USDA - FEDERAL MILK ORDER HEARING

Sheraton Hotel Station Square
300 West Station Square Drive
Grand Station Ballroom I
Pittsburgh, PA 15219

Monday, December 11, 2006
1:17 p.m.

BEFORE: VICTOR W. PALMER
U.S. ADMINISTRATIVE LAW JUDGE

TRANSCRIPT OF PROCEEDINGS

VOLUME I

Reported by:

Michelle L. Hall
Registered Merit
Reporter

APPEARANCES:

U.S. Department of Agriculture:	Office of the General Counsel by Garret B. Stevens, Deputy Assistant General Counsel, and William Richmond
U.S. Department of Agricultural Marketing Specialists:	Gino M. Tosi Jill Hoover
Dairymens Marketing Cooperative Association, Inc., Dairy Farmers of America, and Association of Dairy Cooperatives in the Northeast:	Marvin Beshore, Esq.
Select Milk Producers, Inc., Continental Dairy Products, Inc., and Dairy Producers of New Mexico:	Yale Law Firm by Benjamin F. Yale, Esq., and Kristine H. Reed, Esq.
O-AT-KA Milk Products Corp.:	Upstate Niagara Cooperative, Inc. by Timothy R. Harner, General Counsel
National Milk Producers Federation:	Roger Cryan, Ph.D., And Kevin Brosch, Esq.
Agri-Mark Dairy Cooperative and Association of Dairy Cooperatives of the Northeast:	Robert D. Wellington
Lanco-Pennland Milk Producers:	Crossland & Speis, LLC by Edward C. Crossland Esq.

APPEARANCES (CONT.):

Berlin Cooperative of New York:	Ken Dibbell
International Dairy Foods Association: Foods Association:	Covington & Burling, LLP by Steven J. Rosenbaum, Esq.
Prairie Farms Dairy, Inc.:	Gary Lee
Lamers Dairy:	Richard Lamers
Mid-West Dairymens Company:	Dennis Tonak
University of Wisconsin:	Brian Gould
Alto Dairy Cooperative; Associated Milk Producers, Inc.; Bongards Cooperative Creamery; Burnett Dairy Cooperative; Ellsworth Dairy Cooperative; Family Dairies USA; First District Association; Manitowoc Milk Producers Association; Midwest Dairy Coalition; Mid-West Dairymens Cooperative; Milwaukee Cooperative Milk Producers; Prairie Farms Dairy, Inc.; Wisconsin Farm Bureau; Wisconsin Department of Agriculture, Trade & Consumer Protection:	John H. Vetne, Esq.
Land O' Lakes:	Dennis Schad
Southeast Milk:	Thomas Pittman

I N D E X

WITNESS: ROGER CRYAN, Ph.D.

E X H I B I T S:	MARKED	RECEIVED
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P R O C E E D I N G S

JUDGE PALMER: First of all, my name is Victor Palmer. I'm an Administrative Law Judge, and I've been assigned to this particular proceeding. I understand that Judge Peter Davenport already conducted some part of the hearing involving these issue, but he's not available for this hearing, so I've been assigned to it.

This is a national public hearing to take evidence on a proposal seeking to amend the Class I and Class II milk price formulas applicable to all Federal milk orders. Evidence is also going to be taken to determine whether emergency marketing conditions exist that would warrant omission of a recommended decision under the Rules of Practice and Procedure.

The Rules of Practice are found in 7 CFR Part 900. We do take evidence under oath, we do have cross-examination, and we do take -- if you have an exception to any ruling I make, you may state that, and then at the end, we will set up a time for filing proposed findings and briefs and any exceptions to whatever has happened here.

Who represents the Government?

MR. STEVENS: Your Honor, my name is Garrett Stevens. I am with the Office of General Counsel, United States Department of Agriculture, and there are some other administrative officials who will enter appearance in the record.

JUDGE PALMER: Yes.

MR. TOSI: Thank you, Your Honor. My name is Gino Tosi. I'm with the USDA Dairy Programs.

MR. RICHMOND: Good afternoon. I'm Bill Richmond, also with Dairy Programs.

MS. HOOVER: My name is Jill Hoover, also with Dairy Programs.

JUDGE PALMER: All right. Anyone else for the Government's side of things? The impartial side of things? All right.

We have, let's see, there's so many boilerplate things put in these Notices these days that it takes you awhile to find the actual proposals. But proposal one, I gather, is by the National Milk Producers Federation, and who represents them?

MR. CRYAN: Your Honor, my name is Roger Cryan. National Milk is the proponent for proposals one through five.

MR. BROSCH: Your Honor, Kevin Brosch, counsel for National Milk.

JUDGE PALMER: And how do you spell your name, sir?

MR. BROSCH: B-R-O-S-C-H.

JUDGE PALMER: Okay. All right. Well, that's one through five, and number six is just a pro forma thing about making technical changes. All right.

Who else wishes to enter an appearance?

MR. ROSENBAUM: Steven Rosenbaum for the International Dairy Foods Association.

JUDGE PALMER: All right. Yes? Who else?

MR. BESHORE: Marvin Beshore,

B-E-S-H-O-R-E, representing the Association of Dairy Cooperatives in the Northeast, Dairy Farmers of America, and Dairymens Cooperative Marketing Association.

JUDGE PALMER: All right. Anyone else?

MR. HARNER: Tim Harner, representing Upstate Niagara Cooperative, Inc., and O-AT-KA Milk Products Cooperative, Inc.

JUDGE PALMER: All right. Shall we keep going this way? All right, we will go back here. Do we have somebody here? Yes.

MR. LEE: Gary Lee, Prairie Farms Diary, Inc.

JUDGE PALMER: Which group?

MR. LEE: Prairie Farms.

MR. TONAK: Dennis Tonak, T-O-N-A-K, Mid-West Dairymens Company.

JUDGE PALMER: All right.

MR. GOULD: Brian GoUld, University of Wisconsin. G-O-U-L-D.

JUDGE PALMER: All right. Yes?

MR. CROSSLAND: Edward Crossland, Lanco-Pennland Milk Producers. C-R-O-S-S-L-A-N-D.

JUDGE PALMER: What group?

MR. CROSSLAND: Lanco-Pennland Milk Producers.

JUDGE PALMER: All right. Yes, sir?

MR. DIBBELL: Ken Dibbell, D-I-B-B-E-L-L, South Berlin Co-op, New York.

JUDGE PALMER: All right. We will switch over here.

MS. REED: Yes. Kristine Reed and Ben Yale, Select Milk Producers, Continental Dairy Products, and Dairy Producers of New Mexico.

JUDGE PALMER: Anyone else? Any other -- I would ask if you have business cards, if you would give them to the reporter, that will help her, and, also, if you wish to order a copy of the transcript, to let her know that as well.

I was handed some exhibits by Mr. Stevens just a moment back, and I'm going to give those to the reporter, but we're going to mark them the following: The first one, which will be Exhibit No. 1. We are going to do all the exhibits by number, and just sequence.

Exhibit No. 1, which I'm identifying and receiving at the same time, is the Notice of the hearing that appeared in the Federal Register Volume 71, at Page 67489, et cetera. I will just put a one on here so that that can be followed.

(Exhibit No. 1 was marked for identification and received into evidence.)

JUDGE PALMER: The next thing we have is a news release. We will identify that and receive it. That's a news release. It's dated November 20, 2006, Washington, D.C., and it's states that the U.S. Department of Agriculture is announcing that it will hold this hearing and where the hearing will be held, et cetera.

It indicated each of the market administrators who would have copies of materials that would be helpful to anyone that wished to follow along, so that will be Exhibit 2.

(Exhibit No. 2 was marked for identification and received into evidence.)

JUDGE PALMER: It looks like we just have a certificate of officials notified, and I guess we will just put them all in one group and make them Exhibit 3.

MR. STEVENS: Let me -- I don't mean to interrupt.

JUDGE PALMER: Yes.

MR. STEVENS: But in order to aid the record, I did hand you copies of these. There is a certificate of the notice of the officials notified, and then there are eight determinations or mailing of the Notice of Hearing.

JUDGE PALMER: All right.

MR. STEVENS: So the record clearly reflects there are these separate documents.

JUDGE PALMER: Let's do it this way then. The certificate of officials notified will be three.

(Exhibit No. 3 was marked for identification and received into evidence.)

JUDGE PALMER: And then we have --

MR. STEVENS: There are eight of these, Your Honor.

JUDGE PALMER: Eight determinations, we will just make them four.

(Exhibit No. 4 was marked for identification and received into evidence.)

JUDGE PALMER: That's about it. I guess we are ready to take evidence. Is there anything we wish to discuss first?

I did get an indication that the Secretary of Agriculture for the State of Pennsylvania will be here tomorrow, and I will allow him to testify as soon as he gets here. We will interrupt whoever is -- well, probably conclude whoever is talking to put him on as promptly as possible.

Do we have any farmers here that are going to testify? If you gentlemen want to get in and out fairly early, I will accommodate you. Is there anybody -- do you want to raise your hand if you are a dairy farmer? Yes, sir, you would like to get on fairly early?

MR. DIBBELL: No, Your Honor. I would like to observe for a while.

JUDGE PALMER: You would like to observe then you will let me know? The gentleman behind you?

FROM THE FLOOR: Same thing.

JUDGE PALMER: You want to observe everything for a while, and you might testify later?

FROM THE FLOOR: Yes.

JUDGE PALMER: At that time, we will take your appearance.

FROM THE FLOOR: Likewise, Your Honor.

JUDGE PALMER: So there's three gentlemen in that situation.

All right. Shall we hear from the proponent of proposal one? Does the Government have any preexisting materials?

MR. STEVENS: We have nothing further, Your Honor.

JUDGE PALMER: No Government

statistics to put in?

All right, sir. If you would just take that stand over there and --

ROGER CRYAN, Ph.D.

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

JUDGE PALMER: All right, sir, you are sworn. Is your colleague going to ask you the questions or are you just going to give a statement?

DR. CRYAN: I'm going to begin with a statement.

JUDGE PALMER: Give your full name and identification again.

MR. BESHORE: Before you -- you better distribute --

DR. CRYAN: There were some on the back table.

JUDGE PALMER: Go off the record for a moment until all of that is straight.

(Discussion was held off the record.)

JUDGE PALMER: If you would

give your full name again and affiliation.

DIRECT TESTIMONY

DR. CRYAN: My name is Roger Cryan, C-R-Y-A-N. My affiliation is National Milk Producers Federation.

JUDGE PALMER: All right.

DR. CRYAN: I have been the Director of Economic Research for the National Milk Producers Federation for six years. For four years before that, I was the economist in the Atlanta Milk Market Administrator's office. I have my M.S. and Ph.D. in agricultural economics from the University of Florida. I also currently serve as a Secretarial Appointee to USDA's Advisory Committee on Agricultural Statistics.

Today I'm speaking on behalf of National Milk Producers Federation. NMFP is the voice of America's dairy farmers, representing three-quarters of America's 64,000 commercial dairy farmers through their membership in NMPF's 33 constituent cooperative associations.

NMPF developed proposals one through

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five as they are published in the hearing of this notice and now urges their adoption. These proposals are thoroughly consistent with the logic and principles of Federal order precedent, including the Federal order reform plan decision.

In summary, these proposals as numbered by Dairy Program staff would, one, add 77 cents per hundredweight to the Class I milk price by updating the cost-based elements of the national minimum Class I milk price; two, simplify the calculation of the cheese-based skim milk price used in setting the Class I skim milk price; and, three, simplify the calculation of the butter-and-powder-based skim milk price used in setting Class I skim milk price; four, simplify the calculation of the Class II skim milk price by removing two redundant and offsetting expressions of the nonfat dry milk make allowance; and, five, calculate the Class II butterfat price similarly to the minimum Class I butterfat price.

Federal order language to effect

these changes is attached to my statement. NMPF's proposed amendments would maintain a direct relationship between dairy product prices and Class I and Class II prices, and they would reestablish the appropriate relationship between the Class I and II prices on the one hand and Class III and IV prices on the other hand through those dairy product prices.

They would complete the update of all cost considerations that define the current formulas, including both the manufacturers' make allowances and fluid milk supply costs; and they may impel future amendments of the Class I and II price formulas to be based on full consideration of these costs. These proposals are all founded on well-established Federal order principles.

Regarding the bases for emergency consideration: The National Milk Producers Federation appreciates the timeliness of this hearing and urges the Secretary to implement the noticed proposals on an emergency basis without a recommended decision.

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The tentative final decision, recently issued under previous docket, addressed outdated manufacturing costs for certain Class III and IV users, but applied these changes to all four classes. This increase of make allowance will reduce producer prices for all four classes of milk. This change was proposed to remedy an emergency situation faced by manufacturers of cheddar cheese, dry whey, butter, and nonfat dry milk.

However, based on current language and the defined scope of that proceeding, any changes to Class III and Class IV make allowances will also unnecessarily result in lower Class I and Class II prices and lower income for producers.

This does not provide economic relief for dairy product processors, and it does not consider offsetting increases in the fluid milk supply costs originally incorporated into the Class I and II milk price formulas. Unless adjustments are made to the Federal order of Class I and Class II prices, dairy farmers will be faced with unnecessary and

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unjustified economic hardships.

The first basis for emergency consideration: The tentative final decision will impose an undue hardship on producers. NMPF asserts that the same factors that increased dairy product manufacturers' costs have also raised the costs to producers and cooperative associations of supplying Class I and II milk.

The potential reduction of Class I and II milk prices under Docket No. AO-14-A74 does not give proper consideration to these costs. By Federal order precedent, discussed below, these costs should be acknowledged and Class I and II prices raised accordingly.

It is important to state that NMPF's current proposal stands alone on its own merits. However, the incomplete results of the recent make allowance hearing would unduly deny the producers well-justified offsetting compensation in the Class I and II price formulas.

Our proposal does not depend, in principle, upon the results of the make

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allowance hearing. However, after giving full and expedited consideration to costs whose update will reduce farmer prices, it will be inequitable for the Department to delay equal consideration of costs whose update would partially offset those reductions.

52 percent of milk pooled in the Federal orders in 2005 was Class I and II milk. U.S. dairy producers are now experiencing an extended period of below-average milk prices, high production costs, and exceptionally low farm returns. Unnecessarily large reductions in Class I and II revenues will further stress farm income and undoubtedly will be disastrous for many producers.

USDA's economic analysis of the tentative final decision on make allowances estimated that producer losses from lower Class I and II revenues would total nearly $500 million over nine years. This is 43 percent of the negative producer revenue impact of this change. In the first year alone, Class I and II revenues are down $93 million, according to the USDA.

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An expedited hearing and decision are necessary to provide a more complete consideration of the Class I and II price formulas. NMPF expects this fuller consideration will produce offsetting compensation in these formulas, and thereby avoid unnecessary and excessive reductions in producer income.

A second basis for the emergency consideration of these proposals is the inadequacy of current Class I and II pricing which contributes to -- I'm sorry. The inadequacy of current Class I and II pricing contributes to disorderly marketing in the Federal order markets.

Class I and II price formulas were defined during order reform, based on specific cost considerations, which are discussed in more detail below. These have not been updated since the proposed rule was issued in 1998 despite substantial changes in these costs.

As a result, the Class I and II prices are inadequate to ensure orderly marketing, as evidenced by several conditions.

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The growing difficulty of supplying local and regional deficit markets threatens orderly marketing in the Southeast and Northeast, in particular. Current revenues are often inadequate to maintain efficient local supplies of milk. Additional Class I revenue will compensate producers and help maintain production for the future.

The costs of transportation are rising in all markets. The longer hauls allow processors to achieve savings through the operation of larger plants; but the higher hauling rates and longer hauls that allow these plant savings are imposed upon producers and their cooperatives.

Class I over-order premiums in milk surplus regions have risen substantially, the result of inadequate uniform prices to compensate producers and cooperatives for the costs of participating in the Federal order pool.

There's also been a great increase in "de-pooling" in recent years, also associated with inadequate Class I and II pool

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revenue. This is discussed, and accompanying data presented, later in the testimony; but it fully applies to the need for an expedited decision, omitting a recommended decision. An expedited decision can address these conditions of a disorderly market.

Now, I would like to make a comment on make allowances as considered in this proposal. Before outlining our specific proposals, I would like to comment on the parameters of our proposed price formulas.

NMPF's original petition described a status quo based on the make allowances which are in effect now and have been for several years. We applied our proposed changes to these specific formulas in order to make clear how the changes would work.

On November 22, a tentative final decision was published in the Federal Register that proposed to adopt revised make allowances for Class III and IV product price formulas. We anticipate these revised make allowances will be adopted in every Federal milk marketing order that continues to operate through 2007.

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Therefore, and in order to present our proposals as we expect them to be applied, we have recalculated each Class I and II price formula, based upon these new make allowances. To these recalculated formulas, we have applied our proposals.

Again, these proposals do not depend upon the make allowances in principle, but the clearest way to demonstrate our proposals is to show their effect in connection with the new make allowances, to lay out specific language and specific formulas.

NMPF proposes simplified and updated Class I and II price formulas based directly upon dairy product prices. If these formulas were applied, Class I and Class II prices would move in concert with Class III and IV prices, as they do now, but in a form that maintains a proper consideration for the fluid supply costs borne by producers and handlers.

NMPF's proposed Class I and II formulas would better describe the appropriate relationship among class prices and dairy product prices, consistent with Federal order precedent and principles.

The last time the relationship between Class I and II and Classes III and IV was fully considered was at the time of order reform in 1996 through 1999. At that time, several specific costs of supplying Class I milk were applied to the establishment of the Class I price formula.

The May 2000 hearing considered updates to the Class III and IV price formulas only. The January 2006 national hearing considered the changes in Class III and Class IV manufacturing costs. The resulting tentative final decision, issued last month, applied these changes directly to the Class I and II price calculations.

It did not, however, consider the changes in the cost -- consider changes in the costs borne by producers and handlers of maintaining Grade A milk supplies for Class I and II use and the competitive pressures that must be addressed to achieve orderly marketing through the Federal orders.

Suppliers of Class I and II milk

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face additional costs which vary sometimes exactly with Class III and IV manufacturing costs; but while costs are subtracted in the Class III and IV formulas, they are added in the Class I and II. A full consideration of these Class I and II costs is a necessary and analogous complement to the make allowance changes recently issued.

Class I skim milk formula:

Expressed in its simplest form and applying the November 22 make allowance decision, the Class I skim milk mover formula is equal, per hundredweight, to the higher of these two equations: nonfat dry milk price times 8.9 minus $1.40, or the cheese price times 10 plus the whey price times 6.1 minus the butter price times 3.9 minus $2.40.

In each case, these are in effect incorporated -- effectively incorporated yields of individual products, and make allowance per hundredweight of milk for producing these products.

There is an appendix to this statement which contains the formulas and their

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derivations in details so that they can be gone through to be verified more easily.

NMPF proposes the following replacement for the Class I skim milk price mover, equal to the higher of the nonfat dry milk price times 8.9 minus 63 cents, or a cheese price times to plus the whey price times 6.1 minus the butter price times 3.9 minus $1.63.

NMPF's proposed formula incorporates the same commodity values and yield factors as the current Class I formula, including all Class III and IV make allowances and yield changes, in addition to the decision, minus a Class I adjuster, which combines product conversion costs and corresponding changes in the estimated per hundredweight costs of supplying Class I milk. The difference that is the current formula simplified, plus 77 cents.

At the time of order reform, certain costs of supplying Class I milk were explicitly incorporated into the minimum Class I differential. NMPF does not propose to change the Class I differentials at this time, but

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maintains that any change to these Class I supply costs can be applied just as effectively to the Class I skim milk and butterfat movers. These Class I supply costs were built into the Class I differential during order reform only because the Class I mover directly incorporated the Class III and IV price formulas by reference.

Especially if the Class I mover is simplified according to the formula NMPF proposes, it is equally appropriate to apply adjustments in any fixed element of the Class I price to the mover calculation.

The Class I skim milk price and Class II price are currently calculated using Class III and IV price formulas by reference, adding differentials that are designed to reflect their relationship to Class III and IV values.

These differentials are designed to compensate not processors, but rather the suppliers of Class I and II raw milk. In the Proposed Rule for Order Reform, USDA set the minimum Class I differential at $1.60 per

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hundredweight, based upon several enumerated costs, beginning with the costs of maintaining Grade A standards.

A quote from that decision, "There are several requirements for producers to meet to convert to a Grade A dairy farm and then maintain it. A Grade A farm requires an approved water system (typically one of the greatest conversion expenses) specific facility construction and plumbing requirements, certain specifications on the appearance of the facilities, and specific equipment.

"After achieving Grade A status, producers must maintain the required equipment and facilities, and adhere to certain management practices. Often, this will require additional labor, resource, and utility expenses. It has been estimated that this value may be worth approximately $0.40 per hundredweight."

Well, Grade A standards have only become more exacting in the meantime through a state-Federal process of review and revision culminating at the bi-annual National

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Interstate Milk Shippers conference.

Of course, the labor, resource, and utility expenses of dairy farmers, cited above, rise along with those of milk processors. Non-feed costs in the production of milk, which closely correlate with the labor, resource, and utility expenses, plus the cited infrastructure costs, have risen by 38 percent between 1998 and 2005, according to the USDA estimates.

Our initial proposal, which was based upon data through 2004, has been updated to reflect the new availability of data through 2005. That should say data.

And just to clarify that, in the last couple weeks, it came to my attention that the economic research service at the USDA issued its cost of production estimates for the year of 2005, which allowed me to update the numbers I used here, and that is the reason for the proposal as presented today having been four cents more than the proposal published in the Federal Register.

Based on the above, and applying the same 38 percent increase to the 40 cent cost of

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maintaining Grade A supplies, NMPF conservatively estimates the present costs of maintaining Grade A standards at 51 cents per hundredweight, an increase of 15 cents from the status quo.

USDA's order reform decision also stated, traditionally, the additional portion of the Class I differential reflects the marketing costs incurred in supplying the Class I market. These marketing costs include such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or give-up charges at manufacturing milk plants that service the fluid Class I markets. This value has typically represented approximately 60 cents per hundredweight.

Most of these same costs -- most of these are the same costs associated with operation of plants producing such products as cheese, dry whey, butter, and nonfat dry milk powder. The operators of cooperatives supply plants often sacrifice plant profitability of

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their manufacturing operations in order to provide Class I and II milk supplies.

The costs of this supply rise as energy costs and per-pound processing costs rose, and these costs should be offset in the Class I price.

Shipping milk from distant sources imposes an even larger cost of balancing Class I markets; transportation costs also rise with higher energy prices, as has been acknowledged in a recent tentative partial decision on the transportation credits in the Southeast and Appalachian markets. I believe that may be a final -- final. I'm not sure.

The manufacturing costs estimated from the recent surveys tend to reflect costs of plants running near full capacity; processing costs of balancing plants are higher and should be reflected in the Class I price. In addition, some part of the costs of plant operation were associated with maintaining certification to supply milk to Grade A fluid milk plants, costs that are required of the plant before it may be pooled in the Federal

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order system.

Very conservatively, the same percentage increase in the costs of butter and powder manufacture (the primary form of market balancing through manufacturing) that is applied to Class III and IV make allowances should also be applied to the 60 cents supply cost.

The data presented at the January make allowance hearing suggested a 22 percent increase in the costs of converting milk into butter and powder. This calculation is attached to my statement.

A 22 percent increase in the 60 cent handler fluid supply costs applied in the Federal order reform decision would be an additional 13 cents per hundredweight.

In addition, shifts in milk production and manufacturing consolidations have led to longer hauls to Class I plants. A study by the Minneapolis Market Administrator and his Chicago predecessor concluded that the weighted average hauling charge in the Upper Midwest market in May 1998 were 17.6 cents per

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hundredweight, and the weighted average hauling charge in the Chicago Regional market in May 1999 (the first year for which data was compiled for this market) was 11.1 cents per hundredweight.

The first data for the consolidated Upper Midwest market is for May 2001. At that point, the average hauling rate was 17.1 cents for the consolidated market. By May 2006, the average weighted -- the average -- the weighted average for the consolidated Upper Midwest market was 23.5 cents, 6.5 cents higher than five years earlier, and 6 and 12 cents higher than the figures for the predecessor markets.

Studies by the Seattle Market Administrator showed average hauling rates rising from 43.3 cents per hundredweight in 2000 to 51.7 cents in 2005.

Based upon these studies, and the record in the ongoing transportation credit proceeding, we conservatively estimate an additional 10 cents per hundredweight increase in average Class I assembly costs, for a total increase of 23 cents of this component of the original $1.60 Class I costs. Again, I emphasize that this is a conservative estimate.

The last element of the minimum Class I price, per the proposed rule, was the additional competitive factor, estimated at 60 cents per hundredweight based upon two price comparisons. The proposed rule reported Grade A milk received an average premium above Class III in 1995 and 1996 at 86 cents in Minnesota and 89 cents in Wisconsin.

In 2004 and 2005, these average premiums were up to $1.33 in Minnesota and $1.53 in Wisconsin. In addition, the proposed rule considered the substantial over-order premiums were paid for Class I milk in Chicago, Milwaukee, and Minneapolis in 1996 ranging from $1.19 to $1.79.

By 2005, these over-order premiums were $2.10 in Minneapolis and $2.72 in Chicago and Milwaukee. These growing premiums are an indication of the inadequacy of the current minimum Class I prices to draw milk to the pool to meet Class I needs, and of their failure to meet the objectives of the Act.

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In both cases, the competitive costs associated with Class I milk have risen by an average of about 65 percent. Applying this percentage increase to the 60 cent competitive factor incorporated at order reform would produce a 39 cent increase in the minimum Class I price.

All together, these considerations conservatively justify at least a 77 cent increase in the Class I skim milk price mover. I emphasize again that these are conservative estimates. One could easily argue that the full increase in average premiums over manufacturing grade milk, or even in average over-order Class I premiums should be applied to the Class I price.

So our proposal is a modest one, aimed at striking a balance in the market. Certainly no one can believe that the Class I supply costs are unchanged in ten years, and that they should never be updated in the Class I price formula.

It only follows from the updates in Class III and IV make allowances - including

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the application of these updates to the Class I and II prices - that other cost-based elements of these prices should be updated as well.

These Class I and II supply costs (hauling, assembly Grade A standards, et cetera) are primarily borne by producers, directly or through the cooperatives that they own. To delay that update would be to delay fair and offsetting compensation to producers, cooperatives, and other participants in the Federal order system.

Regarding the Class I butterfat formula, in its simplest and -- in its current and simplest form, the Class I butterfat price mover, adjusted for the newly announced make allowances, is calculated as butter price times 1.2 minus 14.42 cents. This incorporates the butter yield, which is 1.2 pounds of butter per pound of butterfat, minus the make allowance, which is 14.42 cents per pound of butterfat.

NMPF proposes the following replacement: Butter price times 1.2 minus 13.65 cents per pound. This corresponds exactly to our proposal for Class I skim milk,

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adding the same 70 cents per hundredweight or .77 cents per pound, estimated increase in the fluid supply costs.

Again, this is a conservative estimate, and we proposed only this modest adjustment, although experience in California's state program has shown the feasibility of a substantially higher premium on Class I butterfat, vis-a-vis the manufacturing classes.

Class II skim milk formula in its simplest form is calculated as the nonfat dry milk price times 8.9, minus $1.40, which is the same -- which is simplification of the Class IV skim formula -- plus a 70 cent Class II differential. So together they become the nonfat dry milk price times 8.9, minus 70 cents, which is the combination of the make allowance for the 70 cent differential.

NMPF proposes the following direct replacement for the Class II skim milk price: The nonfat dry milk price times 8.9, minus 53 cents, and NMPF's proposed formula is equal to the full value of nonfat dry milk derived from a hundredweight of skim milk, minus

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condensing costs, plus the cost of rehydrating powder, and is similar to the current calculation, except that it avoids offsetting duplication of the costs of drying condensed skim milk in the formula.

In the Order Reform Proposed Rule and in the Final Decision, the calculation of the Class II price was based on the Class IV calculation, plus 70 cents, and I quote, "The 70 cent differential represents the costs of converting concentrated milk to dry solids, plus rehydration."

Another quote, "Only a small portion of the 70 cents is intended to represent the cost of rehydration. The majority of the 70 cents, 57, represents the cost to dry condensed milk. It should be noted that the cost to purchase or manufacture nonfat dry milk for use in Class II products would include not only the cost of milk at the Class IV price, but the cost of making nonfat dry milk."

This can be expressed mathematically as the Class II skim milk price is equal to the Class IV skim milk price, plus 70 cents, for

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the Class IV skim milk price, plus drying costs, plus rehydration costs.

Recognizing that the Class IV skim milk price is equal to the powder value of skim minus the cost of condensing and drying -- it should say drying milk -- this is equal to powder value, minus condensing costs, minus drying costs, plus drying costs, plus rehydration costs.

Put more simply, canceling out the two drying cost terms, the Class II skim milk price equals the powder value, minus condensing costs, plus rehydration costs.

If we add condensing costs to both sides, that kind of helps describe the heart of the matter, that Class II condensed skim milk must not be priced any higher than powder plus the cost of rehydrating. That's specifically the competition in the market is between skim condensed Class II and nonfat dry milk powder, so this a direct comparison of Class II skim plus condensing, which is essentially a value of the Class II skim condensed equals powder value plus rehydration, which is the cost of

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buying powder and rehydrating it just to replace Class II skim condensed.

This is noted in the final decision. "Generally, the source of inputs alternative to product milk for the manufacture of Class II products is dry milk products and butterfat that otherwise would be used in butter. Basing the price of milk used to make Class II products on these alternative ingredients should help considerably to remedy a situation which it is perceived that a separate product class for dry milk (Class III-A) has resulted in a competitive advantage over producer milk used to produce Class II products."

In other words, the relationship between the nonfat dry milk price and the Class II price is the objective of a 70 cent price -- Class II price differential. This relationship depends upon make allowances established at that time; it is therefore out of date and inconsistent with any update to the manufacturing make allowance.

It is now appropriate to establish a direct relationship between the Class II skim

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milk price and the nonfat dry milk price with only a negative allowance for condensing and a positive allowance for rehydration.

NMPF's proposal follows the same logic as the current Class II skim milk price formula, but simplifies it by canceling the redundant elements. In other words, Class II skim equals the powder value, minus condensing costs, plus rehydration costs, which equals nonfat dry milk price times 8.9, minus 6.2 cents for condensing costs, plus 9 cents for rehydration costs, or nonfat dry milk price times 8.9, minus 53 cents.

This is exactly the relationship intended at the time of order reform. This simplification makes it easier to understand, and less dependent upon regular corrections. Much Class II skim milk is sold as skim condensed milk, which competes with nonfat dry milk as an ingredient. Substitution between the Class II skim condensed and nonfat dry milk can help balance markets, but the margin should be such that otherwise uneconomic permanent year-round substitution of nonfat dry milk is

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not made for skim condensed.

Therefore, this formula is equal to the value of an equivalent of buying nonfat dry milk, minus the condensing cost, plus the cost of rehydration.

I conducted a panel survey of dairy processors recently. This panel estimated direct costs of condensing skim milk in between 6 cents and 7.5 cents per pound of solids, a bit higher than the conventional range of 6 cents to 7 cents range due to the current high energy prices.

They estimated the cost of rehydration at 1 cent to 1.5 cent per pound of solids. Conservatively applying the 7.5 cents for condensing, minus 1.5 cents for hydration gives a deduction of 53.5 cents per hundredweight of skim milk, nearly identical to the relationship defined at the time of order reform.

This result is also consistent with the panel's consensus that the current relationship between the powder price and the Class II skim prices maintains a good balance,

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and that the current (pre-make allowance hearing) gap should be neither raised nor lowered.

NMPF's proposed formula maintains this current effective balance between the use of Class II skim condensed milk and its occasional appropriate substitution with nonfat dry milk, based upon sound Federal order principles.

Class II butterfat formula: In its simplest form, the current Class II butterfat price is calculated as butter price times 1.2, minus 14.42 cents per pound, plus 7/10 of a cent per pound, which equals the butter price times 1.2, minus 13.72 cents.

This incorporates the butter yield of 1.2 pounds per pound of butterfat -- I'm sorry, butter yield of 1.2 pounds per pound of butterfat, minus the make allowance of 14.42 cents per pound of butterfat, plus the Class II differential, 7/10 of a cent per pound of butterfat.

NMPF proposes the following replacement: The butter price times 1.2, minus

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12.15 cents. This is equivalent to the proposed Class I butterfat mover, plus the minimum Class I differential of 1.6 cents per pound, or $1.60 per hundredweight. That is, it sets the Class II butterfat price equal to the minimum Class I butterfat price, without applying any location differential, so that this a price that is uniform across the country.

The average 2005 butterfat test for Class I use and Class II use were 1.97 percent and 7.42 percent respectively. Combined, their average butterfat test was 3.34 percent, close to the Federal standard of 3.5 percent.

Class I and II supplies are complementary, with much Class II butterfat use coming from the surplus butterfat at Class I bottling plants.

In the 1994 Class I (sic) pricing decision that helped define current Federal order principles regarding Class II pricing, USDA concluded that "This decision makes a clear break from the past in that Class II milk pricing will function in a manner consistent

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with Class I pricing largely in recognition of the similarity of the distribution and marketing channels shared by milk used in both classes."

That is, Class II milk pricing should and would approximate Class I pricing, except for the potential substitution of nonfat dry milk powder in Class II uses.

Class II butterfat, however, is not constrained by competition with a manufactured substitute. Class IV and Class III butterfat can be used to produce butter, butteroil, plastic cream, and anhydrous milkfat. Under normal conditions, though, these are not viable economic substitutes for cream in Class II applications.

The clearest evidence of this can be found in the market's reaction to the California price and pooling system. Together, California Classes 2 and 3 contain the same uses as Class II in the Federal order system.

The California Class 2 and 3 butterfat price formulas are 3.7 cents and 3.93 cents higher than the butterfat formula

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for California Class 4A, (which is an equivalent to the Federal order Class IV).

NMPF's proposal would set the Class II butterfat formula only 2.27 cents above the Class IV butterfat formula. If substantial substitution of butter, butteroil, or anhydrous milkfat for cream has not occurred in California where the gap is nearly 4 cents, there's no reason to expect such substitution in the Federal order system when the gap is just over 2 cents.

In other words, if substitution of butter, butteroil, plastic cream, or anhydrous milkfat for Class II cream were economical at a 2.27 cent Class II butterfat premium, they would be economical at 3.93 cents in California; since they are not economical substitutes at 3.93 cents, then they are not at 2.27 cents.

As such, it should be set equivalent to the minimum Class I butterfat price, excluding only the location component of the overall Class I butterfat price.

Class II skim needs can be balanced

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using nonfat dry milk. Since manufactured butterfat products are not economical tools for balancing Class II butterfat needs, they must, instead, be supplied in the same way as Class I milk; through the participation of producers and their cooperatives to maintain pooled reserve surpluses.

The reasonable conclusion, based on the 1994 decision and the lack of economic substitutability between Class II cream and manufactured butterfat products is that the Class II butterfat should be priced at a price approaching the Class I butterfat price.

However, because some Class II products trade on a national market, Class II butterfat price should be uniform across the country and set equal to the minimum Class I butterfat price. This will avoid creating regional disparities among the manufacturers of such products.

Regarding economic impacts, according to a static analysis of our proposed changes, the Class I price would be increased by 77 cents, the Class II skim milk price would

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be increased by 17 cents, and the Class II butterfat price would be increased by 1.57 cents. This would result in positive impacts in the blend price in all markets.

According to USDA's analysis, published in connection with the notice of this hearing, and based on our original calculation of slightly smaller increases in Class I and II price formulas, and which analysis takes -- well, the USDA's analysis takes into account the response of supply and demand to these changes.

That is to say the USDA's model is a dynamic model that takes into account supply and demand changes when a shock to the system, change to the system, such as change to the formulas is applied.

This analysis by USDA projects a positive impact on producer revenue averaging nearly $200 million over the first two years. Actually, each of the first two years. No, averaging -- I'm sorry, averaging, yes, $200 million dollars for the first two years and averaging $150 million over nine years.

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Based on USDA's projected Class price impacts, the blend price would be increased in all markets for at least the first two years.

USDA's economic analysis is based on a very good model; however, it's an econometric model. Econometric models necessarily depend upon past data to project the future, and they assume that the underlying market structure has not changed.

USDA's econometric model is based on data for the past ten years and appears to be a very effective representation of the past ten years; however, I believe that the U.S. dairy market is becoming, and will continue to become, more tied to the world markets.

Because the world market is larger than the U.S. market alone, that means the changes like the NMPF proposals would have a smaller impact on the price of cheese, butter and powder prices. For this reason, I believe that the positive impacts of this proposal will be larger than USDA projects. I also believe that they will be positive in all Federal order

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markets indefinitely.

The proposed Class I and II formulas better meet the objectives of the Act. NMPF proposes that the Secretary establish a new Class I and II milk price formulas. These would better meet the objects of the Agricultural Marketing Agreement Act in several ways:

First, the Class I and Class II prices are constrained by, and so are only incidentally related to, make allowances for Class III and IV milk. The manufacturers of cheddar cheese, dry whey, butter, and nonfat dry milk who receive Federal order milk are collectively constrained by the orders to operate within a margin between the average product prices that they must report to the National Agricultural Statistic Service, and the Federal order minimum prices for Class III and IV milk which are based upon the recorded prices. The make allowance hearing was about establishing a margin wide enough to provide a reasonable opportunity to cover costs.

By contrast, the processors of

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Class I and Class II products are able to pass on increased costs to the market. Higher Class I and II product prices do not raise the minimum Class prices. The relationship between the Class I and II prices, on one hand, and the Class III and IV make allowances, on the other, is indirect.

Changes to these make allowances should only be applied to the Class I and II prices in connection with a direct consideration of the Class I and II formulas. This hearing is providing that direct consideration.

Second, the costs of supplying raw Class I and II milk must be recognized in the calculation of their prices, in the interests of orderly marketing. Producer, cooperative, and other suppliers of raw milk for Class I and II use face substantial costs, as has been discussed above. These costs are analogous to those faced by dairy manufacturers that have had increases analogous to increases faced by manufacturers.

Manufacturing costs are subtracted

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in Class III and IV price formulas. In just the same way, Class I and II supply costs are added in the Class I and II price formulas.

In order to maintain the proper relationship between the product prices and the Class I and II milk prices, both of these sets of costs must be considered and applied. Strict application of new Class III and IV make allowances to the Class I and II prices, without consideration of conditions specific to Class I and II milk, perverts the relationship among Class prices.

Failure to address legitimate milk supply costs in establishing the Class I and II milk prices will undercut the ability of the pool to attract a stable supply of milk to these higher uses and lead to increased de-pooling.

De-pooling causes disorderly milk markets, due to the unpredictability of the producers' uniform price relative to the Class prices, due to the risk the pooling handlers bear as a result of other handlers' decisions to de-pool.

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Since the beginning of 2003, the average producer price differential in the Upper Midwest market has been 3 cents. Under the NMPF's proposals, we estimate that it would have been 23 cents, and at least two individual months of negative PPD's would have been prevented at the base point.

Over the same period, the average producer price differential in the Pacific Northwest market was a negative 9 cents. That's the average. Under our proposals, it would have averaged positive 15 cents, and at least three months negative PPD's would have been prevented. A table of PPD's for these two markets, and the projected PPD's under NMPF's proposals is attached to my statement.

Establishing these new Class I and II price models is clearly justified and will as clearly further the objectives of the Act.

Third, Class I and II price formula provisions should not incorporate the Class III and IV price formulas by reference. While the elements of the Class III and IV price formulas may continue to be necessary bases for defining

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the Class I and II price formulas, their direct incorporation -- that is their incorporation by reference -- into the Class I and II price formulas can lead, and has led, to changes to Class I and II prices without due consideration for the independent conditions that pertain to Class I and II milk supplies.

Establishing distinct and simplified Class I and II formulas will help ensure the future changes in the Class I and II prices are based upon direct consideration of the cost and processing considerations for both fluid milk and manufacturing milk. This would avoid unintended distortions in the relationships among Class prices that might lead to disorderly marketing conditions.

Fourth, these proposals have the support of producers and their cooperatives. NMPF represents between 40,000 and 50,000 farmers through its 33 cooperatives. As such, NMPF serves as the voice of the majority of American dairy milk producers. These proposals represent the policy of this collective membership. In addition, many of our members

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have written the Secretary directly in support of this hearing.

There will be substantial producer and cooperative support for these proposals at this hearing and in its follow-up, just as there was substantial producer and cooperative support for NMPF's call for an alternative to the strict application of the Class III and IV make allowance changes to the Class I and II price formulas.

In conclusion, the tentative final decision arising from Docket No. AO-14-A74 of the make allowance docket recognizes increased processing costs for cheese, dry whey, butter, nonfat dry milk, and will reduce the price for all four classes of Federal order milk.

The analogous Class I and II milk supply costs, which are incorporated into the current Class I and II price formulas, will not be updated by that decision, and offsetting increases in those Class prices that would have resulted will not be realized by farmers.

NMPF urges the Secretary to issue, on an expedited basis, an amended rule that

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would establish simplified and updated Class I and II price formulas, in order to maintain the proper price relationship among the four classes and to the dairy product prices, and to avoid unnecessary losses of $100 million a year for the American dairy farmers.

NMPF's proposed Class I and II formulas remain linked to the Class III and IV prices through dairy product prices and through formulas based upon the same manufacturing costs and yields. However, placing the simplified Class I and II price formulas in distinct order provisions will help to assure Class I and Class II revenue will be affected by future changes in make allowances only when the Class I and II supply costs are fully considered.

America's dairy producers will face substantial and unnecessary economic hardship if the tentative final decision on manufacturing cost allowances is not followed in a timely decision on Class I and II -- I'm sorry, Class I and II cost allowances. NMPF therefore urges immediate and expedited attention to the proper determination of Class I and Class II prices.

Just as the Department has moved forward in an expedited proceeding on make allowances, so should a speedy decision address the substantial and analogous inadequacies in the Class I and II price calculations.

We thank the Secretary and the Department for hearing this proposal, and before I welcome the questions, I have a couple other things to add.

I want to point out, first of all, as I said before, that we have attached to the statement specific Federal order language which we believe would affect the changes to the proposal.

JUDGE PALMER: Shall we just mark your statement as Exhibit 5?

DR. CRYAN: That would be fine with me.

JUDGE PALMER: And receive it.

(Exhibit No. 5 was marked for identification and received into evidence.)

JUDGE PALMER: We will mark

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the statement with attachments as Exhibit 5 and receive it. That way it will be there for everybody's review and use.

DR. CRYAN: Thank you, Your Honor. There's also a table demonstrating the -- our members' place within the cooperative -- the country's dairy cooperatives publishes the top 50 co-ops in the country. I attached that list, that list with the rankings, and highlighted the co-ops and members of National Milk.

The next table is the comparison of manufacturing costs for the 1998 decision, which is the numbers used in the current make allowances. That is the make allowances not -- that are currently in effect and compared with the plant costs estimated for 2004 that were brought to the January hearing on make allowances, which numbers were put together as a direct comparison with the 1998 ones.

At that time, we attempted as closely as possible to duplicate the estimation of manufacturing costs for butter and powder as they were done in '98 in order to make them

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comparable so that we have a clear comparison of 1998 and 2004 for application to marketing costs in the Class I price formula.

The next page is a comparison of -- it is a comparison of producer price differentials as they were in the first and third column, and as they would have been, according to our calculations under the -- under our proposals if our proposals had been in effect since 2003.

Again, Federal Order 30 is the Upper Midwest milk marketing order, Federal Order 124 is the Pacific Northwest Federal marketing order, and you can see the difference.

Finally, we have derivations of all the price formulas in order to clarify for anybody who has any questions about how we arrived at what we arrived at to make sure that they are laid out for all to see.

I also have two items, two additional items I would like to offer as -- to the hearing. One of them is a letter from the National Farmers Organization, they wanted to be heard, and they asked me to read this letter

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into the record.

It's from Bradley Rach, who is their director of Dairy Programs. It reads -- it is addressed to Secretary Johanns. It says, "National Farmers Organization, NFO, with its headquarters in Ames, Iowa, is a national all-commodity --

JUDGE PALMER: Why don't we take a recess, let you rest your voice a little bit, get a copy over to the reporter so she can see it, and we will resume in ten minutes. Give you a break.

DR. CRYAN: Thank you.

(Recess was taken.)

JUDGE PALMER: You had two statements. I'm just going to mark them as exhibits so we can save some time reading them in.

The first one is the one from NFO, I think it was.

MR. CRYAN: Sure.

JUDGE PALMER: We're going to mark that as Exhibit 6, and then you have another statement from Keith Pagell at Cass

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Clay Creamery, we will mark that Exhibit 7.

MR. CRYAN: Very well.

(Exhibit Nos. 6 and 7 were marked for identification and received into evidence.)

JUDGE PALMER: They are here, and anybody who wants to review them may do so. The witnesses aren't here to testify anyway, so we will put them in as exhibits for the Secretary's information.

MR. CRYAN: Very well.

JUDGE PALMER: What else do you need to do?

MR. CRYAN: Well, I want to mention just --

JUDGE PALMER: Is that microphone better? We had some complaints about the sound.

MR. CRYAN: I will talk more directly into the microphone.

FROM THE FLOOR: You can turn it up a little bit.

JUDGE PALMER: We don't have much control. Who is the gentleman that is

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controlling the sound system? He was here before. He's not here now. I think he did turn it up.

Can you hear me?

FROM THE FLOOR: Yes.

JUDGE PALMER: Well, keep going.

MR. CRYAN: I will speak directly into the microphone and try to amplify.

I wanted to emphasize again that according to my assessment of this, all markets will gain from proposals -- the changes we are proposing. I also had asked that the sources and -- sources and comments in my footnotes be included in the record of the statement.

JUDGE PALMER: Well, they are part of the statement, we've made it an exhibit so they are there, and you can be cross-examined on it and so forth.

MR. CRYAN: Thank you, sir.

JUDGE PALMER: Sure.

MR. CRYAN: I also ask that a statement of California milk price formulas be

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recognized for the record. I can cite -- give a Web page. I can give a URL that will identify those.

JUDGE PALMER: It's something that's put out by the State of California?

MR. CRYAN: These are effectively regulations for the State of California.

JUDGE PALMER: All right. If you give the reference, we will take official notice of it.

MR. CRYAN: On the Internet they are at http://dairy.ca.gov/pdf/steps, space -- that's an underline, STEPS, underline, FOR underline, CALC underline, minprices.pdf. That's the end of that one.

And I also wanted to ask that notice be taken of the AMS Dairy Public Database, which is a database that's available on the dairy division's Web site. It's downloadable as an access database file which contains effectively data from 2000 to the present on milk prices and pool utilization.

Those are the numbers that I used in

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the calculation of my price differential estimates with and without the National Milk proposals. I have a URL for that if that would be appropriate.

JUDGE PALMER: Yes, go ahead. Give it.

MR. CRYAN: http://www.ams.usda.gov/usdamib/main/welcome.asps.

Sir, that is all I have to say. I welcome questions now.

JUDGE PALMER: All right. Who wishes to first question? Do you have anything further for the witness?

MR. BROSCH: No, sir.

JUDGE PALMER: All right. Who else has questions? Anyone here?

Yes, sir. I guess we will have you come up to this microphone, and please give your full name and affiliation again before you start the questioning.

MR. ROSENBAUM: Steve Rosenbaum, International Dairy Foods Association.

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CROSS-EXAMINATION

BY MR. ROSENBAUM:

Q. Dr. Cryan, I would like to start by asking you some questions related to the adequacy of the milk supply, and I wonder if you could turn with me in the hearing notice, Exhibit 1, to Page 67492.

A. 67?

Q. 492.

A. What document?

Q. Do you have the Federal Register version of the hearing notice?

A. I don't have it, no.

JUDGE PALMER: Here you go. It's a little marked up.

Q. Dr. Cryan, I assume you've read through this more than once?

A. I have read certain parts of it many times and certain parts of it I may have skipped, but go ahead and --

Q. Have you reviewed the model?

A. I have.

Q. Now, the model has various columns,

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one of which is called the baseline; do you see that?

A. Yes, I do.

Q. And is it your understanding that the baseline represents what the United States Department of Agriculture projects will occur during the years 2007 through 2015, assuming that your proposal was not adopted?

A. That is my understanding.

Q. Do you see that there is, under the heading Federal Order Class Uses, in the baseline column -- the rows are Federal order class uses and the baseline column, various figures setting forth the million pounds of milk that USDA projects will be used in each of the four classes, assuming that your proposal was not adopted; do you see this?

A. Yes, I do.

Q. And do you see that the total projected Federal order marketing, which is simply addition of Classes I, II, III, and IV, are shown as being 130.2 billion pounds, roughly?

A. Yes, I can read that.

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Q. And that of that, Class I only represents 45.8 billion pounds; do you see that?

A. Yes.

Q. And if my math is correct, this would suggest that Class I usage is projected on a nine-year average to be approximately 35 percent of total uses. Does that sound about right to you? Simply dividing 45.8 into 130.2.

A. The numbers are the numbers. I'm not sure -- whatever it is.

Q. Have you analyzed whether -- well, let's just -- let me strike that.

Let's assume that the math is right, which I think it is. This would indicate that USDA projects that if your proposal is rejected, that there will be pooled on the Federal order system almost three times as much milk as is needed simply to meet Class I needs. Do you agree with that interpretation?

A. That's -- yes, I would agree that's what it says.

Q. And would you also agree with me

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that this represents a projection that the Class I as a percentage of total Federal order milk will decline from its current levels?

A. That's the projection of the model. I don't necessarily -- I don't know that that's necessarily the case because I believe the next ten years may be a little different from the past ten years that is reflected in this model.

Q. Just to -- you agree with me that the model suggests that --

A. Yes.

Q. -- Class I utilization will be falling?

A. That's what the model says, yes.

Q. So that if one assumes the accuracy of the model, it's reasonable to conclude that we do not need to increase milk production in order to meet growing Class I needs; do you agree with that?

A. No.

Q. Does the model -- do you agree that that's what the model shows?

A. No. That's your conclusion from the model.

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Q. Does the -- have you -- does the model project increasing milk production as a whole?

A. I don't have the numbers in front of me to identify that fact. I don't have the -- I don't have the write-up in front of me to -- it shows an average of U.S. marketings of 191 billion pounds, and that's more the current production.

Q. So as a necessity, then, there's a projection here that total marketings will increase over current; correct?

A. Yes.

Q. And is it also correct that the projection is essentially no increase in Class I usage?

A. I don't have the data from the model in front of me. I can't tell you.

Q. I take it you have looked at the Appendix to Preliminary Analysis for the hearing?

A. I have. Yes, I have.

Q. Let me just -- this document, Appendix to Preliminary Analysis for Hearing

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Concerning Class I and II Price Formulas November 2006, you can identify this as the -- as of the documents that USDA posted on its Web site in conjunction with this hearing?

A. It looks like it.

Q. If you turn to Page 10, can you confirm for me that for Class I, the baseline shows essentially flat Class I total pounds?

A. The model based on the data of the past ten years projects flat -- almost flat growth. There's small growth in the Class I. Again, that's based on the last ten years.

Q. Well, this is USDA's best effort to project these years; correct?

A. Yes. Yes, it is.

Q. And it does project, as we've already seen, that the average total Federal order marketings would be 130 billion pounds; right?

A. Yes, that's what it says.

Q. But that is the average over nine years. It actually shows growth from 124.9 billion pounds in 2007, right, to 135.4 billion pounds in 2015; correct?

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A. Yes.

Q. And so, one can only conclude that from USDA's perspective, there is no need to increase Class I prices in order to attract a sufficient milk supply to meet Class I needs?

MR. BROSCH: Your Honor, is that a question or is he testifying?

Q. I'm asking you, is that a fair conclusion to reach from these statistics?

JUDGE PALMER: Do you agree or not agree?

A. I don't believe that. That's not my conclusion, that's your conclusion.

Q. I'm simply seeing whether you interpret the figures in that way.

A. I do not.

Q. So you -- you do see that USDA projects that if your proposal is rejected, there will be, from the year 2007 to 2015, a 9.5 billion pound increase in total milk pool in the Federal orders of which only 150 million pounds would be needed to serve a change in Class I needs; is that right?

A. The numbers say what they say. I'm

not going to agree necessarily with the way you are expressing it. But the numbers say what they say. They show relatively flat -- this particular model projects relatively flat growth in Class I use and somewhat larger growth in total production, total --

(Discussion was held off the record.)

DR. CRYAN: Mr. Rosenbaum is making conclusions and expressing the numbers in a way that fit his conclusions. I would not agree with the way he's expressing those numbers. But the numbers are what they are.

There is a table here in front of us that has the numbers that it has, and he can keep asking me if that says what it says, and I will agree it says what it says, but it's his conclusion that there is no need to raise Class I differentials, there is no need to raise Class I prices. That's not our conclusion.

BY MR. ROSENBAUM:

Q. Well, you agree with me that USDA's projection shows that even with no increase in

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Class I prices or differentials, there will be more than three times as much total milk as is needed for Class I needs alone? Is that a fair interpretation?

A. Yes, that's a statement of fact that I agree with. That's what the projection of the model says.

Q. By the way, is National Milk Producers Federation -- you have undertaken a program to reduce the national milk supply; is that right?

A. There is a program to attempt to manage ups and downs in the milk supply.

Q. Well, this is the so-called CWT program?

A. Yes.

Q. And your employer is the organizer of that program?

A. Yes, it is.

Q. And this started back in July of 2003?

A. That sounds right.

Q. Your program, among other things, includes what is called a Herd Retirement

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Program?

A. Yes, it has.

Q. Which basically provides financial incentives to farmers to eliminate their herds?

A. It has done that.

Q. And I have read that you all have assessed the success of your program as one that has reduced the milk supply by 3.3 billion pounds; does that sound right?

A. I don't have those numbers in front of me.

Q. Let me --

A. Our measure of success is raising the milk price, not reducing supply.

MR. ROSENBAUM: Let me -- Your Honor, I will ask that this document be marked as Exhibit 8.

(Exhibit No. 8 was marked for identification.)

Q. Mr. Cryan, Exhibit 8 is a four-page document taken from CWT's Web site; do you see that?

A. It looks like it is.

Q. And do you see that at the -- in the

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second paragraph, the statement is made, "The money raised by CWT members has funded programs that have reduced national milk supplies by 3.3 million pounds in the past three years." Do you see that?

A. I see where it says that. I would point out that we also have a program of export assistance, which promotes sales of milk, which is sometimes interpreted as a reducing the supply.

I think that is -- that is a very different kind of program, and I would also point out that there's nothing about our proposal or my statement that says that the problem is adequacy of the overall milk supply.

Q. Well --

A. So I'm not sure where you are getting that.

Q. Do you know USDA has historically at times rejected proposals to increase the cost when differential is based on inadequacy of milk supply?

A. I'm not familiar with that.

Q. We will get to that in a minute,

maybe.

I take it that -- I note that the CWT program as of July 1, 2006, doubled the assessment that was going to be used for these programs, is that right, from 5 cents to 10 cents?

A. I have -- I -- that has been discussed and proposed, and I am not entirely sure what the current status is. But that's probably -- I wouldn't want to describe exactly what the program is doing. I am not briefed on that. I don't know exactly the details, and I don't want to say anything because I don't want to make any misstatement of fact.

Q. Okay. Well, I'm just reading here, "Responding to CWT's success and a surging milk production, the membership investment was increased to 10 cents per hundredweight on July 1, 2006." Do you see where I'm reading that?

A. If that's on the Web site, that's what it is.

Q. By the way, as a proponent, are you in agreement that when there's a talk of the

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need to ensure a sufficient quantity of pure and wholesome milk to meet current needs, the inquiry is limited to the fluid market and doesn't include the Class II market?

A. Well, it's based on the idea that there should be an adequate supply available to the Class I bottlers within the context of the pool and the overall program. Not that it's necessarily to pay over-order premiums to attract milk outside the pool or the basis of compensation that is not associated with the pool.

The pool is supposed to work more or less on its own. Over-order premiums should be added to pay some of those specific costs of supplying, but shouldn't have to compensate the market for the inadequacy of the general level of pricing pool.

Q. Well, my question, perhaps it wasn't artful, was attempting to focus on whether the concern is a sufficient quantity of milk to meet Class I needs in terms of the objective of the Act. You understand --

A. Can I answer the question?

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JUDGE PALMER: I think that's an objection.

MR. BROSCH: I think part of the problem is Mr. Rosenbaum keeps making statements and not asking questions. If he would ask it in a form of a question, it might be easier for Dr. Cryan to respond.

JUDGE PALMER: Maybe you want to think about the phrasing of the question.

MR. ROSENBAUM: I'm happy with my question.

JUDGE PALMER: I thought you would be.

BY MR. ROSENBAUM:

Q. Is it your understanding that the need to ensure a sufficient quantity of pure and wholesome milk to meet current needs is addressed in the context of fluid, needs not in the context of Class II needs?

A. It is my understanding that one of the objectives of the program is to assure adequate fluid milk supplies within the context of the overall program. That's different from saying there's -- we can say today there's

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enough milk to feed the world.

I mean, the point is, just because there's enough milk -- just because there's more milk produced in the U.S. than there is fluid demand doesn't mean there's no further need for Federal orders. In fact, the whole program is predicated on the fact that there are other uses for milk that are complementary, that they work hand in hand; that the establishment of the reserve supply involves the production of the products, the program is -- it facilitates the overall industry.

Q. At the bottom -- I'm looking at your statement. If you could take a look at that, Exhibit 5. You state at the very last sentence on that page, on Page 8 and carrying over to Page 9, "In the Proposed Rules For Order Reform, USDA set the minimum Class I differential at $1.60 per hundredweight, based upon several enumerated costs, beginning with the costs of maintaining Grade A standards." Do you see that?

A. Yes, I do.

Q. And then you quote from a document

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which you footnote as being Volume 63 of the Federal Register, Page 4908; is that right?

A. That's what the footnote says.

Q. Now, I would like to focus on whether in fact USDA did in that document set a minimum Class I differential of $1.60 based upon these costs. I think -- so let me show you that document, if I could.

(Exhibit No. 9 was marked for identification.)

Q. Now, Exhibit 9 --

A. You were going to show me that document.

Q. Well, I have to get one copy back then.

JUDGE PALMER: It's fairly long with table after table. In fairness to the witness, we will give him some time to digest it once you point him to the section in which you wish him to comment on.

Q. Now, this is a long document, but I'm only going to, fortunately, direct our attention to some pieces of it.

You see from the title that this is

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in fact the 1998 Proposed Rule For Order Reform; correct?

A. Yes.

Q. And it contains the Page 4908 that you quote from?

A. Yes.

Q. Now, I wonder, though, were you involved in Federal reform at this time period?

A. As a matter of fact, I worked for the Atlanta Milk Market Administrators' Office, and I was very involved.

Q. Then you recall that at this point in time, there was under consideration what they call Option 1A and Option 1B?

A. Yes.

Q. And can you confirm for me that the discussion of these various elements as they might relate to Class I differentials was in this document the context of Option 1A?

A. Yes, it was. Yes. It was in the description of 1A.

Q. And that, in fact, the discussion of Option 1B starts on Page 4910, which is subsequent to the materials that you quoted;

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correct?

A. Yes.

Q. And can you also confirm for me that Option 1B would have resulted in many Class I differentials well below $1.60?

A. It would have, yes.

Q. And that in this document, USDA expressed its preference for Option 1B on -- I can --

A. Yes, why don't you show me that.

Q. Sure. Page 4914, the last column at the bottom. "At this time, Option 1B is preferred for several reasons," and it gives the reasons.

A. At this time was January 30, 1998.

Q. Yes.

A. That was not the option that was in the final rule.

Q. Well, I'm going to take you to that in a second.

But its from this document that you derived your discussion of the elements that you say go into a Class I differential; correct?

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A. This document constructed two very specific options. The explanation, justification for the construction of Option 1A resulted in an Option 1A exactly as it was applied in the final rule.

Q. We are going to turn to that in a second, but I want to just see whether you agree with me as of January 1998, USDA in fact was preferring -- expressing its preference for a model different than the one that had these elements go into the Class I differential, as of this point in time, January 1998?

A. Is that a question?

Q. Yes. Do you agree -- I think it was. Do you agree with me --

A. It says here, "At this time, Option 1B is preferred for several reasons." I agree with you that that's what it says.

(Exhibit No. 10 was marked for identification.)

Q. Now, I've marked as -- if I could ask you to mark as Exhibit 10 the April 2, 1999 --

A. Sorry, was the previous one marked?

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JUDGE PALMER: Yes. That was nine.

Q. That was nine. Can you identify the April 1999 document as being the subsequent proposed rule that USDA published after it had received comments on the document we marked as Exhibit 9?

A. It appears to be part of it, yes.

Q. And do you recall that in that document, USDA -- and I reference you to Page 16110 -- came up with what it called an adopted Class I price structure, which was something a little different than Option 1A or 1B?

A. I see that it says that.

Q. And, in fact, on Page 16115, the first column there actually is a comparison of Option 1A and the adopted Class I price structure, and it talks about what the similarities are and what the differences are; do you see that?

A. I see that. If you want to ask me specifically, I need more time.

Q. No, that's as specific as I need to

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get for that question.

But could I ask you to look at the actual county by county Class I differentials that USDA's now proposing be adopted and ask you to confirm for me that under this adopted Class I price structure, there would once again be many locations in which the Class I differential would be significantly lower than the $1.60. Take, for example, Page 16219.

A. I would agree that in this proposed rule that was never implemented, there are class differentials that are well below $1.60.

Q. Do you recall that the reason why we ended up with $1.60 was because a lawsuit was brought challenging this rule, and Congress ultimately stepped in and set the Class I differentials; correct?

A. I don't know that any lawsuit had anything to do with it, but I do know that Congress decided the objectives of the Act would be better met by adopting the 1A option as drafted by the Department.

In fact, the statute in which they adopted the 1A option made direct reference to

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this -- these proposed rules and incorporated it directly so that all the logic associated with that option is embedded in the statute.

Q. Are you aware of the fact that USDA had in fact defended in court the Class I differentials of the adopted Class I pricing structure taken that it thought those were the most appropriate way to carry out the Act?

A. I'm sorry, could you ask the question again?

Q. Are you aware of the fact that the USDA defended the so-called adopted Class I pricing structure against the legal challenge that was brought?

A. I'm not aware of it. Congressional action supersedes everything else is my understanding. I'm not an attorney, but my attorney --

Q. It's no question we are under the Class I differentials that Congress --

JUDGE PALMER: Well, he's answered your question. He said he doesn't know.

Q. All right. But you don't know

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anywhere where USDA stepped back and said, "we were wrong," do you?

A. USDA issued a final decision, a final rule, that incorporates Option 1A, based on some combination of their construction of the option, the 1A option, and Congress' direction to do so. The bottom line is that the current law embodies -- the current law includes Congress' direction to use Option 1A and includes all the logic that was used to construct Option 1A.

It's not -- I don't -- it can't be looked at as having come from heaven because it is identical -- Option 1A that Congress instructed them to adopt is identical to the option that they developed based on a sound set of Federal principles and have put it into practice in the meantime.

Q. You agree with me that USDA would have preferred something different, as reflected in Exhibit 10?

A. Well, I -- I expect that the Secretary of Agriculture at that time preferred something different. I think if you define the

USDA in those terms, that may be the case.

Q. Have --

A. I couldn't say.

Q. All right. Have you performed an actual study of the cost of a farm being a Grade A farm versus a Grade B farm?

A. I have looked into that. As a matter of fact, I looked into that, and I spoke to a professor named Joe Balagtas at the University of -- Purdue University who was working with a Dan Sumner, who is a professor at the University of California-Davis, and they were attempting to do some studies on Grade A and found it more or less impossible to find direct data, so we went to -- we went through due diligence to attempt to ascertain specific costs.

Q. Well --

A. We gave credence to the numbers put together by USDA at the time.

Q. Well, it's interesting you mentioned Dr. Balagtas. Isn't his official position as stated in his publications that the Grade A and Grade B standards have narrowed, thereby

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reducing the cost difference?

A. Well, now -- well, if you read his paper, you will see that he says that improving technology has reduced some of the costs of maintaining standards, but he doesn't take into account the fact that the standards have become more exact in the meantime, and he doesn't take into account the fact that all the inputs to maintain those standards have risen.

So he does make a statement on one aspect of the Grade A standards, but the technology, the costs, they should move together.

Q. Don't you understand him to have said directly that the standards have -- the difference between Grade A and Grade B standards have narrowed?

A. No. I read the paper, and as a matter of fact, that's -- he talks about one specific aspect, and which ignores a number of elements of the overall difference in the cost of the standards.

Q. You have done no actual study yourself of what those costs are?

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A. No, Mr. Rosenbaum, I haven't.

JUDGE PALMER: I'm having trouble hearing you again.

A. No, I have not.

Q. Do you know whether Grade B farms are now subject to stricter requirements with respect to, for example, somatic cell counts than they once were?

A. Grade B standards are a matter of the state. The states -- different states have different standards. It's very different. I can't characterize standards for Grade B.

Q. Well, you rely upon the discussion of the Grade A versus Grade B milk issue as it was discussed in the 1998 proposed rule; correct?

A. Yes.

Q. And you are aware that in that connection, when USDA was addressing whether or not -- what the difference was in cost, they were relying upon USDA recommended requirements for manufacturing milk as their source of information; correct?

A. Mr. Rosenbaum, not every state has

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adopted those standards as a requirement for manufacturing milk.

Q. I understand that. But is it your understanding that, nonetheless, it's the USDA recommended requirements that was looked at in 1998 by USDA to come up with the 40 cents?

A. I believe they referenced that -- by the way, the version that they reference was from 1976. I believe they referenced that merely as an example of some of the types of requirements that may be required.

I don't think that that was an exhausting -- that reference represents an exhaustive look at the Grade A, Grade B, and other state requirements.

Q. Are you aware that USDA, for example, in its recommended requirements has tightened the drug residue requirements for manufactured milk?

A. The USDA has?

Q. Yes.

A. For those standards that are not required by every state, I'm not aware of that.

Q. Are you aware of the fact that USDA

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has reduced the somatic cell count for Grade B milk to make it identical to Grade A requirements?

A. Again, I think you may be misapplying the term Grade A. There's standards -- manufacturing milk standards from AMS you are talking about. I don't believe they define Grade B milk. They define standards for milk to be used in Grade A products, which is a different kind of Grade A.

Q. Well, I'm comparing the requirements under the PMO versus the USDA recommended requirements for milk for manufacturing purposes, and are you aware of the fact that USDA has cut down the somatic cell count maximums in the recommended requirements for manufactured milk to make them identical to PMO requirements?

A. I am not aware of that.

Q. Now, in the language you quote on Page 9 from the 1998 proposed rule, there's a mention of the fact that a Grade A farm requires an approved water system which is typically one of the greatest conversion

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expenses; do you see that?
A. I do.
Q. And do you know whether those costs decline on a hundredweight basis as the farms grow in size?
A. I do not know.
Q. Have farms grown in size since 1998, the average dairy farm?
A. The average farm has grown since 1998.
Q. Do you have a rough idea by how much?
A. No.
Q. Let me move to the next item that you include in your discussion of --
A. I would point out, though, that the larger farms represent new investments that have maintained Grade A. They are conversions, faster turnover of facilities, so it's not necessarily over time it would be less expensive than the smaller farms which facilities at one time had a very long life, 50, 60 years.
Q. By the way, Grade B production today

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is, what, 2 percent of the total production?

A. I don't have the number. I would say, though, that Dr. Balagtas and Dr. Sumner have concluded that the Federal order has contributed to the successful conversion of much of the milk supply from Grade B to Grade A.

Q. Actually, they harshly criticize the Federal system for over --

A. They do identify that as a factor leading to that conclusion which represents a success.

Q. They are great critics of the Federal order system; aren't they?

A. Yes, they are.

Q. Assume with me, and I think the statistics will bear this out, that Grade A milk is currently 98 percent of total supply; okay?

A. If the numbers bear you out, they bear you out.

Q. Would you agree with me, if that's the case, and then we've got three times as much Grade A milk as we need to -- roughly

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three times as much Grade A milk as we need to meet fluid Grade A needs?

A. We probably have about three times as much Grade A milk production as we have Class I use, give or take 5 or 10 percent.

Q. So there's really not much of a need to be providing incentive to switch to Grade A farms, is there?

A. I think that's an important part of the maintenance of the program, the current status. I think -- I disagree with you. I think the fact that the program is working is not an argument to kill it.

Q. Well, I'm not suggesting kill it. I'm just saying, don't we -- haven't we successfully converted farms to Grade A milk well in excess of what we need to meet fluid needs in this country?

A. Not according to my definition, no.

Q. In terms of the balancing costs, which is the next item you talk about in your discussion, you --

A. I discuss marketing costs.

Q. Marketing cost, right. And

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marketing costs, you have two components of that, one of which you say -- suggest -- you want to increase the Class I differential or Class I prices by 13 cents a hundredweight, and another one which is transportation, an additional ten cents; correct?

A. Yes.

Q. I want to focus on the 13 cents for right now; okay?

A. Okay.

Q. The data you put in to support that is from that which was submitted in January of this year at the make allowance hearing; correct?

A. Yes.

Q. And you say that data suggests a 22 percent increase in the cost of converting milk into butter and powder; correct?

A. Yes.

Q. But USDA issued its tentative final rule last month on that hearing; correct?

A. Tentative final rule, I think that's right.

Q. Do you agree with me that they only

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agreed to increase -- let me back up a second.

Argument for increasing the buttermilk allowance was that the costs had increased since the time the current make allowances were set; correct?

A. I'm sorry, could you ask the question again?

Q. The predicate for the request for increase in the butter make allowance was that costs had increased since the time those make allowances had been set; correct?

A. Yes.

Q. And will you agree with me that the USDA ultimately only agreed to increase the butter make allowance by 4.5 percent, not by 22 percent?

A. The Department increased make allowances by however much they did, let's say it's 4.5 percent, not entirely based on the increasing costs. The numbers are not -- showing are apples and apples. It's showing, here are the numbers that were used to calculate the 1998 make allowances, and here are the same numbers applied to 2004, so we get a straight comparison of the same numbers just to look strictly at costs.

What the Department did in November was get additional data, go and find additional data sources which they concluded were more representative of the plants that they happened to be looking at, that there were different numbers, different set of numbers, apples and oranges.

They concluded that those were a better source of data than the original data that they used in 1998. That was their decision. That has nothing to do with assessing whether costs had gone up in a similar set of plants from 1998 to 2004. It's two different issues.

Q. USDA's efforts, and whether you and I agree they did it right or not, I don't know, but --

A. I'm not saying if they did it right or not. I'm saying they concluded that they used different numbers, and their conclusion was that it was more appropriate to apply numbers from a different source in calculating

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manufacturing make allowance in the --

Q. And they concluded that based upon a better data set, they would only increase the make allowance by 4.5 percent; is that your understanding of what happened?

A. Again, if it's 4.5 percent. I don't have that comparison in front of me. But if that's what it is that they concluded was a better source. I did not have access to the source for 1998 that was comparable to the numbers that were used in the 2004-2005 numbers that they used in the recent decision. If I had, I would probably have incorporated that as one option, but that doesn't exist. Those numbers don't exist.

Q. You are aware that the proponents of the increase in the butter make allowance had argued that the 22 percent increase should be reflected in the new make allowance; right?

A. You mean they argued that costs had gone up 22 percent?

Q. And that the make allowance should as well?

A. They argued that the costs had gone

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up 22 -- they argued that the costs had gone up 22 percent, and I'm telling you today, costs went up 22 percent, but the Department concluded that the numbers used in 1998 were not necessarily the most reflective of manufacturing costs in Federal order plants; the plants processing Federal order milk.

Q. All right.

A. That's a different issue. I don't -- this isn't a make allowance hearing.

Q. Well, a make allowance is supposed to reflect the cost of making a product; correct? That's the whole idea?

A. That's the principle. I think that's the principle that was applied.

Q. In terms of transportation costs, which is your 10 cents per hundredweight additional factor, now, are you familiar with the recent decisions to increase the transportation credit in the Appalachian and Southeast orders?

A. I am somewhat familiar with them, yes.

Q. Do you know they came into effect

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December 1, just a couple weeks ago?

A. (Witness nods).

Q. Are you aware of that?

A. I was generally aware that -- of I think another tentative final decision. I'm not sure if that's correct or not.

Q. I believe that is how it was done. Do you know that the transportation credit assessment, the maximum transportation credit assessment, was doubled in the Southeast order from 10 cents to 20 cents?

A. That sounds right.

Q. And that in the Appalachian order, it was increased by more than 50 percent, from 9.5 cents to 15 cents?

A. I don't remember exactly, but it sounds about right.

Q. And those, of course, were deficit orders from a milk production versus Class I needs perspective; correct?

A. Yes.

Q. And this transportation credit is intended to cover the vast majority of the costs of bringing in milk from distant sources to meet those needs during the months in which it was needed; correct?

A. Those payments are intended to bring in very specific sources of milk. That is intended to bring in milk that is not normally associated with that market, which means that for the milk that is normally associated with the market, in order to compensate for all the costs associated with supplying that milk that is normally associated, that there is call for higher Class I prices to compensate that, those costs.

Q. Well, so for milk that's not normally associated -- do you know how that's defined, as to whether milk is or is not normally associated with --

A. At one point, the original version of the transportation credit program, it was defined based on certain months of pooling and certain months -- but I -- I know that that continues to be the principle, but I don't have the detail in front of me.

Q. And for that milk -- for the milk that qualifies, is it your understanding that

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the cooperative that actually brings in that extra milk for Class I purposes, they get the money; correct?

A. Or the proprietary handler.

Q. And the payment is made by the Class I handler that actually receives the milk; correct?

A. The payment is made to a -- as I understand it, the Class II -- the assessments are in Class I, it goes to transportation credit settling fund -- transportation credit balancing fund -- and those payments are made to the handlers that are bringing in supplemental milk from that fund. That's how it worked at one point in time.

Q. And the funding is by the Class I handlers itself; correct?

A. Collectively.

Q. Yes. Correct?

A. Yes. And that's compensation for one aspect of market balancing.

Q. The costs of transporting milk for -- as supplemental milk is needed in those markets; correct?

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A. Right. It's the costs of transporting specific volumes of milk. It doesn't cover give-up charges, it doesn't cover costs of maintaining the viability of the regularly pooled milk. It covers one specific element of your costs of supplying Class I markets.

Q. And those other charges are covered by -- currently covered by over-order premiums?

A. If they are adequately -- can you make -- ask me --

Q. Make-up charges -- make-up -- give-up charges are a component of over-order premiums; correct?

A. Give-up charges are something that the co-op has to pay to get the milk to meet their obligations in the Class I supply contract. That's a cost that the co-op producer bears. It is not necessarily reflected in the Class I price for the over-order premiums.

Q. What do --

A. Especially as those costs rise, and they are not reflected in the current Class I

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prices.

Q. What do over-order premiums cover in your view?

A. Traditionally, they cover specific costs that are co-op or typically co-op bears in -- very specific costs that the co-op bears bringing milk to a Class I bottling plant instead of a manufacturing plant is distinct from the costs just generally associated with maintaining the adequate supply of the pool, is designed to maintain an adequate supply of milk overall, and that over-order premiums are traditionally based on intent to cover more specific costs.

The current over-order premiums are very high. They extend beyond that, and they cover not only those costs of -- specific costs of supplying Class I milk, but they also are covering the short-fall of current blend prices to attract adequate milk into the pool and to make it available for Class I handlers.

Q. If you could look back at Exhibit 1 again, which is the notice of the hearing and includes the model, and if I could call your

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attention to the model page, which is 67492, we've looked at it before.

Do you see the columns where USDA has attempted to model what the impact is of your Class I proposal, of your Class II proposal, and then of your Class I and II proposals combined; do you see that?

A. Uh-huh, yes.

Q. Do you note that USDA concludes that your Class II proposal as a stand-alone matter would actually reduce the order milk price in the Federal order system?

A. I see that this particular model generates that result.

Q. And then do you see that the USDA model concludes that your Class II order change or formula change would actually reduce producer revenues by $21 million a year?

A. First of all, I'm not sure whether they are comparing this to the -- right off the top of my head, I don't know whether they were comparing this to the current status quo or the projected status quo within the make allowances.

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Because with the current status quo, my Class II skim proposal is a wash. There's no impact. There's no positive impact. But if it's compared to the projected status quo, then it is an increase, and if that's not accounted for, I'm not sure if it is, then that wouldn't show any positive impact. It would just show no impact from that.

Beyond that, they have some very specific assumptions about the responsiveness of the butter market to changes in butter use, the classes -- at the Class II level which I again, as I said earlier, I believe are based more on the conditions of the last ten years, from whose data this model is built, than from the next ten years, which is the period we're actually looking forward to.

Q. You have not done your own econometric study, I take it?

A. No, I have not.

MR. ROSENBAUM: That's all I have. Should I move the exhibits at this point or --

JUDGE PALMER: We will receive

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them. Is there any objection to the exhibits? They are received. That's Exhibits 8, 9, and 10. They are received.

(Exhibits 8, 9, and 10 were received into evidence.)

JUDGE PALMER: Other questions? Any other questions? Yes, sir.

MR. CROSSLAND: Thank you, Your Honor.

JUDGE PALMER: Sir, if you could give your full name and affiliation again.

MR. CROSSLAND: Edward Crossland, Lanco-Pennland Milk Producers.

JUDGE PALMER: Yes, sir.

CROSS-EXAMINATION

BY MR. CROSSLAND:

Q. Dr. Cryan, in reviewing your remarks in your proposals, is it fair to say -- is it a fair conclusion that, basically, these proposals are necessary in order to prevent a loss to farm income due to the increase in the make allowances for the Class III and IV milk

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that has just been proposed?

A. This -- okay. These proposals -- the implementation of these proposals is necessary to achieve a proper balance between the formulas compensation for Class I and II costs and the formulas appropriate compensation for Class III and IV costs, which is to say that the formulas, all the formulas, need to be updated.

So in a sense of timing, we believe that this is important to do this on an emergency basis to make sure that the losses associated with the Class III and IV -- Class III and IV make allowance changes that are being applied to Class I and II have their offsetting adjustments in the Class I and II and the other elements of the Class I and II decision.

So, you know, in one way, one sense, the answer to what you are saying is yes, and in another sense, it's not quite the effect as yes.

Q. And is it fair to say, without this, you believe with the proposed changes for

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Class III and IV make allowances, farm income would suffer, as you've indicated?

A. Farm income will suffer from the Class III and IV make allowance change, and farm income, at least in the aggregate, it will be, according to the USDA's assessment, will be offset in aggregate by the implementation of our proposals -- of the adoption of our proposals.

Q. What was National Milk's position or is National Milk's position on these proposed increases on the make allowances for Class III and IV?

A. Well, this isn't a make allowance hearing. But at the time, our position was to acknowledge that costs in the formulas needed to be recognized, and we take and apply the same principle now at this hearing. The costs that are embedded in the formulas need to be recognized.

We believe our position was balanced and moderate, and we don't think there's anything inappropriate about updating one-half of the formula after you've updated the other

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half of the formula.

So we recognize the principle that farmers need to have an outlet for their milk, and make allowances needed to be at least adequate to allow for those costs.

Q. Sir, what is the net effect of this increase on the farmers that I represent in order one with the 45 percent class utilization? What is the net effect in their milk check every month?

A. I don't have -- I don't have the numbers in front of me. But if there is a 70 cent increase in the Class I price, then that should increase the plant by 77 cents times 45 percent, which I guess is about 35 cents.

That's probably -- that's probably the -- that would probably be the static effect in the Class I, with some additional increases from the Class II proposals, especially following up on the make allowance changes.

Q. Do you believe that a 35 cent increase is enough to sustain the survival of dairy farmers across this country?

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A. I never testified to that. This system is evolving. There's an awful lot of factors involved. Certainly it's better to have the 35 cents than to not have the 35 cents, but I don't say that this is the end of the road.

Q. What additional steps then -- what additional proposals would you make to improve farm profitability?

A. I think it would be unnecessarily complicating to this hearing to bring up additional proposals, and I decline to answer that question.

Q. Your proposal is for an increase of 77 cents per hundredweight; correct?

A. Yes, sir.

Q. If that only increases the profitability by farmers in order one 35 cents a hundredweight, why did you not propose a higher increase in that cost?

A. The proposal is based on an application of all the -- the same principles that went into the current formulas. Recognizing that the make allowance again was

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an update of the methods that were used in order formula, the methods that were used in the current price formulas, it was a very good idea to move forward and make the same application of an update based on the same principles to the rest of the formulas.

It is another issue whether there's something more to be done, but right now, we are doing what we're doing.

Q. Why did you not propose a higher amount than 77 cents?

A. It was my assessment of the numbers, and when I went back and I looked at the way the Class I prices was constructed in the order one process, I did my best to update those numbers in a reasonable method, in a way that reflected a balance, and that, again, represented my best estimate of the cost increases associated with the elements of the formula that are already in place.

I would love to come in and say that, you know, from now on milk is going to be $30 a hundredweight, but I don't think the Department would have accepted that. But we work with the system, and it's a good system, and this is a step, this is a positive step, that doesn't really reflect any radical changes. It's a modest follow-up to the make allowances issue.

MR. CROSSLAND: Thank you. Thank you, Your Honor.

JUDGE PALMER: Other questions? Anybody else wish to ask questions at this time? Yes, sir. Again, state your full name and affiliation.

MR. LAMERS: Richard Lamers, Lamers Dairy, of Appleton, Wisconsin. L-A-M-E-R-S.

CROSS-EXAMINATION

BY MR. LAMERS:

Q. I just want to be clear exactly what your motivation is here, really, in making these proposals.

You say that you want to increase the price of milk for the producers, yet you have said that money that would go into the pools go to the manufacturing plants; is that

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correct?

A. The money that goes into the pool goes to all pool producers. So, for example, if you are producing milk in Pennsylvania and your pool -- milk is pooled on more than one, but it is being delivered to a cheese plant, then as a pooled producer, you get part of the -- you get a share of the Class I value on the market.

Q. From the manufacturing plant?

A. From the -- well, the manufacturing plant pays -- the way the pool works is that, you know, the idea, the simplest idea of it is that everybody pays -- all the plants pay the full value for all the uses, and it goes into the pot and gets divided among the farmers.

It doesn't quite work like that. The accounting is a little different so that the cheese plant is actually going to get a check from the marketing administrator, and that -- to allow him to pay the difference between Class III price he has to pay and the blend price that he has to pay to producers.

So the accounting works out -- where

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the accounting works out, the market will send a check to the cheese plant, but he gets a check so he can pay the producers.

Q. I understand, sir. And so then, actually, these manufacturing plants that pay the producers, do they compete with other manufacturing plants as well as distributing plants for milk -- for the fluid?

A. They do.

Q. They do. So that the manufacturing plant has the benefit of being able to compete in the market for a Grade A milk manufacturing through the use of the pool; is that not correct?

A. Well, the milk has to meet some performance standards. The milk has to be available according to standards set within the Federal orders. It has to be available to the pool for Class I uses, and a certain share of the milk delivered by a producer or by a manufacturing plant by a cooperative has to be delivered to the Class I uses.

So the competition is based on a starting point is a presumption that they are

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contributing to the supply of the bottling market.

Q. I would like to go two directions from here, if I may.

JUDGE PALMER: Do one at a time.

MR. LAMERS: One at a time. Correct. Thank you.

Q. In the establishment of the prices, the Class prices under I believe all the Federal order systems, it is the Class III or IV price as determined by a NAS survey the higher of which establishes the base price for producer milk; is that not correct?

A. Right. Class III is based on cheese and whey prices and butter prices somewhat, and Class IV is based on powder and butter, and right now, right now, they do a calculation of those formulas for some different rates, and whichever one is higher, they use as the basis.

Q. They use that as the basis?

A. Right.

Q. Does not the co-op have within its ability to be able to purchase cheese at the

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Chicago Exchange at higher-than-market prices, bolstering the market price and thereby raising prices to producer?

A. I wouldn't -- I wouldn't speculate on that kind of activity.

Q. You didn't get to read the article that was in the "Milwaukee Sentinel Journal" last year where co-ops have stated they have done this?

A. I don't remember reading the article. Whatever I would say about that would be speculation and hearsay, and I don't want to get into that.

Q. And, again, the Chicago Cheese Exchange basically assessed the price for manufactured products, and it is a very, very narrow portion of the market in total in which in turn the prices are used by the NAS surveys?

MR. BROSCH: Your Honor, the gentleman may not understand that this is a questioning period, not a period for him to testify. If he would like to testify, he can do that later, but he really should restrict it to questions.

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Q. Well, isn't that true?

A. I would say it's true. But let me point out that the Department made a decision to use NAS prices because it's a full-blown survey of the large share of production.

If the market as a whole follows the Chicago Mercantile Exchange, that's an inefficiency. It has to kind of correct itself. There's always going to be some difference between the NAS prices and the prices on the Chicago Exchange.

So the use of the NAS price should mean that you don't really have that kind of problem, at least in the long run, because in the long run -- in the short run, you can do all kinds of things, but in the long run, it always has to even out.

Q. All right. Now, you referred to reserve supplies of milk, and so did the previous gentleman questioning you were talking about reserve supplies.

Are you not in agreement with the fact that a reserve supply of milk for the fluid market is 120 percent of the fluid sales?

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A. There have been a lot of definitions of what an adequate reserve supply is, and I don't intend to get into that. I think we are following all the principles that were applied in 1998 in the development of the Class I price.

The Department made determinations about the way to do that, and Congress confirmed those determinations. We're just updating those things. We're not getting into what an appropriate reserve is. That's a whole other discussion about a whole other set of provisions in the orders, and all I'm talking about today is updating provisions that were put into place by the Department based on a 1998 proposed order.

Q. All right. You also have in your paper that over-order premiums were ranging anywhere from 60 cents up as high as $2.10 and $2.72 per hundredweight.

Now, if in fact the manufacturers are losing all this money because of the narrowing of or increase in costs and not having adequate make allowances, how in the

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world are they paying these kind of premiums?

A. These premiums are being paid by the Class I handlers. Those are Class I over-order premiums for bottling plants.

Q. Oh. So then you mean the Class I price is not attracting milk to the fluid market?

A. That's right. Class I -- that's what we're here proposing, the Class I price should be higher.

Q. And the differentials of -- Class I differentials now range what?

A. Beg your pardon?

Q. What do the Class I differentials range at this time?

A. I believe they range from about $1.60 is the minimum Class I differential to something over $4. I'm not sure how high they go.

Q. They are quite a ways up there; aren't they? And now you propose that we increase the Class I differentials --

A. No. I'm proposing we move the Class I --

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Q. Or Class I movers based on the additional -- or the costs to produce butter, powder and cheese and whey because those costs have --

A. Based on costs to producers maintaining Grade A status and costs to co-ops and producers of marketing milk to the Class I market, and based on obviously a competitive factor based on the fact that bottling plants are having a hard time in certain portions of the Midwest to attract bottled milk into the Class I plants.

So even though I've used the manufacturing costs of the butter-powder plant as approximate for marketing costs, as a basis not as -- not as an approximate to the overall costs, as a cost that should evolve the same way as the marketing costs, that doesn't mean we are increasing it to pay necessarily for the average for -- certainly not to pay for -- it's to pay for a range of costs.

Q. Well, is it not true that much of the milk shipped to the bottling plants, the fluid market, are direct ship milk?

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A. You mean by --

Q. Direct from the farms to the bottling plant?

A. Most of it is, yes.

Q. You heard of that; haven't you?

A. Yes.

Q. Yeah. Well, then there can't be any additional costs involved to the manufacturing plant that's supplying that milk?

A. To the manufacturing plant?

Q. To the manufacturing plant, the supplier.

A. The co-op -- the co-op that supplies milk to a bottling plant for a variety of reasons needs to -- a co-op typically signs a full supply contract for the bottling plant. That means they have to bring to the plant all the milk that they need day in and day out, including variations, that don't necessarily match with the seasonal variations in production.

So, for example, the demand for milk in the bottling plant hits its peak in late August when the schools reopen just when heat

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stress is reducing production. It drops off -- demand drops off in June when the schools close, just when in some parts of the country production is peaking.

So there's a lot of things that the co-op has to do to either have enough milk when things are short and there's high demand, or to deal with the milk when there's a lot of extra milk and demand is short.

There are a lot of costs associated with supplying a bottling plant with Class I milk beyond just shipping milk from the farm to the plant.

Q. Well, would that then include the cost of qualifying kickbacks in order to qualify for pool?

A. I don't think that's -- I don't think that's -- I'm not going to answer that question. That's --

Q. Yeah, Bloomington here, you saw all kinds of that, okay, two years ago.

Now, then, if we raise the price on -- essentially raise the price on Class I and Class II products, how is the Secretary of

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Agriculture supposed to justify that increase in the interest of the consumer?

A. Okay. I'm sorry, would you ask the question again?

Q. The Secretary of Agriculture has to set prices and make prices in the interest of supply and demand and in the interest of the consumer. By increasing the Class I or Class II prices, the consumers of fresh bottled milk, they are going to have to pay more for their milk.

When there is also surplus milk or greater reserve in the market than is needed, how is the Secretary of Agriculture going to justify that cost increase to the consumer?

A. It's about -- the program ensures that there is enough milk for a variety of uses. It makes sure that the fluid milk uses are compatible with the continued growth in manufacturing, in dairy manufacturing, and it is -- it contributes substantially to the stability of the supply for bottling plants.

Q. But do the Grade A regulations require that manufacturers obtain Grade A milk?

A. The PMO?

Q. PMO, whatever.

A. Yeah. The states bottlers have to buy Grade A milk.

Q. Yes. Not the manufacturers; correct?

A. The manufacturing plants, in order to participate in the pool --

Q. They have to have Grade A milk?

A. It has to be Grade A.

MR. LAMERS: For the pool. That's all. Thank you very much.

JUDGE PALMER: All right. Anyone else who is -- Mr. Yale? Again, sir, if you would give your full name and affiliation.

MR. YALE: Benjamin F. Yale, Yale Office, on behalf of Select Milk Producers, Continental Dairy Products, and Dairy Producers of New Mexico.

JUDGE PALMER: All right, sir.

CROSS-EXAMINATION

BY MR. YALE:

Q. Good afternoon.

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A. Good afternoon.

Q. I would like to -- some of these are clarification questions, and I would like to go over your form. This is the first issue.

If you would look at Page 7 of your testimony, and in the middle, there is the skim milk price for Class I, which is either the, as we now call it, a Class IV and Class III, but powder base or a cheese base.

The 8.9, as I read through this, that is .99 which is the yield under the current regulations times 9 pounds and 100 pounds; is that where you come up with the 8.9?

A. That the -- one of the reasons I attached the derivations is so that all of those things could be examined in detail. If there are any mathematical errors, it will be obvious that it's a mathematical error, and the Department, as they go through this stuff, will identify that.

I believe it's all correct. I believe everything is correct and approved and right in this statement. So given that, I'm

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not putting you off, but we can -- I can look at that, and the question again is whether the Class -- effectively, the current Class IV calculation is based on -- yes, based on 9 times .99.

Q. Okay. Now, I think you, in the back in your examples of the formulas where you simplified them, rather than doing the nonfat dry milk times 8.9, minus $1.40, you started out with the formula, did you not, which is already in the formula, which is the nonfat dry milk price, minus the make allowance, and then that difference multiplied by .99; right?

A. Let me see. Yes. Yes. That's right.

Now, let me point out something on this. What you may be getting at, the rounding -- the rounding on this -- on all these formulas in the text is pretty extreme. I'm assuming the Department will adopt whatever standard for rounding that they have chosen to adopt in their formulas.

I have noticed that the last decision, the make allowances, they go out to four decimal places per pound of product. And I think, you know, whatever convention they adopt in rounding would be -- I assume would be applied to this. I'm not making a case for one rounding method versus another.

Q. That's fine. I'm kind of leading up to another line.

A. That's fine. I wanted to clarify that. You gave me an opportunity to clarify.

Q. Is that 14 cents or $1.40, is that 8.9 times the -- or 9 times the 14 cents? How do you come up with $1.40 in this formula?

A. Well, it must be -- it must be 15.7 cents times .99 times 9.

Q. Okay. So this is using the current November make allowance?

A. Yes. As I tried to make that clear in the testimony -- in the statement, but I will say it again, all these formulas begin with the make allowances adopted on -- well, proposed for adoption -- on November 22, under the presumption that those will be applied next year.

Now, again, I don't know whether --

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this is still a proposed rule, so, technically, they are not current. But in this case, we anticipated that it is going this far and will continue. But it's not -- it's not an endorsement or a condemnation of the make allowances. The make allowances are what they are. The new make allowances are what they are. We thought it was the clearest way to move this forward to make it understood what we were talking about was to use the make allowances proffered on November 22.

But, again, in this -- sorry to be repetitive, this -- not that I'm just starting now, but this proposal stands on its own. It stands on its own. Wherever you start from, everything we are proposing in principle stands on its own. It does not depend on what the make allowances are.

If the Department decides to reverse the make allowance decision, this would stand on its own in terms of adding 77 cents to the Class I in terms of canceling out the make allowances in the Class II skim. Every element of what we are doing stands alone, and, in

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effect, the only reason to apply any make allowances in the calculations is to be able to demonstrate in concrete terms what we're doing, so --

Q. That's how we understand them. I want to move down, though. There's a couple other numbers I wasn't sure.

The cheese using the 10.0 factor, how did you come up with that?

A. Now, you really want to get into that, huh? That's a very complicated calculation.

Okay. The protein price starts with the cheese value, and then it takes a -- I think it backs out butterfat by taking additional cheese values, subtracting butterfat to get to the protein value.

So let me try and go over this. The -- what do you want first? The yield?

Q. Yeah. The yield is -- how did you come up with 10?

A. The 10 is -- it is the 1.383 yield, the first piece of the yield, times -- times -- okay. 1.83 -- I'm sorry, 1.383 times 3.1.

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Q. Okay.

A. Plus 1.572 times 1.7 times 3.1. Do you follow both of those? There's two elements. The protein -- there's two cheese elements in the protein price calculation, and there's a partial yield attached to both of them, and there's a factor -- there's a factor, an additional factor, associated with the cheese minus butter adjustment.

Q. The 1.17?

A. Right, the 1.17. So it is applying all the current yields. That's on Page 32 of the -- this statement.

Q. Derivations of proposed --

A. Derivations.

Q. And so in that formula, you included not just the protein, but the butterfat element as well?

A. Right.

Q. Because that's what cheddar is is protein holding butter.

A. This is the skim price, so it doesn't include the positive butterfat value that you get -- that you use to calculate the

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price of 3.5.

Q. Right.

A. But it does include the negative butterfat value -- is that right? Negative? Yeah, the negative butterfat value, then back it down to zero. Down to zero butterfat, yes.

Q. At 3.16 percent butterfat; is that what your testimony is?

A. Yes.

JUDGE PALMER: Your voice lowered. We can't hear you.

Q. That might be beneficial for a lot of people, but for the moment, it's 1 point -- 3.16 percent, I think you stated that in your testimony?

A. It's in the footnote, yeah, that 3.16 butterfat, that the butter -- all the butterfat value is washed out and becomes Class III milk is 3.16 percent butterfat is strictly a function of cheese and whey prices.

Q. Okay. You clarified it further than I had, so I have to relook at it.

Now, let's follow up on that. You made a comment that they are stand-alone. You

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would agree, would you not, that there's two aspects of your proposal, one of which is to change the formula itself; right?

A. (Witness nods).

Q. So whether using the higher or -- the higher and advance three or four, we have a whole separate formula; right? That's the kind of decoupling; is that correct?

A. Right.

Q. And the second thing is that you also are proposing changes in some variables to effectively increase the Class I price by 70 some plus cents; right?

A. Right.

Q. Now, if you -- I'm sure you've read the Notice of Hearing that came out; right?

A. Right.

Q. And in there is made a comment, the Department did, in noticing this is that, you know, these had specific numbers, but the formulas are known, and that as make allowances and yield is adjusted, that there could be an adjustment; do you remember seeing that?

A. That was the -- that was -- yeah, I

read that.

Q. All right.

A. And I would say -- I would say, as I think -- I think my testimony reflects this idea that if the Department is going to -- one of the objectives of having these formulas set aside is that to recognize even though you may go ahead and adjust these on the basis of changes to the make allowances, if there's changes in yields and make allowances -- if, for example, a III and IV hearing that might be out next year, comes to the conclusion that the yield factors and make allowances are different, that ultimately you want to bring those into a Class I hearing to make appropriate corresponding adjustments, but you wouldn't want to do it all by yourself without also taking into account changes in Class I and II marketing costs -- Class I and II supply costs that are also built into the formula.

So I would -- you know, when we propose these specific formulas, again, we're not saying these yields and baseline make allowances are our choice. We are saying, this

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is the baseline, this is what we understand to be the baseline moving forward, and we are proposing specifically, not those, but we are proposing some changes.

We're proposing 77 cents added, we're proposing that the Class II butterfat price be equal to the minimum Class I butterfat price.

In fact, the only formula we are proposing very specifically to be -- that we are laying out specifically is the Class II skim price in which we're trying to -- this is the one formula where we found feasible to mostly just get away from having make allowances in the calculation.

You still have to make some accommodation for, you know, recognizing condensing and rehydration costs, but the larger part of the, you know, manufacturing costs that were built into that Class II skim milk price formula we have been able to drop out, which we think is a big proven because it doesn't -- it can stand alone -- it can stand on its own longer and still reflect the

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reasonable relationship between powder and Class II skim milk.

Q. Under the current regs that are in effect right now, forget this decision, I don't want to talk about that, I want to talk about the current deal, would you not agree other than the 70 cents that's added to the Class -- the advanced Class IV price, is that the nonfat dry milk value in skim, Class II, is equal under the current formula to the Class I skim, if in fact it's the powder price that becomes the mover?

A. I'm sorry, could you ask the question again?

Q. Yeah, I'll be happy to. Right now, take away the 70 cents. When they announced the decision by the 23rd --

A. Yes.

Q. -- of what next month's skim price is going to be for Class II and Class I skim and butterfat, right, if there is a time -- there are time -- by the way, in that higher of between III and IV excessive mover for Class I; right? You would agree with that under current

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regs?

A. I'm sorry, I think I must be having a brain freeze, but I'm having a hard time understanding your question. Could you -- I'm not giving you a hard time. Could you ask it again?

Q. I may be incoherent, and I'm trying not to be. So let's start again.

A. Okay.

Q. There is a Class IV formula that is used as a potential mover for Class I milk; right?

A. That's right.

Q. And only if the Class III potential mover is higher does the Class III become a fact, but if the Class IV is higher, then it becomes the mover for Class I; right?

A. Right.

Q. There have been months in which the Class IV has been the mover; right?

A. Yes.

Q. Now, in those months in which the Class IV was the mover for Class I, the skim value of the Class I mover was equal to the

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Class II skim value, minus the 70 cents; is that correct?

A. Yes.

Q. All right. Does that same correlation fall with this formula? Will we still have, in those months in which we use the powder price for the Class I, and then we have the formula over here for the Class II, will the skim values between the Class I, using the nonfat dry milk mover, and the Class II, which uses the nonfat dry milk, minus that 70 cents, will they be equal under your proposal?

A. Well, they would -- depending on the formula, they could be. I mean, but they are basically calculated separate. So, in principle, they would not be equal. They would move together because they are based on the same nonfat dry milk price and the same yield factor in the formula. Essentially, just one is simplified. It's the same idea, same formula, just simplified.

So they would move together, but there would be a difference in the -- in the fixed amount because it's that fixed amount

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that we had to determine based on condensing and rehydration costs for Class II in order to get rid of the make allowances because they were, you know, just -- they were redundant.

In Class IV, they may be a little different. So there may be -- there would be some fixed difference between the Class II skim price and the -- and a powder-based Class I mover even before the 77 cents.

Because what we are talking about for the Class I skim mover is essentially -- you know, if it's based on skim, the skim mover, we are talking essentially about -- we're talking relative to Class IV formula pulled out, simplified, just the same number. It's really the same formula, just a bunch of interlocking formulas that are all kind of shrunk down to their simplest form, plus 77 cents.

Q. Let me move to this question. And we talked about the formula part of your proposal because it's a radical change in both the Class II and Class I formulas; right? That's your position, they are completely

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different formulas. That part we agree on. Based on your proposal and what is currently now, there is a change in --

JUDGE PALMER: I see a hand from counsel. Yes?

MR. BROSCH: I'm very interested in Mr. Yale's question, but I can't hear him, number one, and number two, it doesn't seem to be a question, so I would ask if he would speak up, if he would ask a question.

JUDGE PALMER: Rephrase it again, sir.

MR. YALE: I'll be happy to rephrase it.

BY MR. YALE:

Q. You are proposing a change in the formula. Forget the values, you are proposing a change in the formula; are you not?

A. I'm proposing a change in, yeah, the Class -- the Class I and Class II formulas, yes. We are proposing several changes.

Q. And those changes, you also are effectively changing, either by removing it or

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adding other factors, that make allowances that are currently in III and IV will not show up in the I and II formula; right?

A. Right.

Q. Now, you would agree, would you not, that with your proposal, you said you are laying it out so that evidence can come to see how it all fits together and involved in different formulas; right? I mean, that's part of -- very transparent where this is going to go and how you got there; right?

A. Right.

Q. Now, I'm going to ask you a hypothetical.

If the Department uses the language that appears in that proposed rule where it says that as other changes occur in make and so on and so forth, that there could be adjustments to the formulas, if the Department, based upon the testimony at this hearing, come to the conclusion that we're going to give you the same value of Class I today, or under our rule, as you have today, we are not going to give you that extra 77 cents, that's the

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hypothetical I'm setting up, you just get your formula, but they are going to change the numbers, like the $1.40 something to make -- you know, add or take off the 77 cents, all right, if all they do is change the formula, but the net result, if you match it month by month is basically the same price we would have gotten under the old formula, is there a value to just changing the formula and not the values of Class I and II?

A. There's a lot of ways to answer that. You are talking about impact on producer revenue and --

JUDGE PALMER: Keep your voice up.

A. You are talking about impacts on producer revenue, and if they -- I mean, again, it does matter what the numbers are.

If you are talking about just -- okay. Let's assume -- let's lay a scenario. The make allowances go into effect on February 1, the new ones, and the one you're talking about, the scenario that you are talking about with -- where they only revise

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the formula so that they are both now separated, that -- if that suggests that they've denied the concept of making -- taking into account the adjustments that we're looking for in Class I, then I don't know.

What we're talking about is the number of things that work together. They all work together, and it's very difficult to suggest one or the other in pieces. It's a unit. It's an integrated proposal.

Each piece bears on the other, and speculating over individual things is -- they all have -- each element has its value in the context of the overall proposal, and I think it's very troubling and problematic to talk about having a separate formula because there are so many things you can talk about, so many different ways -- results or ways of thinking or conclusions they could arrive at that it has to be looked at together.

Q. All right. So, in other words, the 77 cents -- the formula without the 77 cents or the 77 cents without the formula is not what you want, you want the two of them together; is

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that right?

A. Yeah. Yes. That's right, yes.

Q. I don't want to get into argument of germaneness, but I use this as a hypothetical: If the Department says, the formulas are just more complicated than we want, but we buy your 77 cents, we're just going to add, you know, to the, essentially the advanced Class I price and take the higher of the two and add another 77 cents, would you be opposed to that?

A. We proposed a number of concepts, and the Department can look at them. We believe that they all fit together. You know, it's not really up to us when the Department makes a decision on Federal orders to say, well, we don't want that part.

They make the decisions. We -- you know, we do our best to offer proposals. They make the decisions, and it would be pointless to speculate on what elements we would accept or not accept because it's not our decision.

Q. But it's within their discretion to change that 77 cent factor one way or the other; right?

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A. Certainly, yes.

Q. You might have some farmers here that can give testimony that it should be a dollar, and somebody would come back, parties are known here, but I'm not going to name them, and they might want to say, get rid of that and even the $1.40?

A. Yes. I think that's logically if you are going to add the 77 cents by itself, then do what you were talking about. But there's -- it's a proposal. It's a set of interlocking proposals. Some pieces can be extracted more easily than others, but it is an integrated proposal.

Q. I'm going to summarize this. We are not setting up this formula with these prices with the idea that the Department can use this as a basis to reduce the differentials between Class I after the order is opposed to; right? It is both a formula change, but it's also a price enhancement and they come together?

A. As we -- yes, we proposed a formula change and a price enhancement.

Q. And you also are proposing that

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unless somebody specifically requests that, that any changes in the yields or make allowances on the III and IV in the future are not to be automatically adjusted into the Class I and II; is that right?

A. Yes. It's our belief, and we expressed this before when we were at the ex parte, we expressed our belief that this is clearly preferable to have separate formulas so that -- and in the testimony it states it pretty specifically, too, I think.

The separate formulas are valuable because they would -- they would -- in our opinion, they should prevent a make allowance change and III and IV from necessarily and immediately impacting only part of Class I and II, the Class I and II formulas.

That is to say five years from now, which is probably more valuable, a more illustrative example than what is going to happen next year, five years from now, costs go up some more. They decide the make allowance changes have to be looked at again, and they reduce the make allowances.

Dr. Cryan - Cross by Mr. Yale

We don't believe that with this -- with this, we don't believe that they should necessarily make the formula changes in the I and II formulas immediately. We believe they should -- they should hold another hearing to look at all the costs so that if they need to make -- if they feel it's appropriate to update the application of those manufacturer make allowances and the calculation of I and II, that they also at that time take into consideration changes in the costs to marketing costs and all issues associated with I and II as well.

So that's how we expressed it. However, the Department can -- you know, has a lot of latitude in the hearing. We can express our interpretation.

Q. So, really, the advantage of the formula by itself without the numbers is the fact that you decoupled I and II from an automatic adjustment every time you look at III and IV, that's the beauty of the program; right?

A. I believe that the beauty of it is

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that it encourages a balanced consideration of I and II in sequence with a Class III and IV change, so that there's not just a kind of a -- there's not an automatic and one-sided impact on the Class I and II prices when there is a make allowance change.

It offers the Department the opportunity to take that kind of balanced step-by-step approach to updating prices. That's an important part of what we're proposing.

Q. I wanted to change subjects a second and move to this Grade B issue as part of your obligation -- or of your presentation.

In the -- right now, I mean, have you done any research or looked at any documents to see -- you mentioned roughly the amount of Grade B milk but where that Grade B milk is located? Is it concentrated -- are some states prohibited?

A. I looked at some of the numbers, but they don't come to mind. I am not going to, you know, push my memory beyond what I remember, so --

Dr. Cryan - Cross by Mr. Yale

Q. Do you know whether there are any states in which there's only one grade of milk, and that's Grade A? If they went to Grade B, then it's an unmarketable product?

A. Every state has Grade B milk at some point.

Q. Why do you say that?

A. Because every state -- at some point, producers in every state have to degrade when they fail an inspection, and at some point every state has producers that get degraded.

Q. And if that milk has been degraded, is that equal to the Class III price or does that tend to be discounted from the Class III price? You don't know?

A. I know different cooperatives have different agreements with their producers, and there's different provisions in different states about compensation versus dumping versus Grade B versus completely unusable, but I don't have the details.

Q. I want to take another topic. I want to move to something else. I want to talk about the impact of increasing the Class I

Dr. Cryan - Cross by Mr. Yale

price by 77 cents.

Have you or have you seen any literature that would tell us -- I got a couple of questions. First of all, will this higher price have an impact on the amount of Class I that is actually sold? Did you do any analysis of that?

A. I did not do analysis on that, the Department did.

Q. You're aware that in most markets, that there are over-order prices for Class I milk in most of the Federal orders at some point in time; right?

A. There are?

Q. Over-order premiums, so -- you know what I mean by over-order premiums?

A. Yes, yes.

Q. Those are fairly common in the industry; are they not?

A. In the markets I looked at, there are over-order premiums and higher now than they were a few years ago.

Q. Now, have you done any analysis or talked to anybody about the impact -- if you

Dr. Cryan - Cross by Mr. Yale

raise the Class I differential, how much of that raise will be absorbed by reducing existing cooperative premium structures?

A. We're proposing to raise the Class I mover, not the Class I differential.

Q. But if you are a plant out there and you feel that you need to market milk at so much per gallon, and suddenly there's a raise in the mover, isn't there a natural expectation that this extra order premiums will cover some or all of that increase because they are wanting to come in at whatever that price yields for them to sell milk?

I mean, really, my question is have you done any analysis --

A. I haven't done an analysis.

Q. All right. I'm not going to try to debate here. If you don't have an analysis, we don't need to talk about it.

What about the impact on pooling in orders, whether it's going to increase the amount of pool writing or the additional milk pooling orders if you raise the Class I values? Have you done any analysis on that?

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A. I have not done an analysis on that.

Q. I wanted to switch here to one other subject, and that is, you made a comment in one of the questions of Steve Rosenbaum about adequate supply.

Are you saying that adequate supply and the existence of adequate supply is not a consideration for the Department today in making these rule changes?

A. I'm saying the fact that there is more milk produced than is bottled doesn't necessarily mean that there is adequate supply in the context of fluid milk marketing.

Like I said, I think that the orders contribute to -- contribute to the adequacy of fluid milk supplies in the context of a growing manufacturing market through -- manufactured dairy product industry.

Q. And in reality, today, most of the milk that's going into manufacturing facilities is not viewed as surplus, it actually has a long-term demand for that milk at that plant?

A. I think the degree to which it is seen as surplus has been reduced, which

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probably is one good argument for why this surplus is larger.

Q. Now I want to go to one final issue here.

In your tables, back in your appendix, if I can find it, you had -- maybe you can help me -- you had a table in there that talked about the different manufacturing allowances.

A. Well, compared costs.

Q. Compared costs. Page 28. I do not see in this the Cornell study.

A. No.

Q. Is there a reason that it's not in there?

A. The Cornell numbers don't exist for 1998. So the objective, as I said, I talked to -- as I explained to Mr. Rosenbaum, the objective was to have two comparable sets of manufacturing cost data for 1998, when these things were -- when these make allowances were put together.

When the order reform defined the Class I price in 1998 and 2004, which was the

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most recent year we could see comparable numbers, and ideally we would have something like this for 2005 or 2006 to really assess the increases in these -- the tendency to increase costs of this type of operation, but the reason the Cornell numbers aren't in there is because we didn't have the numbers from 1998.

So this represents the -- the 2004 numbers are a -- as near as possible to the duplication of the 1998 numbers that went into calculating the make allowances, the current make allowances.

So the best we could have comparing apples to apples, 1998 apples to 2004 apples, was to combine -- just to do the RBCS numbers with California numbers.

(Discussion was held off the record.)

Q. I'm going to go back to a comment you just made about apples to apples.

You are not implying any disparagement on the Cornell study or whether it's right or wrong, you are just simply --it doesn't have a data set that I could use for

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the purposes that I'm trying to do?

A. I am -- for the purposes of this hearing today, I am entirely neutral or what numbers were applied in the make allowance decision.

(Discussion was held off the record.)

A. No, so I'm not -- it doesn't imply -- like I said, it doesn't imply endorsement or disparagement of the Cornell numbers or the application of data by the Department. It is not a suggestion that they should have used these in order to update what they had.

Again, the Department made decisions on make allowances based on a different set of the numbers. The conclusion was that those numbers are more appropriately applied to calculating the make allowance, defining the make allowance, and -- but they are not the same numbers. So this is the closest we get to the same numbers: The 1998 numbers that were used to calculate the make allowances and the 2004 numbers that were not are in effect same -- as close as we can get to the same numbers.

MR. YALE: That was my only question and the answer, and I'm done. Thank you very much.

JUDGE PALMER: Let's take -- recess for a second. I just want to find out where we are going. I think it's a good time.

How many more people have questions for the doctor? Mr. Vetne does. Anybody else? Mr. Beshore. Okay. What is your name again, sir?

MR. SCHAD: Schad.

JUDGE PALMER: Schad?

MR. SCHAD: Yes, sir.

JUDGE PALMER: Anybody else? Mr. Tosi. Anybody else? So that will be the -- there will be four people that have some questions.

What are we looking at for additional testimony? When you conclude, that ends the presentation of the proponents on one through five, and then what? We're going to have, I guess, opposition testimony on it?

MR. CRYAN: Well, that ends our organization's testimony, but there are other supporters.

JUDGE PALMER: Who would be giving testimony then in support? All right. Let's get the names. I just want to know who is who. Yes, sir?

MR. PITTMAN: Thomas Pittman.

JUDGE PALMER: Pittman?

MR. PITTMAN: Yes.

JUDGE PALMER: And you are with who?

MR. PITTMAN: Southeast Milk. Southeast Milk.

JUDGE PALMER: Southeast. Okay. Yes, sir? Somebody else, I saw a hand somewhere. Mr. Beshore?

MR. BESHORE: For Dairy Farmers of America, we have Mr. Holland and Mr. Williams and Mr. Matthees.

JUDGE PALMER: Okay. You have three witnesses?

MR. BESHORE: For Dairy Farmers of America. For the Association of

Dairy Cooperatives in the Northeast, Mr. Wellington, Mr. Herring, and Mr. Beeman.

JUDGE PALMER: So there is another three for what was that?

MR. BESHORE: The Association of Dairy Cooperatives in the Northeast.

JUDGE PALMER: Association of Dairy Northeast. Okay. It looks like we have a few witnesses. Anyone else? This is all for in favor of this proposal.

Anybody else that's going to be testifying in favor of? All right.

How about opponents? Do we have opponent, opposition testimony? Mr. Vetne for who again do you represent?

MR. VETNE: I haven't entered my appearance yet, Your Honor.

JUDGE PALMER: I know you haven't.

MR. VETNE: I will. All right. I will have three or four witnesses.

JUDGE PALMER: Three or four. And who else? Yes, sir, Mister?

MR. ROSENBAUM: Rosenbaum.

JUDGE PALMER: You have?

MR. ROSENBAUM: Perhaps ten.

JUDGE PALMER: Ten?

MR. ROSENBAUM: Yes.

JUDGE PALMER: Short. All under five-two or something?

MR. ROSENBAUM: All telling the truth and good looking.

JUDGE PALMER: Okay. Who else? All right.

Well, what I'm trying to do, I don't want to kill the witness, he's going to be here a while, anyway, let's take a recess for 15 minutes, and we will come back at a quarter to five, and I think we will quit at six.

Does that sound reasonable to everybody? Okay. Let's do that.

(Recess was taken.)

JUDGE PALMER: We want to be able to do a little business before 6:00 comes, so let's all gather together.

We were just talking about a couple of housekeeping things. The reporter really should have an original and one of everything, which we are probably okay on because I'm getting one and she's got one, but let's make sure you have at least two copies to come up here, one for her and one for me.

The other thing is I think now is the time that you can reveal your hands a little bit, and if you would try to have all of the statements together by tomorrow morning and have copies in the back so everybody can look at them and be ready to go when the witness testifies, that would be helpful.

I'm not going to make that hard and fast right now, but let's try for tomorrow morning to get all the statements in the back; certainly of anybody that's going to testify tomorrow and go do a little work tonight, get your statements complete.

All right. I think that takes care of everything.

Who is the next person that had questions for the witness? Yes, sir.

Dr. Cryan - Cross by Mr. Schad

CROSS-EXAMINATION

BY MR. SCHAD:

Q. Good afternoon, Roger. My name is Dennis Schad, S-C-H-A-D, Land O' Lakes. Just a couple of topics, and probably very quickly.

I'm going to address myself the first topic to footnote 8 and footnote 12 on Pages 9 and 10, and my intent here is just to have you amplify what you have put in your testimony.

Start with footnote 8, it talks about the requirements for a dairy farmer to be on a Grade A status. The Department in their, I guess it was the proposed rule for order reform, laid these out and basically put a price which -- and that price of 40 cents per hundredweight was captured in the Class I mover; is that correct?

A. At the time it was captured in the $1.60 Class I differential.

Q. Yes. Okay. It was part of the $1.60?

A. Yes.

Q. Okay. Thank you. Would you agree

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with me that all dairy farmers that were pooled on the market, whichever order we are speaking about, incurred those costs?
A. Yes.
Q. Irrespective of whether the dairy farmer went to a Class I plant or not, he was expected to keep his facilities for Grade A?
A. Yes. In order to pool milk on the Federal order, milk must be Grade A.
Q. And the dollars that were captured in that Class I mover, part of that $1.60, they flowed into the producer settlement fund; would you say that's true?
A. That's right, and they were divided among producers.
Q. That was my next question. They were divided by the producers on an equal rate?
A. That's right.
Q. So there was some economic efficiency -- would you agree with me, there was some economic efficiency so that those that incurred the costs got the full value back out through the PPD?
A. I believe that was the intention of

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the original formulation by the Department in 1998, yes.

Q. Okay. Thank you. We go to the next footnote, 12, and they speak of marketing costs, and they define -- they say these markets costs include such things as seasonal and daily reserve balancing the milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or give-up charges at manufacturing plants, and it goes on.

Just a quick question before I go on. It speaks of shrinkage. Would you think that that use of the term shrinkage would be the same use of the term in a Class III or IV make allowance?

A. I'm not sure I understand the question.

Q. Would you agree with me that the use of shrinkage here relates only to Class I and would have nothing to do with the use of that term in relation to Class III or IV uses?

A. I would have to think about that some. I'm sorry, I don't have an answer for

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that.

Q. Okay. But would you agree with me that not every dairy farmer would incur the costs that are listed here in these marketing costs on any particular month?

A. These charges -- these costs would go -- they rise and fall where the milk is delivered. I'm not sure I --

Q. Is it --

A. I'm not sure I follow that question.

Q. Is it possible that a particular dairy farmer, you know, could be contracted on a proprietary basis and not part of a co-op have his milk delivered to the same plant every day, and he would not incur the balancing costs and transportation to distant Class I plants?

A. I would say, though, there are some balancing costs which are rather specific to a producer and, more specifically, a cooperative, although it could be -- it could be producers contracted to provide -- it could be proprietary, I imagine, in the same process.

But there are some balancing services that probably need to be compensated

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specifically, and you can't really expect the market -- you can't really expect the blend price to cover that because, as you say, not every handler, not every producer is bearing balancing costs in the same proportion.

So I don't believe that you can really deal with all balancing issues through this, but there are elements -- there are many elements of this that are necessarily addressed through -- there are elements of balancing that are addressed through the Class I differential and there are elements that are not necessarily. That does continue.

Q. Would you share the same conclusion with me just that through the PPD, every dairy farmer will get the benefit of the 60 cents per hundredweight, but not every dairy farmer will incur those costs?

A. I wouldn't say it quite like that.

Q. How would you say it?

A. I think there are costs. These costs -- there are costs that are specific to the pool, and I think these are all relevant in here. I think probably there are other

Dr. Cryan - Cross by Mr. Schad

balancing costs that aren't covered that are not necessarily fully accounted for in these things that should be over and above, but that's another issue. That's a whole other --

Q.   That would speak to your footnote 13; is that correct?

A.   13, yes. As I say there, I will read it out loud, "Marketwide balancing assessments and credits may be ultimately be necessary to fully compensate balancing plants, as opposed to full-capacity manufacturers."

I would say the same I believe applies to some Class I supply co-ops in extreme situations where there are -- that there's been recognition of a need to balance certain balancing costs in the Southeast, but those are very specific for right now.

Q.   Agreed. The specific topic: When I read your language, your proposed language, and I'm looking at Section 50, you don't need to turn to it necessarily, I notice that your pricing for Class II butterfat, you are not changing the price series, you are still using the price series, the national butterfat price

Dr. Cryan - Cross by Mr. Schad

for the -- for the month of sales; is that correct?

A. That's the status quo. I don't -- I have no intention of, again, complicating this by randomly introducing innovations that are not fundamental to this specific proposal.

Q. You are not proposing an advanced Class II butterfat price?

A. No.

Q. Why would you not propose that? Do you have any reasons why that would be a --

A. I think that's something that needs a lot of thought. Class II -- the Class II butterfat is a quarter of the butterfat in the Federal order system, and to, you know, put together the Class I and Class II butterfat would make almost half of the butterfat in the Federal order system advance in price which would put a tremendous burden on the rest of the butterfat, and the Class III and IV butterfat being current price because Class III changed most of that burden is on Class IV butterfat.

So it would be a relatively small

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pool of butterfat responding to current prices, with 50 percent of the pool butterfat responding to prices that are a month and a half old.

Q. If someone else at this hearing proposed advanced Class II butterfat, would National Milk oppose that proposal?

A. National Milk is here today offering a specific proposal, and I don't -- I think that's -- I think that's what -- we have a proposal that's out there. We are not proposing any more or any less.

MR. SCHAD: Thank you very much.

THE WITNESS: Sure.

JUDGE PALMER: Would it be Mr. Vetne or Mr. Beshore? Who wishes to -- you would like Mr. Vetne to go? Fine. Mr. Vetne? Since he's not going to be here tomorrow --

MR. VETNE: You might not get to him today.

JUDGE PALMER: You never know.

Dr. Cryan - Cross by Mr. Vetne

CROSS-EXAMINATION

BY MR. VETNE:

Q. My name is John Vetne, V-E-T-N-E. I'm an attorney. My address is 11 Red Sox Lane, in Raymond, New Hampshire.

I represent -- I will enter my appearance now. I'm counsel for the following cooperatives: Alto Dairy Cooperative; Associated Milk Producers, Inc.; Bongards Cooperative Creamery; Burnett Dairy Cooperative; Ellsworth Dairy Cooperative; Family Dairies USA; First District Association; Manitowoc Milk Producers Association; Midwest Dairymen Cooperative; Milwaukee Cooperative Milk Producers; and Prairie Farms Dairy, Inc.

In addition, I enter my appearance for Trade Association Wisconsin Farm Bureau as well as for the Wisconsin Department of Agriculture, Trade & Consumer Protection.

All righty here. Let's see. Mr. Cryan, you can have a copy of that list later.

A. Okay.

Q. I'm joking.

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A. You won't give me a copy of that list?

Q. It's right there.

A. Thanks.

Q. Dr. Cryan, you indicate that National Milk is not proposing an amendment to Class I differentials. By that -- let's define that term.

By that, you mean the add-on that is different at every -- or not every location, but many locations throughout the United States? In Section 52 of the --

A. The add-on?

Q. The add-on is what you mean by location?

A. Class I pricing is made of up two components: the mover and the differential. We are proposing a change in the mover.

Q. The mover post reform is somewhat akin to the Class I price at O'Clare pre reform; am I correct?

A. I don't -- I don't think so. I don't know what the Class I price at O'Clare was, so I can't answer that question.

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Q. You don't know that the Class I price at O'Clare was basically the Grade A differential, the difference in cost of producing Grade B versus Grade A milk at the most productive production area of the country?

A. I understand that the Class I was the BFP plus a differential, but I understood that O'Clare had a positive differential on it.

Q. Yes. Above the Class III price.

MR. BROSCH: Your Honor, is he asking a question or is he testifying here?

MR. VETNE: I'm asking a question.

MR. BROSCH: We have this continued problem that counsel doesn't seem to understand the difference between those things.

JUDGE PALMER: I think counsel understands. They like to do it differently.

MR. VETNE: I've asked like four questions, and already I'm being tarred with the practices of prior lawyers?

BY MR. VETNE:

Q. Let's see. My question is you are not aware that the O'Clare price was

Dr. Cryan - Cross by Mr. Vetne

approximately the Grade A differential, i.e., Class III at --

A. I'm sorry, I don't know what the Class I differential in O'Clare was in 1999, no.

Q. You are not aware of the theory upon which it was established or based or reasoning; is that correct?

A. I am not. I am aware -- I'm aware of the certain elements of the 1994 decision to establish Class IV pricing. I have reviewed the 1998 proposed Federal order reform since that is essentially what we are operating under today, but I haven't gone back into such old history for my amusement. I'm sorry.

Q. Okay. Now, as I understand it, we're here, at least logistically, in response to the hearing on manufacturing or make allowances and the Department's recommended decision on make allowances, and you've discussed a balancing component as part of the proposal to introduce Class I and Class II prices.

With that foundation, let me ask

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this question: Isn't it true that in decisions of the Secretary in Federal order reform in the post reform manufacturing allowance decisions that a component of the manufacturing allowance was balancing requests?

A. I remember it being discussed, but I couldn't tell you that necessarily. I don't remember that it was necessarily made part of the calculations, so I can't answer that question.

Q. You don't recall or aren't aware of discussion of the Secretary explaining that part of the reason for using most plants or trying to recover the cost for most plants is to include some balancing costs?

A. I remember the discussions, Mr. Vetne, but I do not remember that discussion necessarily being tied to a final decision.

Q. Okay.

A. Or final rule.

Q. Okay. You do recall the discussion of a make allowance, however, in past decisions covering costs of most plants? That part you do remember?

A. The -- I'm sorry, could you clarify the question?

Q. My question is do you recall the part of the prior make allowance decisions from 1999 and 2003 that the objective was to cover the cost of most plants?

A. I remember something like that.

Q. Okay. And now we have a different approach to make allowance. Now we recovered the cost of most milk or weighted average of most milk.

A. Well, I'm sorry, I don't necessarily recall a distinction between covering the cost of most plants and covering the cost of most milk. I don't recall that. I'm sorry, I'm not disagreeing with you, I just don't recall that.

Q. Do you recall that the decision released a month or so ago was premised on weighted average price that would cover 50 percent of the milk? Under some --

A. Mr. Vetne, I've had -- that decision was issued on November 22, the same day that a hearing notice was published for today. I

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spent much more time dealing with Class I than looking at the Class III and Class IV make allowances, so I am not prepared to discuss the details of make allowances.

Q. All right. Assume for me, if you will, that the Department has moved from a make allowance that was intended to cover most plants to now which covers a weighted average, maybe most milk or half the milk, and because there are also large plants, that would not cover most plants.

Is any component of your reasoning for this proposal, either when you created it or now that I'm asking you, to take some of the balancing costs that were previously covered in a manufacturing allowance and place those withdrawn costs into the Class I differential?

A. As I understand the current make allowances, they address costs in typical plants, and I think typically plants that are operating in nearly full capacity.

So there is an issue -- there is balancing by co-op owned manufacturing plants that incurs costs for balancing, but the powder

Dr. Cryan - Cross by Mr. Vetne

plant owned by a Class I co-op can incur enormous costs in idle capacity in order to balance markets.

There are certain balancing costs that are rather general and are appropriately applied to this. There may be other balancing costs that would be better addressed in another program, but this is the program we're talking about today.

Q. Okay. And your objective at least is to recover some of those balancing costs in a higher Class I or II price?

A. That's been the principle on which the orders have operated for some time.

Q. Am I correct then that your proposal is based on an acceptance rather than endorsement of that principle?

A. I'm sorry, I don't understand that question.

Q. You say that some component of balancing in the Class I differential has been in place for sometime, and you are simply applying that, applying that to your proposal.

Can I take the next step and assume

Dr. Cryan - Cross by Mr. Vetne

one way or the other whether you think that's a good idea?

A. Well, let me -- I think there are -- again, as I've said before and it's said in the testimony and I said this several times today, that there are balancing costs which are appropriately applied to the Class I price. There are certain costs that, extraordinary costs, incurred by balancing co-ops that are over and above that that may require something additionally such as the transportation credit program in the Southeast.

So on the one hand, I would argue that certainly we should have some consideration of these types of costs in Class I prices, but that doesn't mean that that obviates the need for programs like the transportation credit program.

Q. Was it your answer that it is a good idea to include balancing costs as an economist? It's a good idea to include balancing costs in the Class I minimum price?

A. It is a good idea to include some balancing costs in the Class I price, yes.

Dr. Cryan - Cross by Mr. Vetne

Q. Did it also enter in your inclusion of that component of the proposal your understanding that the Secretary has on several occasions now rejected specifically a balancing credit or balancing payments to those that perform the service in several markets, including the Northeast?

A. They have -- the Secretary has rejected specific programs that have been proposed. I don't know -- I don't think that proves that the concept has been rejected.

I think it's a matter of -- I certainly believe -- specific programs have been rejected.

Q. Okay. As I -- as close as I can come here on Page 10 and 11 of your testimony, you propose to add 13 cents for the balancing component of the Class I add-on?

A. For the marketing costs.

Q. Marketing costs, which includes balancing -- well, and transportation is 10 cents. Marketing was 23 cents, of which balancing is 13 and transportation is 10. That's the way I read it. If I'm wrong, please

Dr. Cryan - Cross by Mr. Vetne

correct me.

A. Yes.

Q. Yes, I'm correct?

A. Yes, right. 13 cents for marketing costs and an additional 10 cents for transportation.

Q. Okay. And I'm inferring from that that you believe that somebody out there incurs 13 cents in marketing costs to serve fluid needs of the market, and that's why it should be added to the Class I price?

A. There are certain costs that the participants in the market generally bear in order to qualify in full. That is to say there are cooperatives and handlers and producers who essentially meet by meeting the minimum standards of pooling or incurring a certain level of costs for balancing, marketing, and give-up charges and whatnot.

There are other handlers, co-ops and producers that go over and above that in order to balance markets, in order to take -- take greater responsibility in balancing the markets. The Class I minimum -- the Class I

Dr. Cryan - Cross by Mr. Vetne

price should appropriately cover the kinds of costs that are incurred by Class I suppliers for meeting their obligations under the order.

Q. You referred to two categories. Those typical, some -- and others that go over and above. Would you agree with me that there are other market participants that are in the pool that go -- let's see, over and above -- under and below?

A. They can't go under and below the minimum requirements for participation in the pool.

Q. That's true. I'm not sure that's an answer to my question. I'm talking about incurring balancing costs.

Let's say an independent producer that shipped his milk 50 miles every day to a Class I plant. What balancing costs does that producer incur?

A. His handler -- he's involved in the market generally, and he's qualified. He's performing on the market in the minimum -- minimum basis to qualify. He's supplying a Class I plant.

Dr. Cryan - Cross by Mr. Vetne

If he was shipping to a Class III plant, which would be paying a lower price into the pool, he would have to -- he or the plant would have to qualify by shipping certain shares of the milk or share numbers of days of milk depending on the market to bottling plants.

Q. How would the plant share in that 13 cents that comes out of the pool to that producer?

A. Which plant?

Q. The plant you just described if you were shipping to a manufacturing plant that itself would have to qualify.

A. It has access to milk at the Class III price. That's how it's compensated.

Q. How does the producer then incur that 13 cent additional revenue or any costs to deserve that additional revenue?

A. They meet the minimum standards of the pool. There are pooling requirements, and every order has standards to pool in the market. You can't just ship every pound of milk every day per co-op, you can't -- has to

Dr. Cryan - Cross by Mr. Vetne

take some responsibility for supplying the fluid market in order to participate in the pool.

Q. Pooling costs except for -- strike that. Pooling obligations are obligations imposed on handlers; correct? Including handlers that are cooperative associations, but they are imposed on handlers in their capacity as handlers?

A. That's not necessarily true.

Q. It's mostly true. Section 7 defines plants, regulated plants and their pooling obligations?

A. The plant has no obligation to pool unless it's a bottling plant.

Q. That's true. We are talking about plants that do pool because they meet the requirements of Section 7.

A. They may --

Q. How are their costs recovered by any portion of this additional Class I price?

A. Their producers are paid the blend price, enhanced blend price.

Q. Yes.

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A. It helps them attract milk in return for their cooperation and participation in the market.
Q. But the costs are incurred by the plant?
A. What costs are incurred by the plant?
Q. The pooling costs that we referred to, or the balancing costs, how are -- how is any portion of the increased Class I price that you propose going to the plant that performed, or the handler that performed, those balancing functions?
A. I have gone over that. We talked -- you are going around in circles.
Q. Okay. You think you have answered it, then we will move on to the next question.
There's a 10 cent component here for transportation. Again, that's transportation to fluid milk plants, part of the service to serve the --
A. Pool plants, bottling plants, yes.
Q. Which? Pool plants or bottling plants? There's a difference.

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A. Generally, plants that pool are performing on the market. Pool plants.

Q. So how does that extra 10 cents in the price payable, required to be paid to producers, get back to the plant that is incurring the cost?

A. I don't understand your question.

Q. You proposed to increase the Class I price as part of the marketing component, as you described it, of the Class I mover -- I hate when you call it a differential -- Class I mover, because some people incur additional costs. You described ways in which buyers of milk incur additional costs.

I'm talking -- let's go back. We're talking about a proposal that would add money to the minimum price which was required to be paid to producers. Let's start there. Is that correct?

A. This would increase Class I prices and blend prices, yes.

Q. Okay. And you've also described increased costs incurred by handlers or plants. How does any portion of this price increase

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become directed to those that incur the costs: the handlers and the plant?

A. Handlers that choose to pool are able to pay their producers the plant price, which helps them compete with the plants that do not choose to pool and do not meet standards and do not meet minimum pooling qualifications in terms of performing supplying the fluid milk product.

Q. That's true with or without this proposal?

A. This is true in degree. That's what we're talking about. We are talking about increasing the Class I price so that there's more money in the pool so that the differential -- so that the producer price differential for a cheese plant gets back in order to compensate its producers increase.

Q. So this isn't just a supply of the fluid milk, supply the Class I market rationale, it's --

A. You are backtracking. You are changing, you are going back and forth. You are asking me how -- I'm telling you, cheese

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plants are pooled because they are performing on the market. The performance standards are based on contribution to supplying the bottling market, supplying the Class I milk market. In order to meet these -- in order to meet those contributions, they incur costs which they then are compensated for through the pool.

Q. A handler is obligated to serve as a conduit of money to producers; correct? Handlers don't get to keep any portion of the -- if there is an enhanced blend price?

A. A handler who is able to pay his producer the increased price differential in addition to the cheese milk price has an advantage over a nonparticipating plant that does not have that draw.

Q. I see. What portion of the market are nonparticipants, that receive Grade A milk? In any market.

A. I don't have the numbers. I know there are non-pool -- there are non-pooled plants and non-pooled milk in a number of surplus markets.

Q. Non-pooled Grade A milk in surplus

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markets such as Idaho where there is no Federal order?

A. There were in Idaho when there was a Federal order, but I don't have numbers. I don't have any numbers to show. Maybe you have some.

Q. No, I'm just asking if you know. Do you know of any significant volume of Grade A milk that is not pooled in the Northeast, for example?

A. I am not aware -- I don't have any numbers on that. I don't have information on that.

Q. Do you have any even anecdotal information that any Grade A milk is not pooled in the Northeast that goes to manufacturers?

A. I known generally in many markets, not all Grade A milk is pooled or else there would be a perfect identity between Federal order data and production data, and NAS has found that that's not the case.

Q. Right. For example, Class I milk produced by exempt plants and producer handlers, that is in that category?

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A. That is accounting of the Federal orders has records of that. The reason milk is not pooled, it varies across the country, but it is closer to zero in the Western Southeast and it increases in other areas and varies quite a bit. So it's not fair to say all Grade A milk is pooled.

Q. My question had to do with Grade A milk going to manufacture. Is there any data source that would show us, if there is any at all, for example, in the Northeast? Are you aware of any data source?

A. I'm not aware of it.

Q. You talk about premiums as a rationale for 39 cents of the 77 cents in the increase in the Class I mover.

Now, when a cooperative or other supplier announces a premium and collects it, that supplier gets to keep all of the money; correct?

A. I'm sorry, could you say the question again?

Q. When a cooperative or other milk supplier announces and collects a premium for

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delivering to a Class I plant, that supplier gets to keep the money; doesn't have to share it with anybody?

A. The co-op pays the -- the co-op is paid the premium if they are able to pay the whole premium, what they announce. They have to -- they bear costs, yeah. There may -- they may keep premiums over and above.

Q. My question is the cooperative -- let's deal with a cooperative. The cooperative sells milk to Dean Foods. $2 per -- Dean pays $2 to the cooperative, the cooperative gets to keep $2 and reward its members but it goes just to that cooperative? That's the way it usually works; isn't it?

A. That's the way it works.

Q. So in a system which has less than 50 percent Class I use, how does it benefit supply to the Class I handler to incorporate that premium in a Class I price whereby it's diluted in the pool to everybody else?

A. The premium -- I've gone over all this stuff so many times, I'm kind of -- can you ask the question again, please?

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Q. Yes. How does it benefit supplying the Class I market in a premium that has previously been collected and retained by the supplier is now included in the regulated price and diluted for sharing with everybody, how does it benefit the Class I supplier to do that?

A. Because everyone in the pool is serving the market. Everyone in the pool is meeting minimum standards to serve the Class I market.

The fact that one individual producer or co-op has dealt with one individual plant doesn't mean they don't bear responsibility just to participate in the rest of the market, they do. They benefit from the balance.

Q. Are you saying that the cooperative that collects $2, in my example, has an obligation to share that with the rest of the producers; is that part of your rationale?

A. Well, first of all, I would not assume that the over-order premiums -- if you assume that the over-order premium has been

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reduced, which is not necessarily the case, it's a matter of degree how much they would be reduced. Okay.

As I keep saying, the plant, the Class I plant participating in the market where there are a large number of pooled producers and co-ops participating in the pool and manufacturing plants participating in the pool, they are all meeting minimum standards to supply the Class I market. If those costs are not being shared among all those participants, then the system doesn't work.

Q. You might find a point of agreement there. My question didn't have to deal with costs, it had to deal with revenue.

Assume for me for a minute that the supplier is actually incurring costs and it costs $2, using my example, for the supplier. Why should the Class I price be increased and that $2 be shared with those that are not incurring costs? Why?

What Federal order principle encourages diluting costs incurred by somebody -- as in manufacturing allowance, the

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folks incurring costs --

A. I have no reason to assume -- this is just an analysis or this proposal is predicated on the assumption that over-order premiums would be exceeding the direct costs of the Class I handle -- Class I supplier.

Q. Yes. And the reason for that is because the costs incurred by those supplying; correct?

A. We believe it is because the pool is inadequate to attract the participants, and that the Class I handlers have to pay over and above the normal customary charges with respect to the pool because they need to attract additional --

Q. Let me ask this: If that's true and if the Federal order is the vehicle to address that problem, why should not those additional charges or costs be targeted with a pooling or credit or payment from the pool to those who incur the costs and provide the service rather than being paid to those who do not incur the costs or provide the service?

A. Transportation credits are direct

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payments for providing balancing services, but they are very specific. The fact that you are -- just the fact that you are supplying Class I milk doesn't necessarily mean you are incurring balancing costs. There are -- there is a difference.

Q. There are other costs involved in supplying a Class I plant; is that what you are saying?

A. There are a variety of costs incurred in supplying a Class I plant, and, again, the Class I price should be adequate to compensate the market generally for meeting the requirements of -- to perform on the market.

Q. Let me try once more. Did you give me an answer as to why payments for those costs should be shared with folks that do not provide the services or incur the costs?

A. I've answered it repeatedly. I've answered it over and over and over again, and I'm sorry you don't understand, Mr. Vetne.

Q. It's true, I do not understand your answer, that's why I asked the question. Let me move on.

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To the extent that transportation costs have increased, in any prior proceeding of the Secretary of which you are aware or have studied, going back to 1935, has the Secretary increased the Class I mover to respond to increased transportation costs as a preference over changing location adjustments and zone-outs to specifically target transportation costs?

MR. BROSCH: Clarification, Your Honor. He wants him to answer this question based on precedent back to 1935? Is that the question?

MR. VETNE: Precedent as far back as he knows or studied or he can remember, yes.

A. It's true, I can't answer negative, but I can answer positive. It is true that the decision we are basing this on --

JUDGE PALMER: I was going to say something. I think we are getting into a kind of a questioning here that isn't really helpful.

The witness is an expert, he's been

qualified as an expert, and we're now asking him about these basic principles of the Marketing Agreement Act and why it works the way it works, and I don't think we need that kind of examination. I think it's just a bit too taxing. More than we need.

MR. VETNE: I'll try not to tax, Your Honor, and I won't go any further, but I would say when a witness bases his entire proposal on a recommended and not a final decision and the analysis and policy expressed in that decision, I'm entitled to at least find out if he knows how the Secretary applied policy to similar problems in other cases so that to reconcile this proposal with consistent policy, if there is -- if that exists.

MR. BROSCH: Your Honor, he's entitled if he wants to make that point, to brief that point, or have a witness get up there. But this question about asking the witness to go back and talk about what the Secretary has done or not done since 1935, I --

JUDGE PALMER: I think that goes too far. Go ahead, sir. You were going

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to go into something else.

MR. VETNE: Okay.

BY MR. VETNE:

Q. I think it was in response to a question from Mr. Rosenbaum, you indicated you were not aware of any specific Grade A in most standards?

A. I discussed it in quite a bit of detail. Do you have a more specific question?

Q. No. So my recollection of your testimony is wrong? You are not aware of any specific Grade B milk standards, or are you?

A. I'm not familiar with the standards themselves, no.

Q. And Grade B --

JUDGE PALMER: I do remember you saying, just so the record is clear, that from time to time, a Grade A supplier doesn't qualify as Grade A, and then his milk goes to Grade B, so you -- I think that was your answer, that there is some, but you couldn't specify.

THE WITNESS: Right.

JUDGE PALMER: Is that right?

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THE WITNESS: There are standards. There are Grade A standards, and Grade B is defined by the states. I'm not familiar with all the elements of all the standards.

Q. Let's make sure we don't have a confusion on the record.

If, for example, for reason of a drug residue, antibiotic residue in milk, Grade A milk does not qualify as Grade A, or Grade A producers milk doesn't qualify anymore as Grade A, that doesn't mean it qualifies as Grade B, does it?

A. No, zero -- I mean, I'm not sure what the point of that -- all these technical details about Grade A and Grade B are.

Q. The Judge's question may have inferred that if you don't qualify as Grade A, you may qualify as Grade B.

JUDGE PALMER: I'm sorry, I misstated.

A. Yeah, you can be -- you have to dump it in -- yeah, you can fail to meet the Grade A standards but meet Grade B standards, or you

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can fail to meet any standards and have to dump it. But everything's different in every state, and I'm not an expert on it.

Q. Okay.

JUDGE PALMER: And I was.

Q. And you indicated that you weren't aware of a survey or study that has focused on the cost of converting from current Grade B milk standards to Grade A standards for a producer?

A. I'm aware of researchers who attempted to do it and were unable to find good numbers to -- the numbers are based on the best available -- based on Federal precedent.

Q. But there are some Grade B producers out there.

Are you aware of anybody who has attempted to survey costs of Grade B and Grade A producers in a manner similar to the surveyed costs from manufacturing plants that were used in make allowances?

A. I am not.

Q. You did, however, draw some conclusions from non-feed costs of producers

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and made comparisons to increased costs for manufacturers; correct?

A. In principle.

Q. In principle. Whether it's Grade B or Grade A, do you have any information which would enlighten us as to the cost input components of manufacturing a milk product and how those components are distributed compared to the cost input components for non-feed for producers?

A. I don't follow your question. Could you ask that again?

Q. For manufacturing plants, let's say powder plants, there's a fairly large energy component and there is a labor component and there's a packaging component. Do you have any information which would permit us to see how similar or how different those cost inputs are for producers and manufacturers?

A. I never made a direct comparison of processor costs with producer costs, so that's not really a relevant question.

Q. So you don't think the Secretary should look at a percentage increase in

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manufacturing costs and apply that or any component of it to producer costs?

A. They should apply -- I argued that they should apply it to the marketing costs, which is not the same as the -- there is an element associated with Grade A costs at the producer level, and there is another level that's associated with marketing costs. I make comparisons of marketing costs, for example, co-op marketing costs with manufacturing costs.

Q. Okay. What about that component of Class I price increase, have you done any comparison with the cost input components for manufacturers with that part of the Class I price increase to see if there is a similar relationship to cost inputs? Again, packaging, labor, energy, chemicals, that kind of thing?

A. As I indicate in the testimony, the powder plants are a typical method of handling the marketing of Class I milk, that they are involved in balancing marketing, they have similar costs to the co-op trying to manage the Class I market.

Q. And you reference in your testimony

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a recently published report on producer costs of production. Let's see. Maybe you can help me find that footnote. Released in 2006. I can't find it.

A. There's a footnote on the bottom of Page 9.

Q. Nine. Okay.

A. That refers to the data, Economic Research Service, Milk Cost of Production data which was recently updated through 2005.

Q. Okay. Then you studied that, was that something you consult regularly, or at least you consulted it for --

A. I'm familiar with those numbers somewhat.

Q. That includes -- does that include a component for producer transportation costs?

A. Cost of production on the farm.

Q. On the farm. So it includes producer energy costs on the farm?

A. On the farm.

Q. On the farm. And in your request for a hearing, your proposal, you refer to cost of production data updated through 2004;

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correct?

A. Correct. The original proposal is for 2004. In the meantime, the 2005 numbers have become available.

Q. And one thing that happened in 2005 was spike in energy costs?

A. They rose. Many costs have risen.

Q. Energy costs in particular, as we discussed at the make allowance --

A. Energy costs are actually a relatively small share of milk production costs, but they have an impact. The data is available at that URL.

Q. Okay. The manufacturing allowance was based on data updated through 2004. Is there any reason we should adjust producer prices by more current data if we're going to ignore more current data for other parts of the system?

A. We should use the most current data available.

Q. You refer also to a, in your testimony, to a Grade A premium or a spread between Grade A prices and Grade B prices or

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Grade A prices and Class III prices. I'm not sure which was your focus.

Prior to Federal order reform, the Class III price was the average Grade B price; correct?

A. Roughly.

Q. And now the Class III price is no longer based on a competitive price? Class III price is comparable in the sense that it is a minimal price that is the price that's associated with cheese manufacturing.

A. Yes. Without the bells and whistles.

Q. Without bells and whistles. Okay. But you still maintain, do you not, that if somehow we had been able to continue with a competitive price for the mover and for Class III, we wouldn't have had to -- well, the make allowance would have adjusted automatically as it had for a long time?

A. I haven't maintained that. Can you ask the question again, please?

Q. The Class III prices paid for the manufacturing -- the MW price pre reform, that

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would be pre reform, automatically accounted for changes in manufacturing allowances?

A. Presumably.

Q. And part of the problem was that post reform, it did not? That was part of the reason we were at a hearing earlier this year?

A. That's correct.

Q. And as a result, Class III and IV prices were artificially maintained at a level higher than they would have been under the economics of pre reform?

A. I don't follow your question.

Q. Because there was an -- we no longer had competitive pricing post reform. Manufacturing costs or make costs were no longer automatically translated to the Class III price; do you follow me?

MR. BROSCH: You are drifting off into testimony again.

JUDGE PALMER: Well, he's asking a question.

Q. Do you follow me so far?

JUDGE PALMER: Go ahead, finish.

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Q. And those two things were not permitted, did not occur, with formula pricing post reform? So far are we in agreement both in understanding and in agreement?

A. There is -- to an extent I understand. Yes, I understand what you are saying.

Q. And do you agree?

A. I haven't examined it closely enough to agree or disagree.

JUDGE PALMER: Let's do this. I think the witness is getting tired. I said we were going to stop at six. It's not quite six. We will let you resume tomorrow morning. What time is a good time to start? Do you want to do it at nine? Nine early enough?

MR. VETNE: Earlier? Early enough?

JUDGE PALMER: I'm just asking, do you want to do anything earlier? Nine is good. All right. Let's leave it at nine. We will see everybody at 9 a.m. Thank you. You will still be under oath.

(Whereupon, the above-entitled matter was adjourned at 5:55 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/Michelle L. Hall

Michelle L. Hall