No, I don't know what their decisions were between one product or the other, but, likewise, they have choices to make quite often between internal inputs. They might use oil at one time and natural gas at another.

Q. Although you have the total pounds of powder produced you don't have the total pounds of product that flows through those plants; right?

A. I do. I have all of the products that come into the plant, all of the products that go out of the plant whether they are final products or intermediate products.

Q. Did you do any analysis to determine that between one year and the next there was a change in the mix of condensed versus nonfat

dry milk?

A. I didn't look at that. I do remember at least one plant that had a different looking mix than they did the year before. I just remember noticing that, but I haven't had time to digest these two different studies at that level of detail.

Q. Did you also or do you have the ability or data that would show a difference in the mix between high, low and medium heat products?

A. I don't. I have identified nonfat dry milk powder as one --

Q. Let's talk about the energy or efficiencies first of all that I think there is this kind of truism that seems to float around that a plant running at full capacity is the most efficient use of all its fixed assets; is that correct?

A. That would be the best way to spread those fixed costs across more product pounds.

Q. Isn't it also true that in the producing of product that in the energy consumption that if there is a start-up and

stop down that there is a loss of energy in bringing it up and a loss of energy bringing it down, that if that interruption could be eliminated or reduced there would be savings in the energy costs?

A. Yes. Plants are reluctant to fire up an evaporator or a dryer for small runs.

Q. The evidence that you have, you have no way of indicating whether there has also been a change in terms of the efficiency use of the plant, whether they are having a whole bunch of runs where they can get the maximum use out of line, out of their use of energy, or whether there has been for whatever reasons an inefficient use of that?

A. No, I don't know that. I just know the volume that they put through the equipment that they had available in these two time periods.

Q. So when we see a change in energy costs there is an assumption I think that comes out in your report that that is because the bulk cost of the energy itself went up?

A. The bulk expense for energy went up.

I don't know what happened in terms of the cost per unit.

Actually, I take that back. In many cases I do know what the unit costs were. I know how many kilowatt hours were purchased and what the costs were. I didn't look at that but I could.

However, some of that is likely to be decisions about the way they use equipment. It is also one of the reasons that I think you need to revisit from time to time the cost studies like this and not index some of the costs because over time I would expect plants if energy is really expensive to find ways of accommodating that to recapture better than they do or put in more efficient equipment, but that takes some time before they make those kind of investments.

Q. You answered the question I was about to ask.

A. I got to throw you a bone once in a while.

Q. You always do a good job, not just throwing bones but in terms of the work you do.

The question that goes with that, what you answered is the question can you use your data to be able to index the cost of energy up and down?

A. Yes, I think so. Again, I would hope that this was trying to capture a relatively short time period, but over a long time period you can. Over a long time period we are going to have different equipment.

Q. I want to come back to what will be a final issue for the moment. You understand what the purpose is of this make allowance testimony you have given and how the Department intends to use whatever make allowances. Sometimes we don't know how they are used, but whatever that evidence is you understand where that is going, right, how that is going to be used in formulas?

A. I certainly understand the make allowance and formula, yes.

Q. That end product pricing starts with some product price in the NASS survey and we subtract costs for manufacturing which may be yours or somebody else's; right?

A. Yes.

Q. Then that's multiplied times the yield; right?

A. Yes.

Q. None of your studies show any yields at these plants; right?

A. That's correct.

Q. As I recall the testimony you gave in September 2006, that part of this study was at the request of the Department of Agriculture or not?

A. Yes. We have done a number of these studies over the years and they have been of general interest to the dairy industry and of specific interest to plants, but until we had product price formulas probably not too much to USDA, but at that time USDA had more interest in it and we were ready to redo a couple of the products that hadn't been done in some period of time, most notably cheese and whey, so it was a good timing. We were ready to do it and USDA wanted to see it done.

Q. Was there any discussion in determining what the yields would be at these

plants?

A. No.

Q. I'm going to give a hypothetical. For the moment this is purely hypothetical. The number is not an evidentiary issue one way or the other, but assume for the moment that cheese is produced. A hundredweight of milk produces ten pounds of cheese at test and you have done this make allowance, whatever the cost is, 15 cents or whatever you propose with your stratificational analysis, but USDA uses a formula that says that we are going to assume that there is 12 pounds of cheese that comes out of the hundredpound of milk.

In that formula these make allowances would probably be inaccurate or insufficient to truly reflect what the value of milk is in the end on end product pricing.

A. We have the value of a product, the price of the end product that you are producing and we are trying to impute the value of the milk?

Q. Right.

A. There are two primary parameters in

those formulas that are important. One of these is the make allowance and one is the yield factor. They don't necessarily influence one another and wouldn't have to in the formulas.

The important thing I think is to do your best to replicate what you think the industry is doing in both the cost of processing and in the yield of products that they are making from these formulas.

If you are going to have a formula, it should probably be as close to those industry numbers as you can get with one exception, and that is that I do think if you are going to err you should err on the side of slightly smaller make allowances -- excuse me, slightly larger make allowances. I will repeat that. A slightly larger make allowance. That would give you a somewhat smaller price, room for the market to pick up any of the errors in our trying to determine values.

Q. But at this stage you are not aware of any studies similar to yours on the make allowance of the yield of these products;

correct?

A. On the yield? No, I'm not aware of a study.

Q. As an economist and a person who has obtained a Ph.D. on the research that you have done, is it not true that when you don't have the real data that you tend to rely on the scholarly documents and look at either the theoretical data or the data that has been done by people who are experts in the industry?

A. Sure. We would use sources of information that are as good as can be had. In some cases it is only theoretical data, but in many cases it is observed or measured yields, that yield that is in question.

Q. Being at Ithaca and Cornell it was not inappropriate for you to rely upon someone such as Dr. Barbano to review it in terms of a yield, for example if you wanted to know what the yield would be of cheddar?

A. Dr. Barbano would be a good source to talk about all of the yield potentials, the losses or anything else that a plant might have in a vat. From the standpoint of food

scientists Dr. Barbano is good.

MR. BEN YALE: At this point I don't have any further questions. I may have a follow-up later.

JUDGE PALMER: Very well. Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Martin Beshore for Dairylea and Dairy Farmers of America.

Dr. Stephenson, I would first like to make sure I understand parameters of confidentiality. You made the statement that it was a confidential study that you have done and that means that for instance you cannot identify the plants that are in your cost studies; correct?

A. That is certainly correct.

Q. Are you able to identify the physical location of the plants, what states they are in within your confidentiality parameters?

A. It depends. If there is one cheese

plant in the state I wouldn't tell you what state was involved. It is one of the reasons that in the past I have shown larger regions of manufacturing.

Q. Another element or nature of your study was you said you didn't have the ability to audit the information?

A. That's correct.

Q. Have you reviewed primary data with respect to the subject matter of the studies?

A. By primary data what do you mean?

Q. Invoices, primary documents relating to the cost factors.

A. I have been in plants that have hauled out computer printouts yea deep and extracted the information from those. They were warehoused and inventoried and I have no reason to believe those were generated just for my benefit.

Q. The plant personnel extracted the information from those kind of data and provided it to you in a computer program study that you related?

A. Yes.

Dr. Stephenson - Cross by Mr. Beshore

Q. So the information that you have presented is within all those parameters that you described previously; correct?

A. Yes. I'm not sure I understand that question completely.

Q. Hypothetically if you were rather than a university professor and doing this, if you were a private certified public accounting firm and you were providing cost studies of your client and you routinely prepared annual financial statements and tax returns and financial reviews and things of that nature, would that study be a bit more in depth and more precise than you are able to do with your limitations?

A. It is possible although we made a real attempt to ask as many pertinent questions as we can and no more. We don't want to burden plants with questions that aren't going to get to the bottom line in some way or another.

I don't think that I have always asked all the questions that I should have and we added some of those because we recognized the weaknesses in areas. It has always been a

bit of a learning experience, but I think we have good information.

The other thing I would suggest is that the tax preparers are often preparing material for very different reasons. We have dairy farms for example that have cost of production reports that are generated from tax records and we have cost of production information that is generated from reasons only to understand what the real costs of producing are. There are different reasons to summarize data.

Q. To summarize and prepare financial statements is different than preparing tax returns for instance?

A. Yes.

Q. I was trying to encompass that all in the relationship of an accounting professional with a client. It is a little different relationship that you have as a university professor doing a study with entities that you have not been involved in a long-term relationship with in terms of their recordkeeping and production and that sort of

thing.

A. That's true.

Q. A couple questions about the cheese plants. Do you know what the relationship was with respect to barrel production versus block production?

A. Not off the top of my head, but I do have all that information.

Q. When you allocated costs in the cheese plants was it done on a basis of product pounds or solids?

A. It was done on the basis of pounds of solids.

Q. Pounds of solids going in?

A. No, pounds of solids in the products. If they sold cheddar cheese, then we look at the pounds of solids that are in the end product cheddar cheese. If they sold condensed whey, then it is the pounds of solids that are in the condensed whey.

Q. Pounds of solids? If you have a pound of cheese that is 40 percent moisture, how many pounds of solids?

A. .6 pounds of solids.

Q. So you adjusted the end, you took the pounds of cheese produced and you had information as to the moisture content of the cheese?

A. Yes. I had information about the pounds of solids in the products. I didn't ask for the moisture in the cheese. I can calculate that from what had been given. I asked for the pounds of solids in the end products.

Q. How did you then translate that into pounds, cost per pound of cheese?

A. I also had the pounds of cheese. That's why I'm saying from the pounds of solids and then the pounds of finished cheese I could determine what the moisture content was or the percent of solids.

Q. But is your cost then done on the basis of pounds of cheese or pounds of solids?

A. If I have to allocate costs across a variety of products it is allocated on the basis of the percent of solids in the different products, but when I'm reporting here it is reported on the pounds of finished product.

Q. For cheese what was the moisture content then of the pounds of finished product?

A. I would have to do that calculation. I haven't looked at it in there, but it is likely to be around 38, 39 percent.

Q. I guess my question was was it standardized from plant to plant?

A. No. Again, the information that I requested from them was how many pounds of solids were sold in cheese.

Q. Okay, but your report, I'm not trying to be difficult, I'm just trying to understand it, your report is reported on the basis of cost per pound of cheese?

A. Some of these cheeses were probably 38 percent, some maybe at 39, I don't know, but these are the average pounds of cheese that were produced in that plant.

Q. Did you have any pure barrel plants or primarily barrel production plants?

A. I did.

Q. The moisture, average moisture as reported by NASS weekly for barrels is 2, 3, 4, 5 percent, don't hold me to that, somewhere in

Dr. Stephenson - Cross by Mr. Beshore

that range, lower than for blocks. Are you aware of that?

A. I know it is different. I don't know what the percentage is. I would have to look at it.

Q. Was the cost at those barrel plants adjusted for the moisture content?

A. No. This is done on the basis of the pounds of finished product.

Q. Of course when you have a lower moisture cheese such as barrels you have fewer pounds of product with the same amount of cheese solids; correct?

A. Yes.

Q. If there is not any adjustment made for that, the nominal, the observed cost per pound of cheese would be higher in those plants; correct?

A. Your observed cost would be somewhat higher, that's correct. You would be dividing by a fewer pounds.

Q. Do you know how many primarily barrel production plants you had in this study?

A. I don't recall. I could look and

Dr. Stephenson - Cross by Mr. Beshore

see.

Q. Let me just ask a question about the 1.7 cents per pound change in cost, which is on page 6 of Exhibit 72. Those were the same plants in both the September 2006 and the July 2007 study?

A. Yes.

Q. If my notes are correct there were eight plants that were the same?

A. Yes.

Q. One was a large plant and seven were -- one was in the larger stratum and seven were in the smaller stratum?

A. Yes.

Q. That would basically tend to tilt that grouping towards the smaller size; correct?

A. That's correct.

Q. The two stratum, I think if I was listening correctly I heard you say two things about how you selected the top category, and I think what your testimony in September was was that the top stratum was the top ten percent of plants by number. It was 13 of the 138 or

something like that.

A. No, the testimony was as I reiterated here. It says that five plants were selected from the largest ten percent of plants in the country.

Q. So it was the largest ten percent of plants. I took that to mean --

A. I guess that is a little ambiguous.

Q. I'm trying to figure out what it means. I heard you say two things. I think you said there were 13 in response to Mr. Rosenbaum.

A. If you can wait just a minute I will take a quick look.

Mr. Beshore, I'm having a difficult time finding that exact file. If we had a break would you mind if I look for it then.

Q. Not at all. What I wanted to know for certain was to determine whether it was just the top ten percent of plants which would be listed by size or whether it was plants that produced at least ten percent or some volume of the production in the country.

A. I would like to make sure about that

and I will look at that.

Q. Okay, thank you. A question or two about butter, the butter data. This is Table 3 on page 8. With the clarifications in the clarifying exhibit we have four plants which the last time averaged 11 cents per pound and this time averaged 18.5 cents per pound.

A. Yes.

Q. Which is very substantial?

A. Big change.

Q. Three of the four plants were the same you think or were all four the same?

A. Three of the four.

Q. How do you account for that?

A. I indicated last time I think that I had some concerns about the information that I had on those plants. Now I couldn't look at any of data that I had in there and just simply say I don't think that this plant should be in there, but I had a lot of variability. The data appeared to be good, but there was a lot of variability in the information.

That was part of the difference that we had in here. The other part of the

difference is the same kind of statement that I made about the nonfat plants because typically these are butter nonfat plants that if we were selling a fair amount of solids as intermediate products the same kind of thing can happen in butter plants as did in the nonfat portion.

In other words, I would have assigned too many of the costs to the products that left the plant as skim milk or cream or condensed and not enough to these finished products, butter and nonfat dry milk powder, so there were two things that were going on, but I think that the data last time was not of the same quality that I have this time.

Q. Not only is the cost 70 percent greater this time but the volume of the plants is almost, not quite twice but maybe 90 percent greater this time?

A. Yes.

Q. So we pick up what one would assume to be substantial economies of scale in the plants with greater volume and yet the average cost increases by 70 percent or so. Was that first set of data any good at all?

Dr. Stephenson - Cross by Mr. Beshore

A. You know, after receiving the second set of information I have, as I said at the time, real concerns about that. I think that if I had known better I guess at the time I probably wouldn't have published the butter data at all.

Q. When you have intermediate products going out of the butter plant, as you indicated skim milk or I suppose what else, cream?

A. Cream, condensed.

Q. What portion of overhead do you allocate to those intermediate solids? How did you do that?

A. Well, again, the problem that I had last time or what I will call a problem was that those were allocated based on the pounds of solids that were in the products that left the plant, so if you had a lot of them going out in liquid form they probably didn't incur very much cost but I assigned a fairly high cost to them.

Q. Right, so what cost did you assign? Those intermediate products do take up some of the overhead certainly of that operation, some

of the variable costs, labor costs, et cetera. What portion did you assign? How did you allocate the cost for those?

A. I went back into plant data that we had. I talked with some additional plants to get additional information about costs and the proportion of labor breakdown that was actually used up to the point in that plant before that product would have left the plant, some idea about the energy usage for example up through a separator in the plants, and that was what was used to allocate those costs to the intermediate products.

Q. Those are variable costs, labor and energy. How about the overhead costs?

A. Well, the overhead costs were allocated by using the same relationship between the costs incurred for those intermediate products and what I thought the variable costs were here, so the proportion was kept the same. The intermediates costs, the intermediate products had the fixed costs assigned to them in the same proportion as the variable costs. You can argue that for sure,

but it is an allocation question.

Q. That allocation issue I take it is the primary difference between these two sets of numbers?

A. That is a major one. I wouldn't say it was the primary one.

Q. What other differences were there?

A. As I indicated last time, there were some real differences in what I felt the quality of the data was from the plants received.

In other words, they made an attempt to report information from plants, separate some of the data off. They made a decision about what data came to me I guess based on products that I was looking at, and I didn't have the entire data set there so the calculated costs were much more variable across those plants than what I have this time. This time the data is much more I guess comparable between plants even though we have a fair difference in size.

Q. If you had two plants where the total product cost, the total cost per pound of

product is 16 to 18 cents let's say, which is kind of in the range of butter, cheese, whatever, and you wanted to compare the costs of producing a product in those two plants, would it be fair to take the costs, do you think it would be fair to take the cost categories that totaled about 2 cents out of those 16 or 18 cents and compare only those categories and say that's the comparison between the two plants?

A. What do you mean by that? Can you give me a specific example?

Q. Say you were comparing the cost of producing butter in two plants and you said okay, I'm going to break down the packing costs detailed between these two plants and one is doing bulk and the other is doing, they are both doing bulk and they both end up having close to the same packaging costs.

Is just limiting it to one line item sufficient to know whether the total cost of production of those two plants is the same?

A. That probably bears a little bit of background on here. When we look at the pounds

of butter and the cost of producing butter there are a number of different items that we calculate. One of them would be kind of what did it cost you to put cream into the churn to get the butter out of the churn, and then it is a matter of what are you going to do, are you putting it in readies or continentals or one-pound prints or bulk packages, and if we have labor that is in a small line for example then we try to understand what the labor costs associated with small prints of butter actually are.

What is reported here is the cost of producing the butter up to that point of packaging. The packaging costs themselves I think are very good cost numbers. They are the cost of putting butter in a bulk box, and the rest of the numbers out here allocate G&A, return on investments and repairs and depreciation to all of the pounds of butter regardless of whether they were in and out of there in print or boxes.

Q. So even the packaging is close to the same as the other costs?

Dr. Stephenson - Cross by Mr. Beshore

A. That's right.

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

JUDGE PALMER: Let's take a five-minute break.

(Recess taken.)

JUDGE PALMER: Let's go on the record again. During the break Ms. Pichelman indicated that we do have a witness that needs to leave soon and we wanted to put him on. He is going to give one statistical report.

MS. PICHELMAN: Yes, Your Honor. We have been notified that a representative is here from the United States Government Accountability Office and he just wanted to make a very brief appearance in order to submit a report from the GAO.

JUDGE PALMER: Please come forward, sir. I'm not sure are you going to be a witness or --

MR. WANSKA: I just wanted to submit a report.

JUDGE PALMER: Take the stand anyway. I will even swear you in just to make

sure.

JOHN WANSKA

a witness herein, having been first duly sworn, was examined and testified as follows:

JUDGE PALMER: All right, sir.

MS. PICHELMAN: If you could just state your name, title, where you are from and why you are here.

MR. WANSKA: Yes, I'm John Wanska. I am assistant director with the United States Government Accountability Office in Chicago, and what I'm here is because we recently completed work on a report that was released last Thursday. I think this report is germane to the hearing that you are having here, Your Honor. The title of the report is The Spot Cheese Market. Market oversight has increased but concerns remain about potential manipulation.

All I would like to do here is simply submit the report for official notice.

JUDGE PALMER: You have the whole report with you?

MR. WANSKA: I have five copies here.

JUDGE PALMER: We will receive it into evidence as Exhibit 77 as a government report. I will just call it the GAO report. We have five copies of it. I don't know how you all want to work that.

MR. WANSKA: It is on our Web site.

MR. VETNE: That was my question. Give us a good access on the Web.

MR. WANSKA: It is ww.gao.gov and the report number is GAO-07-707.

JUDGE PALMER: What we will do, we will take these five copies and give them to the reporter. One of them is going to be Exhibit 77 and the government will take the other four. Thank you, sir.

MS. PICHELMAN: Your Honor, can I ask if it has been received?

JUDGE PALMER: Yes, it has been received.

(Exhibit No. 77 was marked for identification and received into evidence.)

Dr. Stephenson - Cross by Mr. Chad

JUDGE PALMER: Back on the stand. Mr. Chad.

(At this juncture, the examination of Dr. Stephenson resumed.)

CROSS-EXAMINATION

BY MR. CHAD:

Q. Dennis Chad from Land O'Lakes. Good afternoon, Mark.

A. Good afternoon.

Q. A couple questions. I will be referring to Exhibit 72, 73 and 76. Just a general question to see if I understand how your cost survey works. If you have a plant which has more than one product and you wish to allocate the cost among those products, you allocate those costs between two products based on the pounds of solids; is that correct?

A. Not entirely. We do ask plants to make the allocation as best they can. A good example is labor. Expenses are asked for a whole variety of centers in the plants, not just what is your overall labor cost.

We also ask on virtually all of the

costs. We allocate them to cheese if it is a cheese plant or whey if it is a whey plant or bulk if they are also selling bulk liquids out of there, so plants are given the opportunity to do that, but, if they don't or if they can't, then I do allocate them in this indirect method according to the solids.

Q. Then what you will do is aggregate the cost for each activity or to each product and you will find cost per unit by dividing that aggregate cost by the pounds of product produced; would that be a correct characterization?

A. Yes. Again, we would take a percentage of the cost that was attributable to the pounds of the solids in the products if there is more than one product and multiply that by the cost so that we have that proportion of costs we want to assign to all of the product, and then we divide that by the total pounds of finished product.

Q. If there was a plant that got yields greater than the yields assumed in the formula, that would mean that in the scenario that you

just put out you would be increasing the proviso so they would have more pounds out than the standard; would that be correct?

A. More total pounds, yes.

Q. As a result the per unit cost would go down?

A. That's correct. If the divisor is larger, then the per unit costs are going to be smaller.

Q. So increases in yields actually lower the per unit cost and the input into the make allowances; would that be a correct characterization?

A. Yes. I mean, it could be that. In fact, I would expect that there may be that kind of relationship here but my study has not looked at yields at all. I made no attempt to do that, but theoretically, yes.

Q. I'm just talking about the mechanics of it and not the yield. I understand you haven't looked at yield but the mechanics.

A. Yes, sure, if you had more pounds of total product it would make a smaller allowance.

Q. Exhibit 72, your last page, you talk about, "It is particularly true," if I can pick up on the third paragraph on the last page, "It is particularly true in nonfat dry milk plants that the indirect allocation method using pounds of solids can miss-apportion costs between products. In the last testimony" -- and I assume that was September of last year -- "this has had the effect of understating the costs of processing nonfat dry milk."

If we then turn to page 7 of Exhibit 73, which was submitted by and read by Michael Brown of Northwest Dairy Association, NDA, he talks about an allocation issue at his plants.

Is the record clear that Michael Brown has divulged outside the limits of confidentiality that it was his plant that was involved in this question to you?

A. His is one of the plants, yes.

Q. Is this the only plant for the nonfat dry milk issue?

A. No. When I went back to take a look at all of the data, this is one of the obvious

ones that really made me stop and think about the allocation issue a little bit differently as to how we were assigning costs to products out here, but all of the plants if they are selling intermediate product are potentially going to have a fairly large impact on that if they sell a fair amount of condensed or skim or cream out of a plant. There is more than one plant where that type of thing has occurred.

Q. If we turn to Table 4 of Exhibit 72, Processing Costs For 7 Nonfat Dry Milk Plants, and we look at the line that reflects the Last Time Wt. Ave., we have an average manufacturing cost of .1423. Is that number correct?

A. That was the number that I gave last time. You know, I think that "correct" is a little bit of a judgment call on any of these kind of things because all of the costs in a plant are accounted for. It is a matter of what are you going to assign those costs to, and I assigned them to all of the products that a plant produces.

In retrospect when I looked at these I felt that I was overstating the costs

involved in intermediate products and thus understating the costs for plants that produce final products like butter and nonfat dry milk.

If a plant produced nothing but butter and nonfat dry milk, if they used all of the product that came in the door and produced those two products, the costs would be allocated I think correctly.

Q. But in the case of Dairy Gold it was moved off site to a different plant, so the cost, there is a difference in the allocation; would you agree?

A. Yes, there was, and I think a cost allocation that wasn't correct.

Q. The bottom line is the Department relied upon your testimony in September to set make allowances. Are the numbers, the .1423 cents, is that number an error?

A. I don't think it is the best number I could have given. It was a number that used the allocation, and if we wanted to understand the best kind of allocation we could have across products we would have asked for a breakdown of labor and of energy across all

products and we would have required plants to do that rather than have me indirectly allocate a few of those costs, so that should have been done. That will be done in the future and I think that that is not as good a number as I could have provided. It was the best number I could provide at the time.

Q. If we go back to Exhibit 73, page 7, Michael Brown testified from the information that he had he estimates that the make cost for nonfat dry milk was understated by 1.9 cents.

Would you say that that number, and you have had obviously conversations with the people at Dairy Gold, would you --

A. From what changes I have made now, if I remember some of Dairy Gold's numbers, that would have certainly been in the ballpark.

Q. If the Department used your numbers to set the make allowances in the current tentative decision the number that they used was understated by about 1.9 cents per pound?

A. If they are using my data, then for the Dairy Gold plant the number was understated by about 1.9 cents. That wouldn't be true for

all the plants. There were three plants that had relatively little intermediate product that left, so that allocation would have been fine.

Q. If you read that page 7, Dairy Gold determined what percentage of the total volume actually came from their plant, so they extrapolated that difference in cost and, correct me if I'm wrong, the difference in cost that you and Dairy Gold have talked about and blew it out to the cost for the entire survey, so the 1.9 as represented by Dairy Gold here represents the understatement for the entire survey cost.

A. I didn't go back and reestimate the cost last time with a procedure that better allocates those costs. I would tell you what I think it was if I had that number but I don't. I think it is a ballpark. I indicated that before.

Q. Butter, I will ask a blunt question, the 11.08 cents, is there anything, I know it is 18.46, is there anything that would say that that number is in error or is that number --

A. Which number?

Dr. Stephenson - Cross by Ms. Pichelman

Q. The difference between 11.08 in error?

A. I think it is not a good number.

Q. For all the reasons you have indicated?

A. For all the reasons I have indicated a number of times.

Q. It doesn't change your allocation?

A. Sure, some of it is because of a change in allocation. The same thing could happen with butter as it does if they have a large number of sales of intermediate product, but some of it was just the data that I had for those plants at that time.

MR. CHAD: Thanks very much.

JUDGE PALMER: Any other questions? Ms. Pichelman.

CROSS-EXAMINATION

BY MS. PICHELMAN:

Q. Heather Pichelman with USDA.

Very quickly, Dr. Stephenson, Dr. Cryan requested from you a monthly energy breakout regarding gas and electric for all

four commodities in your cost study. I think you agreed to provide that to him.

I wanted to ask when will that be available? Are you going to try to do that?

A. I can do it within a couple of weeks if that would be all right.

Q. When will that be available for people?

A. I will post it on our Web site if you like and I can send copies to anyone who would like a copy.

JUDGE PALMER: Would you like that or do you want it posted?

MR. YALE: Your Honor, we are going to object to any evidence that we can't cross-examine on, period.

JUDGE PALMER: All right. Well, he will post it on his Web site and others can see.

MR. YALE: If it shows up in a brief, we are going to move to strike it out of the brief.

JUDGE PALMER: I understand. Any other questions?

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. On your cheese costs at the last hearing where you put in Exhibits 75 and 76 you indicated I believe that the packaging costs included both block and barrel costs.

Is that the same case here?

A. No. I collected both block and barrel costs on cheese plants, but I only reported 40-pound blocks in the table that was there. I do have the barrel cost, but I don't think that those package costs were included.

Q. So both on the earlier study and this study those are just block costs and would be comparable to what California reports with regard to block costs?

A. That's correct.

CROSS-EXAMINATION

BY MR. ROWER:

Q. Jack Rower, Mark.

Were the costs of processing or disposing of whey cream included or allocated

in the cheese processing costs in Table 1, Exhibit 72?

A. This is similar to some of the questions we have had here recently. If there is a whey disposal cost, then there is a line for whey disposal. I doubt that very much whey cream is disposed of, it is sold, and so the costs associated with whey cream are given to whey cream and assumed to be not part of the cheese process itself. If the product is sold, we assume it is sold at the cost of processing.

MR. ROWER: Thank you very much. That's it.

JUDGE PALMER: Any other questions over there?

CROSS-EXAMINATION

BY MR. YALE:

Q. Ben Yale on behalf of Select, Continental Dairy Products and Dairy Producers of New Mexico.

As I understood the testimony in 2006, and it is the same numbers today, this volume of cheese that you used is a monthly

average for the year?

A. No. The volumes reported in these tables is an annual average.

Q. So we could for example take this number times 11, the 118 million pounds times 11, and that would give us the total production of all the plants that are in this report?

A. Times 11?

Q. Because you say eleven cheddar cheese plants?

A. Oh, yes.

Q. Among the cheese plants that you have not included in these eleven, there will be a lot of smaller cheese plants with a lot of higher costs; right?

A. Yes.

Q. And there will be some cheese plants with some of the lower costs; right?

A. Yes.

Q. So one cannot assume that all of the remaining cheddar cheese plants and cheddar cheese that is not included in the study is at that higher range of costs? You gave a high range of about .25 cents or something like that

per pound.

A. You can't assume all of them are at that range, no.

Q. There would be some lower?

A. Sure.

Q. So if we take 11 times 118 and we can compare that to the total cheddar cheese reported by USDA we will get some kind of idea of the percentage of what your survey shows as compared to the total population; right?

A. Yes. I think you are getting a little loose with numbers. The other thing I would say again is .25 is the high cost on what I have as a smaller size operation in this particular one, but it is not really small by most of today's standards. We still have a lot of plants much smaller and I suspect higher costs than that.

Q. You answered that better, thank you.

A. By the way, Mr. Beshore, I did look up the number and it was ten percent of the number of plants. You were correct.

MR. BESHORE: Thank you.

Q. Just a couple of follow-up questions

on that question or two I think from Mr. Rower or Mr. Schaefer. With respect to packaging costs of cheese, there are only 40-pound block packaging costs; is that correct?

A. That's all that is reported in this table.

Q. Irrespective of what products the plants produced?

A. The only thing I'm reporting here are the 40-pound block costs for packaging. They could have produced loaves or slices or anything else in some other area of the plant, but those costs are not included in this report.

Q. So the barrel plants that were in this study, what packaging costs were reported if any for those plants?

A. Thank you. Good question. I do the same thing California does in that regard. I take the average packaging costs for 40-pound blocks for the rest of the plants and assign that to the barrel plants.

I believe, well, there are some plants that are mixed plants and so we have the

40-pound packaging number for those operations, but there is more than one plant that is a pure barrel plant.

Q. Okay. Are there any other costs like those barrel plants which are not included in or otherwise imputed in this study?

A. No. The packaging costs are the only place that that is done.

Q. At the block plants is the 40-pound block packaging cost assumed to -- I think I understood you to say this but I want to make sure -- assumed to accrue on all pounds of cheese at that plant irrespective of whether they are blocks, loaves or whatever?

A. Yes. The way we would calculate the packaging costs in here is that we asked plants to provide things like the average pounds of cheese in a 40-pound box. It is not 40 pounds, it is something slightly different for each plant.

We asked them how many of those boxes they put on a pallet typically, how many feet of stretch wrap are used to secure those boxes, what is the cost of a box, what is the

cost of a liner, what is the cost of tape and glue, and then we calculate what the cost per box is using all of that information.

Q. Another question that was asked by Mr. Rower with respect to whey cream, I want to see if I understand that. Are those pounds of solids in whey cream considered pounds of product for cost allocation in cheese plants?

A. They are. Now admittedly in a cheese plant that is relatively few pounds of product so they don't get a very heavy allocation of any of the costs, but if you somehow or another had a lot of whey cream going out of a plant relative to the cheese, then you could have a misallocation problem again.

There was an example in the testimony that gave an indication of just how one might -- yes, on the bottom of page 4 of the testimony there is an example of if you brought 100 pounds of raw milk in there and processed cheese and whey cream that the allocation would have been .2 pounds of solids and whey cream, just in this example, so

Dr. Stephenson - Cross by Mr. Vetne

relative to the 5 pounds of solids and cheese and 6.12 in the dry whey it is a relatively small number.

MR. BESHORE: Thank you.

JUDGE PALMER: Any other questions? Yes, Mr. Vetne.

CROSS-EXAMINATION

BY MR. VETNE:

Q. Dr. Stephenson, during questions from Ben Yale you confirmed that the eleven cheese plants in the 2007 survey are plants that predominantly produce commodity cheddar but some of which may produce some other lines of cheese?

A. Yes.

Q. On a couple of occasions I think you were asked questions about other varieties of cheddar. Let me ask you this: If one were to look at the NASS Dairy Products Report there is a category called American cheese, a good substantial component of which is cheddar cheese.

With respect to the minority of

products produced by some of these plants, do you know whether some of them could have been other lines of American cheese as opposed to cheddar?

A. Yes, they are. As you indicated, I think in the line of questioning with Mr. Yale there weren't plants that were doing any other particularly exotic cheese. They were using basically the same process to make different styles of cheese but using the same equipment, same labor, same plant. If they had incorporations of peppercorns or whatever it might be in the cheese, none of that was included. That is outside the data that we were asked to --

Q. To the extent there were other cheeses, it was in the American cheese category as opposed to Italian cheeses or blue cheese?

A. Yes, it was pretty much in the family of the cheese made.

MR. VETNE: Thank you.

JUDGE PALMER: Presuming there are no other questions for this witness, thank you, sir. You are finished. Thank you very

much for coming to the hearing.

We are adjourning now until 9:00 tomorrow morning.

(Whereupon, the above-entitled matter was concluded at 5:00 p.m. this date.)

C E R T I F I C A T E

I hereby certify that the proceedings and evidence are contained fully and accurately in the stenographic notes taken by me on the hearing of the within cause and that this is a correct transcript of the same.

S/Vivian D. Macurak

Vivian D. Macurak