USDA - FEDERAL MILK ORDER HEARING

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

Friday, December 15, 2006
8:45 a.m.

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

TRANSCRIPT OF PROCEEDINGS

VOLUME V

Reported by:

Sandra J. Mastay
Court 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 Jack Rower
Dairymens Marketing Cooperative Association, Inc., Dairy Farmers of America, and Association of Dairy Cooperatives in the Northeast:	Milspaw & Beshore Law Offices Marvin Beshore, Esq.
Select Milk Producers, Inc., and Continental Dairy Products, Inc., and Dairy Producers New Mexico:	Yale Law Firm by Benjamin F. Yale, 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.,
International Dairy Foods Association:	Covington & Burling, LLP by Steven J. Rosenbaum, Esq.
Dean Foods	Charles M. English, Jr., Esq.
Association of Dairy Cooperatives in the Northeast:	Dennis Schad Land O Lakes

APPEARANCES (CONT.):

Wells' Dairy, Inc.	R. Bruce Matson
	Ronald D. Knutson, Ph.D., Texas A&M University
International Dairy Foods Association	Robert D. Yonkers, Ph.D.

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WITNESS: R. BRUCE MATSON

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P R O C E E D I N G S

(Exhibit No. 43 was marked for identification.)

JUDGE PALMER: Our next witness, Mr. Bruce Matson. Mr. Matson.

MR. ROSENBAUM: We have distributed his prepared statement which has been marked as Exhibit 43.

JUDGE PALMER: 43. All right, sir.

R. BRUCE MATSON

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

DIRECT EXAMINATION

BY MR. ROSENBAUM:

Q. Good morning, Mr. Matson. You have before you Exhibit 43?

A. Yes.

Q. It is your prepared statement?

A. Yes.

Q. Could you please read it for the record.

A. Yes, I will. I am Bruce Matson. I

R. B. Matson - Direct by Mr. Rosenbaum

am pleased to be here today on behalf of Wells' Dairy, Incorporated, of Le Mars, Iowa. I am the dairy procurement manager for Wells' Dairy in the issue before us today.

The proposed changes to Class I and Class II milk marketing orders will severely impact our business. We oppose these proposed changes along with any changes that would increase our costs of raw milk.

Wells' Dairy, Incorporated, is the world largest family-owned and managed dairy processor in the United States, producing more than 500 Blue Bunny branded fresh and frozen dairy products including milk, ice cream, novelties, fresh yogurt, cottage cheese, sour cream, and snack dips.

Headquartered in Le Mars, Iowa, Wells' is a leader in delighting customers with more flavor, more variety and more of the good stuff in everything we make. In fact, the small northwestern Iowa town of Le Mars is known as the Ice Cream Capital of the World because we make more ice cream in one town, in one location, than any other company in any

R. B. Matson - Direct by Mr. Rosenbaum

single place on the planet. Blue Bunny ice cream can be found in 50 states and over 20 foreign countries including Mexico and Puerto Rico.

Wells' operates five processing plants including a bottling plant and two ice cream manufacturing plants in Le Mars; a yogurt plant in Omaha, Nebraska; and an ice cream manufacturing plant in St. George, Utah. It takes the milk of nearly 70,000 cows per day to provide us with our daily dairy requirements.

To keep up with Wells' entire milk needs, we procure raw milk from four states: South Dakota, Kansas, Nebraska, and Iowa. We utilize over 70 independent producers and numerous local cooperatives to purchase 800 million pounds of raw milk per year. Wells' Dairy's fluid bottling plant in Le Mars serves bottled milk to customers in a five-state region including retailers and schools.

Currently Wells' Dairy has no problem obtaining the Grade A farm milk we need for our fluid needs. The current system of

R. B. Matson - Direct by Mr. Rosenbaum

utilizing both cooperatives and working with farmers directly is working quite well for us.

Wells' Dairy operates a milk plant in Le Mars, and we pay our milk suppliers a premium to cover the costs of the service they provide to us and also to reflect the competition for milk in our procurement area.

The proposal, if adopted in its current form, would substantially increase pricing for Class I milk and for Class II butterfat - 73 to 77 cents per hundredweight higher in Class I; for Class II with 3.5 butterfat, the cost would increase close to .74 cents per hundredweight.

In addition, the proposed changes will reduce fluid milk consumption, increase milk production, and increase regional differences in farm milk pricing. I believe this is a regional issue and must be dealt with in that manner.

A higher minimum Class II butterfat price will potentially cause Wells' to substitute Class IV butterfat products for fresh Class II cream in our Class II products.

R. B. Matson - Direct by Mr. Rosenbaum

One of Wells' commitments is to respect and enhance the communities in which we do business as responsible corporate citizens. We provide products and monetary donations to various nonprofits for help in raising funds. We understand the importance of giving back to the community of which we are such a large part of.

We also play a big part in tourism for the city of Le Mars with our Visitor Center Museum, where tourists and citizens alike can learn the history of our company along with the process of how milk from a dairy becomes ice cream.

We have an excellent relationship with our producers in the area and work with them to get students in the surrounding communities out to farms to better understand the dairy industry.

Wells' Dairy and its over 3,000 employees nationwide enjoy being part of a family-owned company currently managed by the third generation of the Wells' family. There are even fourth generation family members working in the business today.

We are proud of our heritage, and we look forward to an exciting future as we strive to be the No. 3 national brand of ice cream and novelties. Thank you.

MR. ROSENBAUM: At this point I would ask that Exhibit 43 be introduced into evidence.

JUDGE PALMER: It is received.

(Exhibit No. 43 was received into evidence.)

MR. ROSENBAUM: Mr. Matson is available for cross-examination.

JUDGE PALMER: Questions? Yes, sir. Mr. Beshore.

MR. BESHORE: Marvin Beshore for the Association of Dairy Cooperatives in the Northeast and Dairy Farms of America.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Good morning, Mr. Matson.

A. Good morning, Marvin.

Q. It takes 70,000 cows per day to

R. B. Matson - Cross by Mr. Beshore

provide you with your daily requirements. What's the average size of your 70 independent farms?

A. About a thousand cows.

Q. Average size?

A. About a thousand cows.

Q. Of those 70?

A. Yes.

Q. So that gives you -- so that's your entire supply, 70,000 cows per day?

A. No.

Q. Seventy producers, that's 70,000 cows.

A. Pretty much so. But the daily requirements, the dairy requirements, we're a fat utilization company.

Q. Right.

A. That means we use more fat.

Q. So you buy cream off more?

A. Yes, we do.

Q. When you refer to your numerous local cooperatives, your statement says that besides your 70 independents you rely on numerous local cooperatives to purchase your

R. B. Matson - Cross by Mr. Beshore

800 million pounds of raw milk per year.

A. Uh-huh.

Q. So are you buying raw milk from the local cooperatives also?

A. Yes, sir.

Q. What percentage of your raw milk is supplied by cooperatives?

A. That varies with the season.

Q. Can you give us a high and a low?

A. Seventy to 90 that we are provided by independent producers. So 10 to 30 on cooperatives.

Q. Ten to 30 on cooperatives. Okay. Do you have a size limit on the independents that you contract with?

A. A size limit like what? How big they are or the farms --

Q. Yes. I mean do you only contract independently with thousand-cow dairies?

A. No. We have herds that are 30 cows.

Q. What's your largest herd then?

A. Probably 5,000.

Q. In addition to purchasing from cooperatives --

R. B. Matson - Cross by Mr. Beshore

Well, what portion of your fat is bought off the cream market?

A. It depends on the season.

Q. Okay. Can you give us a range?

A. Probably for the year average 50 percent.

Q. Okay. So half your fat is bought off the cream market. That's a wholly completely unregulated market; correct?

A. "Completely unregulated market."

Q. Well, let me --

A. We have to report our cream pounds to the market administrator. So would that be regulated?

Q. You report your cream --

A. Cream pound usage.

Q. But there's no -- what I meant was there's no minimum price established by the market administrator for your purchases of cream?

A. "No minimum price."

Q. Do you know the answer?

A. I'm not following that question.

Q. Okay. The market administrator, the

R. B. Matson - Cross by Mr. Beshore

Federal Order does not establish a minimum price that Wells' Dairy must pay when it's buying bulk cream from other handlers?

A. But they make us -- you know, we have to settle up with the pool on where that utilization of cream goes into, what product it goes into if we're pooling that plant.

Q. Do you know whether the market administrator sets a minimum price that you must pay for that bulk cream?

A. For the bulk cream?

Q. Right.

A. I do not know, Marvin.

Q. Okay. If you assume with me --

Are you involved in those transactions at all?

A. In the purchase of the cream?

Q. Yes.

A. Yes.

Q. Okay. Do you purchase them at multiples of the butter market?

A. Sometimes.

Q. Okay. What other price formulas do you use in those cream purchases?

R. B. Matson - Cross by Mr. Beshore

A. We do purchase some cream from time to time from California.

Q. Okay. Those cream purchases, they are all at market prices then, of course?

A. Market price and multiples, yes.

Q. Assume with me that the Federal Order, these price proposals we have here today, do not establish any minimum payment obligation for those bulk cream purchases. Okay. If you assume that, it is not going to have any impact on what you pay for that 50 percent of your butterfat; correct?

A. If you assume that.

Q. Okay. You say you pay premiums for the milk supply. What is the average premium you pay your independent producers?

A. I would rather just have that private information between us and our producers.

Q. Well, can you give us a range?

A. No, I'm not going to give a range.

Q. Okay. Can you tell me this: How many pounds of milk for any class of utilization have you purchased from your

R. B. Matson - Cross by Mr. Beshore

70 independent dairy farmers at minimum Federal Order price in the last year?

A. Few. Zero.

Q. Zero. Thank you. If you weren't buying milk at the minimum Federal Order price, raw milk, do you think -- is there any available in your market from farms at minimum Federal Order price?

A. I don't know.

Q. Now, did Wells' take a position on the make allowance changes?

A. No.

Q. Do you have a position on those price reductions?

A. We aren't involved in the cheese market at all. We have no position.

Q. How about nonfat dry milk, butter, Class IV usage? Do you have any Class IV usage?

A. No.

MR. BESHORE: Thank you.

JUDGE PALMER: Yes, sir.

REDIRECT EXAMINATION

R. B. Matson - Redirect by Mr. Rosenbaum

BY MR. ROSENBAUM:

Q. Mr. Matson, with respect to the bulk cream that you purchase, if you purchase that cream from a regulated plant, does that plant have to account to the pool for that on a Class II price basis?

A. Yes.

Q. And accordingly, does the Class II price drive the price you have to pay for that cream regardless of whether you're the one who is being regulated or the seller to you is being regulated?

A. That is correct.

MR. ROSENBAUM: That's all I have.

JUDGE PALMER: Anyone else? Yes, Mr. Tosi.

RECROSS-EXAMINATION

BY MR. TOSI:

Q. Bruce, thanks for coming to the hearing.

A. Hi, Gino.

Q. In your statement you say that a

R. B. Matson - Recross by Mr. Tosi

higher minimum Class II butterfat price will potentially cause Wells' Dairy to substitute Class IV butterfat products for fresh cream in our Class II products. How much of a price increase would actually cause you to make that substitution?

A. I'll tell you what we do, and this is my motto on business. I mean, anytime you have cost increases, you have to evaluate your situation and then you have to look at alternatives. Sometimes you end up using the same product back again, but anytime when there's an increase, you have to evaluate your situation, and we do that at Wells'.

So, you know, if we're seeing that cream is going to be higher and there's other alternatives of sourcing that cream, we're going to evaluate that.

Q. Okay. What would be those butterfat products that you would substitute?

A. I don't know all of them. I do know we would be looking at dry cream. We would be looking at butter. There's another one that we would be looking at, but I can't remember what it is right now.

MR. TOSI: Okay. Thank you very much. Appreciate it.

MR. MATSON: No problem.

JUDGE PALMER: Any other questions? There don't appear to be any. Sir, thank you very much for coming down and staying with us.

MR. MATSON: No problem.

MR. ROSENBAUM: Your Honor, our next witness will be Dr. Ronald Knutson who has a prepared statement which was made available at 7:00 this morning, and I would ask that it be marked as Exhibit 44.

(Exhibit No. 44 was marked for identification.)

JUDGE PALMER: We might take a break during his testimony, but I think we'll get him started and see how it goes. I sometimes run these hearings a little hard, and I know most people probably need a break in the morning probably about in a half hour.

Dr. Knutson - Direct by Mr. Rosenbaum

RONALD D. KNUTSON, Ph.D.

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

DIRECT EXAMINATION

BY MR. ROSENBAUM:

Q. Dr. Knutson, you have before you Exhibit 44, your prepared statement?

A. Yes.

Q. Could you please read it into the record.

A. Yes. My name is Dr. Ronald D. Knutson. I reside at 1011 Rose Circle in College Station, Texas. My position at Texas A&M University is that of professor emeritus. Prior to my retirement in 2002, I was the director of the Agriculture and Food Policy Center, a position which I held for 13 years. The Center receives funding directly from the U.S. Congress for the purpose of conducting analyses of the farm level impacts of changes in farm policy upon the request of its agriculture committees. I held the position of professor at Texas A&M for 27 years.

Prior to coming to Texas A&M, I

Dr. Knutson - Direct by Mr. Rosenbaum

served for two years as the chief economist for the Agriculture Marketing Service of USDA and for two years as the administrator of the Farmer Cooperative Service.

Previously I had served for six years as assistant and associate professor at Purdue University. I received my B.S. from the University of Minnesota, M.S. from Penn State University, and Ph.D. from the University of Minnesota.

Throughout my professional career I have received many honors and awards, the most significant of which was being named a Fellow of the American Agricultural Economics Association, the profession's most prestigious award.

I have spent over 45 years analyzing dairy policy issues, with over 300 dairy-related publications. Of special significance to this hearing was my service as the chairman of Assistant Secretary Lyng's Milk Pricing Advisory Committee and as chairman of AMS/USDA's University Scientist Study Committee to analyze pricing options for Federal Milk

Dr. Knutson - Direct by Mr. Rosenbaum

Marketing Orders.

This research led to two publications cited in the 1998 and 1999 proposed rule for Federal Order Reform titled An Economic Evaluation of Basic Formula Price Alternatives and the Modified Product Value and Fresh Milk Base Price Alternatives.

I am testifying in this hearing as an expert witness for the International Dairy Foods Association. The purposes of my testimony include: One, to evaluate whether economic conditions in the dairy industry warrant a change in Class I milk pricing policy; two, to evaluate the specific Class I pricing proposal which is the subject of this hearing; and, three, to explain the economic information required for AMS and the Secretary of Agriculture to make a science-based Class I pricing decision of the type proposed in this hearing.

With persistent infusion and adoption of technology, the milk industry is constantly changing and adjusting. The role of government in this environment is to facilitate

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change and adjustment, not to prevent or discourage it. In other words, Federal Orders have a primary role of providing a soft landing in the face of change.

History demonstrates that the milk industry readily and regularly adjusts to price changes; therefore, one of the primary indicators of undue economic stress and the need for a shift in pricing policy is whether changes in either milk supply or demand are evident and leading to disorderly marketing conditions. My conclusion is that industry supply and demand conditions provide no indication of disorderly marketing conditions.

On the supply side, the key change indictors include, first, new clusters of milk production outside traditional production areas have developed and are continuing to develop. These new clusters include parts of California, Idaho, New Mexico, and, more recently, northern Indiana and West Texas. All of these new clusters are outside traditional production areas of the Midwest and the Northeast.

Second, within these clusters there

is a continuing development of large scale 1,000-cow plus dairy farms. In 2005 these farms accounted for 36 percent of production as indicated by NASS/USDA in the publication titled "Farms, Land in Farms, and Livestock Operations: 2005 Summary." This was published in January 2006 on page 22. At the current rate of increase, these farms will account for a majority of production within four years.

Third, there are the recent developments of higher feed costs and the increased importance in the dairy ration of distillers' grain, which is a byproduct of ethanol production.

The best indicator of smooth adjustment to change is what is happening to milk production and movements of milk to areas of need, particularly for Class I use. Nationally, milk production continues to be above 2005 levels through November 2006. Some states have experienced decreases in production, particularly in the Southeast. However, milk has been effectively and efficiently moved to fill Class I and

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Class II needs from newly developed production clusters such as northern Indiana and West Texas, as well as from traditional production areas, often with the assistance of Federal Order transportation credits.

Federal Orders were never designed to assure state or regional self-sufficiency in milk production but to facilitate least cost milk movements with a minimum of government involvement. This is being accomplished under the current Order provisions. My conclusion is that there is no evidence of supply shortages.

It would be a mistake to focus only on the supply side and cost side of the milk industry because it ignores the sensitivity of consumers to changes in milk prices. On the demand side, milk is experiencing increased competition from other beverages including sodas, energy drinks, juices, and soy substitutes. This leads to more elastic demand for Class I milk, resulting in the need for greater caution in pricing decisions.

In addition to continuing milk promotion programs, the best strategy is to

Dr. Knutson - Direct by Mr. Rosenbaum

maintain the price competitiveness of milk with these substitute products.

At the retail level, demand elasticity estimates cover quite a large range. In his 2003 product classification testimony, Cornell dairy economist Dr. Mark Stevenson concluded, after reviewing the literature, that the standard fluid milk products have a demand elasticity of minus 0.25 but noted that new substitute products have a higher elasticity. As the number of new substitute products increases, the elasticity's demand for fluid milk also increases.

Based on supply and demand conditions, it is my conclusion that there is no economic evidence of a need for a change in Class I milk pricing policy.

Turning to the role of Federal Orders in adjusting to changing economic conditions. One of the key purposes of Federal Orders is to facilitate adjustment to change. The most widely recognized guide to the objectives of Federal Orders is the Nourse Report, which is undoubtedly the most

Dr. Knutson - Direct by Mr. Rosenbaum

extensively cited economic guide to Federal Order decision making.

On the subject of adjustment to changes, the Nourse Report states, and I quote, "It is well to remember that the original statute from which the Federal Order system stems was conceived as an adjustment undertaking. It was set up as an apparatus for improving the lot of the farmer by helping in every reasonable way to bring an industry (and its subindustries) in which productivity was rapidly rising, even faster than the industrial sector of the economy, into better equilibrium over time."

Certainly, today's dairy industry is not the same as when the AMAA was enacted as the hearing proponents appear to assume, nor is the industry the same today as when the Order Reform decisions were made in the late 1990s.

The dairy industry continues to evolve to more regional production, fewer but larger farms, higher feed costs, more complex dairy nutrition issues, and more competition from the competitive products that are often

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nondairy in composition. Markets are automatically adjusting to these changing conditions and should be allowed to do so in order to avoid market distortions.

In order not to interfere with these market adjustments, Federal Orders must also adjust to these changing conditions. Optimally this adjustment must reflect changes in economic conditions and, therefore, simulate those adjustments that would occur in the market while maintaining orderly marketing conditions as prescribed by the AMAA.

Old arguments, so-called established principles by the proponents' petition, require careful science-based economic analysis to determine their relevance to today's conditions and to determine how they should be modified to fit today's conditions. To achieve this objective, the Federal Order Reform process was preceded by the extensive economic analyses required to adjust Class I pricing policy change.

To the credit of AMS and the Secretary, they tried to make the essential

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adjustments in Class I pricing policy based on the analyses that had been done by Cornell University and others as reflected in the hearing record and in the 1998 and 1999 proposed rules. Unfortunately, these rules were derailed by the agriculture committees and appropriation subcommittees controlled by southern interests. This is not the case today.

Turning to avoiding unintended consequences. The challenge facing AMS and the Secretary in this decision is to accurately identify those economic conditions relevant to the hearing issues that have changed and to determine their regulatory implications.

AMS and the Secretary have made adjustments in previous hearings. For example, the boundaries of the Appalachian and Southeast orders were modified in consideration of a consolidation petition. Ninety days' prior notice was provided before a hearing considered the modification of make allowances.

Changing the structure of Class I prices is a much more fundamental issue than

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either of these hearings. As noted previously, in the Federal Order Reform process a separate study was initiated to address the economic forces affecting the Class I pricing issues. This study served as a benchmark or baseline in evaluating the seven policy options considered.

Changed economic conditions suggest the need for another study of the same type so that the decision makers understand the current economic forces affecting their decision. This is not a task that can be adequately undertaken in an emergency hearing environment without incurring unanticipated and unintended consequences.

At the risk of repetition, increasingly hearings have been preceded by studies of the proposed changes in policy. In addition to the Class I pricing study and a basic formula price study promulgated and completed prior to the Order Reform hearings, the recent make allowance hearing was suspended pending the completion of the Cornell manufacturing product cost study.

In preparation for the current

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Class III and IV pricing hearing, prehearing information sessions provide opportunities for input and study prior to the hearing announcement.

These studies and related opportunities for input provide assurance that all relevant economic facts and considerations are studied. The results are available to the USDA decision makers to use in critically important science-based decisions. They also hold the potential for avoiding the greatest danger in rushing to judgment specifically that regulatory decisions are made without adequate science-based analysis of the facts underlying the decisions and of their consequences. More often than not, the result of such a rush to judgment is unintended markets-distorting consequences.

One of the most serious unintended market-distorting consequence of an economically unjustified Class I price increase is the inevitability of increasing benefits to dairy farmers in higher utilization markets, and to those having access to those markets, at

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the expense of those in lower utilization markets. In this hearing the dairy farmers that AMS and the Secretary need to be most concerned about are the large number of smaller farmers located in the Upper Midwest. The inevitable result of the proponents' proposal is to lower Class IV and Class IV prices to the detriment of dairy farmers in the states of Minnesota, Iowa, Wisconsin, North Dakota, South Dakota, and others. This was the effect of the politically inspired Class 1A Order Reform decision.

I have analyzed the effect of the National Milk Producers Federation proposal on the farmers pooled on the Upper Midwest order. To do so I have utilized 2005 Federal Order Market Statistics data to establish the quantity of Class III and Class IV milk utilized in the Upper Midwest Federal Order as a percent of all the Federal Order Class III and IV utilization for the same time period. I multiplied this market share times the AMS estimate of the effect of the National Milk Producers Federation proposal on the nine-year

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average pounds utilized in Class III and IV and the Federal Order minimum price changes at test for Class III and IV as published in the hearing notice dated November 22, 2006.

The results of this analysis indicated that the Upper Midwest dairy farmers would lose a total of $249,000 (sic) in Class III and IV receipts from the adoption of the National Milk Producers Class I option, $37 million from the National Milk Producers Federation Class II option, and $286,000 (sic) from the combination of the National Milk Producers Class II and Class III options.

Even when these revenue reductions are combined with the indicated price and quantity changes resulting from higher Class I and Class II prices, Upper Midwest producers are net losers of $27 million under the Class I option, $27 million under the Class II option, and $54 million if both options were adopted.

AMS economists did not analyze the most recent National Milk Producers proposal increasing the Class I differential by an additional 5.479 percent, from 73 cents per

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hundredweight to 77 cents per hundredweight; however, the losses to Upper Midwest producers would clearly be further inflated. A rough estimate can be derived by multiplying the nine-year loss under the previous National Milk Producers proposal by 1.9479. The result would be 200 -- excuse me. Would be a $302 million reduction in Class III and Class IV receipts and $57 million in total receipts from the adoption of the new Class I and II proposal.

These estimates of adverse impacts on the Upper Midwest are conservative for three reasons. First, they do not account for all of the milk used for manufacturing in the region, while all of the Class I and Class II milk is accounted for.

Secondly, the amount of the reduction is influenced by the relatively low elasticity of demand assumed by AMS. AMS uses a minus 0.048 demand elasticity at the farm level, which is lower than estimated by other prominent dairy economists. FAPRI uses a 0.144 demand elasticity at retail for milk and, as noted previously, Dr. Stevenson uses a minus

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0.25. These imply farm level elasticities of about minus 0.072 and minus 0.125.

Likewise, the supply elasticity estimated by most dairy economists is higher than the 0.269 assumed by AMS. For example, Cox and Chavas, both highly respected agricultural economists, estimated a supply elasticity of 0.37 that was published as a peer reviewed article in the American Agricultural Economics Journal in 2001. These what might be viewed as small differences would be expected to have large impacts on Upper Midwest farmers. It would not be unreasonable to anticipate that they might double the size of the adverse impacts, but the precise effect would require modeling changes.

In retrospect, a serious error occurred in this hearing when the AMS economist who developed the model used to estimate the impacts of the National Milk Producers' proposal did not appear as a witness. These estimated impacts and sensitivities need to be clarified and made transparent for all farmers to see, regardless of their location. Those

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farmers located in the Southwest, Mideast or Central Orders that have access to higher Southeast and Florida markets stand to reap substantial benefits from the proposal. Upper Midwest farmers bear substantial losses.

Moreover, due to the predominance of smaller farmers located in the Upper Midwest region, these changes in policy have particularly adverse impacts on small farmers and other small businesses located in the Upper Midwest and in other regions that do not have access to Class I and Class II policy benefits proposed by the proponents.

JUDGE PALMER: All right. Let's take a break now for five minutes.

(Recess taken.)

JUDGE PALMER: Doctor, would you continue to read your statement.

DR. KNUTSON: Thank you.

A. My conclusion is that it is impossible to raise Class I prices without adversely affecting Class III and IV prices. As has been noted by other witnesses, this conclusion is well documented in the economic

Dr. Knutson - Direct by Mr. Rosenbaum

literature. The benefits of increases in Class I prices get diluted by lower Class III and IV prices, with the greatest economic burden falling on those producers who primarily produce milk for manufacturing and do not have access to the higher Class I prices.

The second unintended consequence for the Upper Midwest would materialize if the Milk Income Loss Contract (MILC) program were extended in the 2007 Farm Bill. To the extent that the options being considered raise the market price, MILC payments decline. This would be another kick in the financial gut of Midwest farmers.

The third unintended consequence is that increases in Class I prices create economic incentives for more milk to be pooled on the higher Class I utilization markets. This was one of the unintended consequences of the Order Reform decision to adopt the Class 1A pricing option as opposed to 1B. It was also one of the factors that led to increased pooling of milk on higher utilization Federal Orders and to eventually require tighter standards for pooling milk on these orders.

The complexity of this unintended consequence is indicated by the fact that it took two rounds of hearings to deal with the issue.

Make no mistake about it, the proponents' proposal is a sister of the adopted option 1A. It is safe to bet that if this proposal is adopted, another round of even tighter pooling standards will be required. Therefore, regulatory decisions not based on sound economics often require offsetting higher levels of regulation.

Both the Agriculture Marketing Agreements Act and the Nourse Report explicitly identify the pursuit of more orderly marketing as a primary objective of Federal Orders; however, these unintended consequences create disorder in the markets for milk.

Specifically, it benefits one group of producers at the expense of another and leads to unnecessary pooling of milk on higher utilization markets.

Therefore, while the proponents

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assert but do not explain how their proposal leads to more orderly marketing, the fact is that it leads to greater disorder as did the 1A Reform decision.

The fourth obvious unintended consequence for the higher Class I prices is that higher consumer prices lead to lower milk consumption and increased consumption of milk substitutes. The result is a lower Class I utilization at a time when there is plenty of milk available to serve all market needs.

Turning now to the lack of science-based proposal, science-based support for the proposal. The proponents' position supporting emergency regulatory action is not based on sound economic science and, therefore, does not justify a Class I price increase. This is the case for each of the enumerated costs because insufficient time and input was provided for study of these issues.

First, the costs of converting to Grade A are no longer a relevant consideration because 98 percent of all U.S. milk production is now Grade A. In addition to the incentives

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for conversion provided by Federal Order classified pricing, increases in sanitation and facility requirements for Grade B have fostered conversion to Grade A. In fact, the industry made the conversion to Grade A decades ago, and all Federal Order milk is produced to meet Grade A standards. As a consequence, the costs of maintaining Grade A are borne by all milk Classes, not just Class I.

The fact that virtually all milk is Grade A was the underlying reason for converting from M-W price series to product formula pricing as indicated by the proposed rule dated January 30, 1998, at pages 4876 to 4877. As a result of the virtual absence of Grade B production, the price needed to maintain Grade A production is the same as that required to assure an adequate supply of milk.

The available supply and demand data discussed previously clearly demonstrates an adequate supply of milk has existed and currently exists under current Federal Order provisions.

It is obvious that AMS and the

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Secretary preferred Option 1B in the 1998 reform decision. It is also a fact that the only option for which the issue of cost of conversion was specifically analyzed was for Option 1A. For all other options the Class I differential was explicitly determined to "Recognize quality (Grade A) value of milk" as indicated, for example, on page 4894. That is, for all options other than 1A, the Class I differential was explicitly determined to be sufficient in the 1998 proposed rule.

In addition, it is a fact that the final decision did not mention the cost of conversion or any of the proponents' cost items.

The 1998 Reform decision did not adopt Option 1A; neither did the April 1999 proposed rule. Therefore, based on the 1998 proposed rule, the current Class I differential is also sufficient to induce and maintain conversion.

If it is determined that the costs of converting from Grade B to Grade A are still relevant in determining the Class I price, it

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should be based on sound economic science as has become the standard principle for USDA domestic and international policy decisions. The proponents have failed to utilize sound economic science in estimating its cost. No study has been made of the differential cost between Grade A and B production since 1977, which is nearly three decades ago. That was a study by Gary Frank, G. A. Peterson and Harlan Hughes titled Class I Differential: Cost of Production Justification. It was published in Economic Issues, No. 8, University of Wisconsin-Madison, Department of Agricultural Economics, April 1977.

The January 30, 1998, proposed rule at page 4908 indicates an estimated cost of conversion of "approximately 40 cents per hundredweight" but provides no source of this estimate. The proponents provide no information on the cost of conversion; but, rather, build on the proposed rule's approximation using flawed methods as opposed to sound economic science.

My conclusion is that the cost of

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converting to Grade A is no longer a relevant consideration in Class I pricing. In addition, I conclude that the proponents have failed to provide a sound economic estimate of the cost of converting from Grade B to Grade A.

The second enumerated cost utilized by the proponents to justify a Class I price increase is higher marketing costs. Here the proponents give primary attention to balancing and transportation costs. Both of these cost elements are already provided for in other Federal Order provision.

Consideration of the costs of balancing in Federal Orders has occurred in at least four hearings since 1980 and has been explicitly rejected for lack of sound science-based economic data. This includes, first, the 1987 Atlanta decision dated May 1, 1987; second, the proposed Federal Order Reform Rule dated January 30, 1998, at pages 4951 to 4952. Third, a previous Federal Order, Northeast Federal Order decision, and the Northeast decision dated January 31, 2005. The conclusion of each of these decisions is that

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balancing costs are part of the Class III and IV prices as stated at page 4952.

Also, the costs of balancing are recognized as a component of full supply contract services provided by cooperatives assessing over-order premiums and handling charges. As a result, they should not be a relevant consideration in setting Class I price differentials. To imply otherwise would be double counting. It would be double counting first the supply/demand determined market premiums and handling charges; and, second, Federal Order regulatory considerations.

No sound economic data have been presented by the proponents to support the third enumerated cost alleging sacrifice in plant profitability at a time when manufacturing plants are running at or near capacity due to the higher levels of production noted previously.

The alleged 22 percent increases in costs of converting milk to butter and powder utilized to establish make allowances in no way represents sound economic science in reflecting

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the "sacrifice in plant profitability."

In fact, the USDA rejected this very data in its recent decision on make allowances, approving only a 5 percent increase in butter and powder make allowances, not a 22 percent increase.

My conclusion is that the proponents have failed to provide a sound economic basis for inclusion of balancing costs in Federal Order Class I pricing and have failed to provide a sound economic estimate of the changes in balancing costs.

Transportation credits are already provided for in Federal Orders where they have been determined to be relevant and, therefore, are not sound economic reasons for increasing the Class I differential. To include increases in transportation costs as a justification for increasing in the Class I differential would imply a lack of transportation credits in Federal Orders, which, as noted previously, are already being addressed in the Southeast, Appalachian, and Chicago Federal Order markets as indicated in the 1998 proposed rule at

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page 4951 and 4958 to 4959.

From the information presented by the National Milk Producers Federation, it appears that the transportation cost increase of 10 cents is based upon milk assembly and hauling charges for all milk in the Upper Midwest and the Northwest, not on the cost of serving Class I markets.

At the risk of repetition once again, the studies referred to the cost of assembly and hauling for all milk, not for just Class I milk. It would neither be logical nor credible to apply a hauling cost for all milk to only Class I milk.

My conclusion is that it would not be sound economic science to use this as one of the economic bases for increasing the Class I differential in all orders.

There is no economic justification for using increases in premiums as a basis for increasing the Class I differential when there is already an adequate supply of milk. Premiums reflect the value of milk in manufacturing and in maintaining the

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utilization of manufacturing capacity and the amount of money required to induce a manufacturing plant to give up milk for Class I purposes, which is related to the obligations of a cooperative under full supply contracts.

Given that Class I premiums are pooled and shared among producers regardless of whether they are supplying Class I facilities, raising the Class I price neither necessarily compensates for the functions performed by the premiums, nor does it necessarily reduce the amount of the premium, unless a reduction in the premium was mandated by Federal Orders.

Turning now to the obligations to generate and make transparent relevant studies. For some individuals, this decision and that of Federal Order Reform in 1999 may be characterized as a difference over whether Federal Order regulation ought to be market oriented or regulatory oriented.

I understand this perspective but believe there is a much more fundamental point, regardless of the regulatory philosophy. The point is that AMS and the Secretary have made a

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public -- have a public interest obligation to gather and make transparent all relevant facts and consequences prior to making a decision on the proposed rule.

A sound economic basis for establishing Class I differentials lies in the comprehensive analysis of the rationale for Class I pricing, considering current industry practices and economic conditions.

Significant changes have occurred and are occurring in the industry structure and costs as demonstrated, for example, by the make allowance hearing and decision. In both the Reform decisions, comprehensive and unbiased economic analyses were completed as a basis for these decisions.

While the results of these analyses were not always followed as in the imposition of the Class I pricing Option 1A by Congressional mandate, the nature and economic reasoning that went into the 1998 and 1999 proposed rules were clear for all to see and pass judgment on Option 1A's economic validity.

Due to the emergency nature of this

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hearing, that transparent, analytical, science-based approach is not being provided in this instance.

With no question as to the adequacy of milk supplies, this is not the time to make fundamental Class I pricing decisions based on approximate costs and shoddy economic analysis obviously not based in science.

As in the make allowance decision, it is time to take a deep breath and do the type of analysis that will stand up to economic and legal and political scrutiny. The starting point for such an analysis should be a replication of the spatial pricing study utilized in the 1998 proposed rule considering plant capacities, production locations, transportation costs and demand points, the updated model for which exists at Cornell University.

This approach was used by the USDA as a part of Order Reform. While such a study may not provide the final answer and may need to be complemented by other studies and factual industry information, the result would be

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economically defensible in consideration of the changes that have occurred and are occurring in the dairy industry.

The overall conclusion of my study is that this proposed change in Class I pricing policy is that no change in the Class I differential is needed or justified. This conclusion is based on: One, the milk supply and demand are adequate; two, the proposal does not facilitate adjustment to changes occurring in the milk industry; three, unintended consequences will result in disorderly market conditions; four, the enumerated costs that sum to Class I price increases are not grounded in sound science-based methods; and, five, the time required for science-based economic analysis of the proposal and of its alternatives and consequences has been insufficient to provide decision makers an adequate basis for science-based decisions and transparency to the industry, the general public, and the Congress.

The conclusions I have drawn, while valid to the best of my knowledge, barely

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scratch the surface in terms of the type and depth of analysis needed for science-based and transparent Class I pricing decisions.

Q. Thank you very much, Dr. Knutson. In reading the statement there may have been a couple points where you deviated in ways that I think were inadvertent, and I just want to call your attention to a couple just to make sure that the written statement is correct.

In paragraph 14 on page five, you state, "The results of the analysis indicate that the Upper Midwest dairy farmers will lose a total of $249,000 in Class III and IV receipts from adoption of the NMPF Class I option, $37 million from the NMPF Class II option, and $286 million from the combination of the NMPF Class I and II options." Do you see that?

A. Yes.

Q. I think when you read that, your last reference, instead of saying Class I and Class II options, you read that as Class II and Class III options. I just want to confirm that the written version is the correct version?

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A. Yes.
Q. And similarly, on page six in paragraph 15 you have a sentence that reads, sort of in the middle, "A rough estimate can be derived by multiplying the nine-year loss under the previous NMPF proposal by 1.05479." I think when you read it you had a somewhat different number. I just wanted to confirm that the written number, 1.05479, is, in fact, the correct number?
A. It is.
Q. In paragraphs 14 and 15 you have analyzed the impact on the Upper Midwest farmers or the farmers' pool on the Upper Midwest Order of the National Milk Producers Federation proposals; correct?
A. Which paragraph?
Q. 14 and 15.
A. Okay. Yes.
Q. And in paragraph 14 you come to the conclusion that there's a $54 million net negative impact of both options -- of both proposals combined; correct?
A. Correct.

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Q. And that estimate in paragraph 14 was based upon the original National Milk Producers Federation proposal of the 73 cent per hundredweight increase; correct?

A. Correct.

Q. And in paragraph 15 you make a rough estimate of what the impact is of National Milk's revised proposal to increase the Class I differential by 77 cents rather than 73 cents; correct?

A. Right.

Q. And you come to a $57 million net negative impact on the farmers pooled in the Upper Midwest; correct?

A. Correct.

Q. And then finally, in paragraph 16 you conclude that the negative impact on the Upper Midwest farmers could double if one were to use the supply elasticities and demand elasticities that you discuss in that paragraph; correct?

A. Correct.

Q. Now, I just want to take you then to the last, the very last page of Exhibit 44. Is

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this a spread sheet that reflects the dollar impacts that you discuss in paragraphs 14 and 15?

A. Yes. And I want to express my regret for the size of the type, but it was necessary to get it on the page.

Q. Okay. And to find the bottom lines that are reflected in your written testimony, if one looks at the lower right-hand portion of the spread sheet under the column Class I and II option non-year revenue change, the figure in the last row is a negative $54,013,586; correct?

A. Right.

Q. And that is the source of the impact, as you calculate it, of the original proposal to increase the Class I differential by 73 cents; correct?

A. Yes, it is.

Q. And that's the number that's in paragraph 14 of your statement; correct?

A. It is.

Q. Then in paragraph 15 as you have already discussed, you make an effort to come

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up with a rough estimate of the impact of the 77 cent proposal rather than the 73 cent proposal; correct?

A. Yes.

Q. And you state in your statement that the impact of that would be approximately a negative $57 million impact on farmers pooled in the Upper Midwest; correct?

A. I did.

Q. And the source of that is the negative $56,972,990; correct?

A. Yes.

Q. Now, you obviously don't have access, currently have access to the USDA econometric model; correct?

A. Correct.

Q. And for that reason you are not able to come up with a precise calculation of what the impact is of using ultimate supply elasticity and demand elasticity assumptions as you have testified could well be justified by the published literature; correct?

A. That is correct. I tried to make some rough estimates, and then I decided that

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my strategy was not necessarily sound science, and I rejected the option of trying to make a rough estimate in that case.

Q. So your statement is the impact of using these alternate supply and demand elasticities could I think, to use your words in paragraph 16, could easily double the negative impact on the Upper Midwest farmers; correct?

A. That's a very conservative statement. Yes.

Q. Conservative in what sense?

A. Conservative in the sense that if you look at those elasticities that are generally used by economists in both the supply and demand side, it would suggest at least a doubling.

Q. So when you say "at least a doubling," you mean the negative $57 million impact on farmers pooled in the Upper Midwest that you calculated would at least be doubled to --

A. 114.

Q. -- a negative $114 million impact if

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supply and demand elasticities routinely used by experts in the industry were substituted for those that are in the USDA model?

A. Yes.

MR. ROSENBAUM: Okay. I would at this point ask that Exhibit 44 be entered into evidence, Your Honor.

JUDGE PALMER: Any objection?

MR. STEVENS: Let me just ask a question. This is Garret Stevens. I'm with the Office of General Counsel.

CROSS-EXAMINATION

BY MR. STEVENS:

Q. In listening -- I'm not sure and I just want to check -- on page three, the last paragraph. I may not have been paying attention, and excuse me if I wasn't, but did you read the last paragraph into the record?

A. I think I did.

Q. Page three? I don't believe you did.

MR. BESHORE: No, it was not read.

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Q. You didn't read that into the record. Do you want that to be in the record?

A. Yes. I'm sorry.

JUDGE PALMER: Why don't you --

MR. STEVENS: Well, I'm not saying he has to read it into the record. If he would like to, that's fine, but I just want to make sure that his exhibit conforms with his statement as far as he's testifying.

JUDGE PALMER: Of course.

MR. STEVENS: I didn't hear him read it. That's why I'm asking.

THE WITNESS: Sorry.

Q. Why don't you go ahead and read that.

A. This is a profoundly important statement to this hearing. It calls attention to the importance of Federal Orders in facilitating adjustment to change. It says that Federal Orders should not only facilitate change but also encourage it.

According to this historically important guide to Federal Order policy, any

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action that discourages adjustment to change would be contrary to the Agriculture Marketing Agreements Act of 1937 as amended, hereinafter referred to as the AMAA.

JUDGE PALMER: Any objection to the receipt of the statement? It is received as Exhibit 44.

(Exhibit No. 44 was received into evidence.)

MR. ROSENBAUM: Dr. Knutson is now available for examination.

JUDGE PALMER: Give your full name before questioning the witness again.

DR. CRYAN: My name is Roger Cryan, C-R-Y-A-N. I'm with the National Milk Producers Federation.

CROSS-EXAMINATION

BY DR. CRYAN:

Q. Good morning, Ron.

A. Good morning.

Q. Thank you for being here.

In your statement you cited demand elasticities for milk, retail demand

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elasticities for milk of .144, negative .144 from FAPRI and a negative .25 from Cornell; is that right?

A. Yes. What paragraph are you referring to?

Q. Paragraph 16.

A. Okay. Yes.

Q. Then you translated those to farm level elasticities of .072, a negative .072 and a negative .0125?

A. Yes.

Q. Could you tell us how you did that?

A. Yes. Roughly the -- this is a rule of thumb by economists for milk between farm level and retail elasticities, and roughly it's because the milk, the raw milk, constitutes roughly about half of the retail value of milk.

Q. In paragraph No. 7 you said that new products in the milk market are more elastic, they have a more elastic demand with respect to price and that that would make overall milk demand more elastic; is that right?

A. Yes.

Q. Is that correct? Am I

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characterizing that correctly?

And the kind of products you were talking about in paragraph 7 are things like single-serve flavored products, things like that?

A. Yes. Dr. Stevenson used that type of product as minus 0.5, as I recall, as an example of their estimates.

Q. Zero point --

A. 0.5.

Q. At the retail level?

A. At the retail level, yes.

Q. Well, isn't the raw milk value of those products, isn't the raw milk share, the raw milk share of the value of those products much lower than it is for milk generally?

A. Sure.

Q. So have you done any analysis to confirm that the impact of these types of products that both are more elastic, have more elasticity, they're both more demand elastic on the retail level but also have a smaller share of farm milk value in their retail price, have you done any analysis to confirm that the

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increased sales of those products actually makes demand more elastic at the farm level?

A. No, I have not.

Q. In your testimony in your statement, paragraph No. 11, you referred, I believe, to both the Class I differential study conducted by Cornell and the BFP study that you supervised at Texas A&M?

A. Yes.

Q. Your BFP study, that looked at potential manufacturing price alternatives; is that right?

A. It did.

Q. Specifically for Class III and IV type products?

A. Yes.

Q. And the study that Cornell undertook which you -- well, you have asked for that study to be replicated?

A. Yes.

Q. You believe that that should be replicated before this hearing should be concluded. Didn't that study look at relative Class I prices?

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A. It looked at the spatial distribution of Class I prices.

Q. And didn't the authors of that study emphasize that they did not speak to the absolute level of Class I prices, that they only spoke to the spatial distribution of Class I prices? Didn't they emphasize that?

A. Yes, they did, but the point is that in order to analyze the impact regionally of this proposal, you've got to have that spatial analysis.

Q. So that would help assess the impact?

A. Absolutely.

Q. But it only goes to the outcome; is that right?

A. It goes to the outcome. It certainly does, yes.

Q. Thank you. I think from your testimony it is clear that you are aware that the MILC program is expiring this summer?

A. Yes.

Q. And as I understand it -- and I am not a lawyer and everyone is aware of that --

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but I understand it would take an act of Congress to extend that program; is that correct?

A. Exactly.

Q. I don't believe Congress acts in a vacuum. Couldn't they take the results of this hearing into account in extending this program since they have to -- since it requires an act of Congress, couldn't they also revise the target upward by 77 cents or find a different target price like the Class III price or something like that?

A. In fact, that would be a much better option than that proposed in this hearing simply because it would apply to all milk and you would not have these regional disparities.

So, you know, as an economist it makes a lot more sense to deal with MILC as a solution to any problems that exist than it does to change in Class I price because you do not have these inner market disparities with MILC.

Q. But the Congress could change the nature of the -- they could change the target level with respect to the Boston Class I or they could change the price series that they use as the basis for the target; is that right?

A. Congress can do almost anything it wants to do as long as the President will sign it.

Q. Do you support the Federal Order system generally?

A. Absolutely.

Q. I'm glad to hear that.

DR. CRYAN: Thank you very much.

JUDGE PALMER: Mr. Yale.

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

CROSS-EXAMINATION

BY MR. YALE:

Q. Good morning.

A. Good morning.

Q. I'm trying to get some broad issues

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here to address and just maybe break down this project, this proposal into some pieces that I think need to be -- I'm going to ask you whether they need to be independently analyzed or whether it should be part of a whole.

It seems to permeate your testimony, isn't the first real policy issue that's facing the Secretary is whether or not to use these prices to increase producer income?

A. Whether or not to use Class I price to increase?

Q. Right.

A. And Class II?

Q. Or Class II.

A. Right.

Q. That's an initial policy decision; right?

A. (Witness indicated affirmatively.)

Q. Now, you have given arguments that suggest why that shouldn't be, that you maybe have not gained as much or it has some undue results. But that is a separate -- that's kind of the first decision the Secretary has to make?

Dr. Knutson - Cross by Mr. Yale

A. Yes.

Q. All right. And on that regard, is that one where the Department needs information or is it something that the Department can just arrive at as this general custodian of this program?

A. No. It certainly needs information, it certainly needs study, and it certainly needs to provide the time required. If they are not going to do the analysis, they need to provide the time to do the analysis.

Q. Okay. Now, once you reach the point that you want to add to producer income. Okay?

A. Yes.

Q. The next step is how much income needs to be generated; right? How much income do you want to enhance; right?

A. Yes.

Q. I know you haven't been here through the hearing. Do you see anything in here that --

Well, first of all, what issues would they look at in determining how much to add, assuming that they're agreeable that they

Dr. Knutson - Cross by Mr. Yale

need to do it?

A. Well, you know, the starting point is what's happening to the supply of milk. Is it falling? I mean, the emergency action, you would have to assume, in my view, to say this is an emergency, that the supply of milk is declining precipitously and there is danger that Class I milk markets will not be adequately supplied.

Nationally the supply of milk has been increasing somewhere in the range of one to two percent for at least three years running now, and Class I utilization is essentially flat.

Now, that suggests to me that the supply of milk is adequate, and I have not heard anyone argue that Class I markets are not being adequately supplied even in those states where production is declining.

Q. Are you equating the growth of milk production as an indication of profit in the production of milk or are there some other institutional factors that are driving the growth of production other than profit or

Dr. Knutson - Cross by Mr. Yale

prices?

A. Well, I am a strong believer that farmers are economically rational, that they would not be producing, would not be increasing production unless there were profits.

Now, I grant that there are some delays in farmer reactions, but the fact is that milk production is not declining nationally.

Q. So I would interpret that answer and the others to the point that basically in your opinion you don't see the need to add to the producer income?

A. No.

Q. Now, assuming --

A. Certainly not -- if I could. Certainly not in this manner.

Q. Okay. Well, that was my next question.

A. Okay.

Q. Let's assume for the moment for the purposes of the next question that there is a value that needs to be delivered to farmers, that they're losing money and we need to

Dr. Knutson - Cross by Mr. Yale

protect them in some way at a point.

A. Okay.

Q. Assuming that there is, then that makes the third issue that needs to be decided is how do you divide the money you have thus collected?

A. Yes.

Q. And I think you have alluded to that in your testimony as well, right, that there seems to be more of a broader spread of the money rather than maybe where it is needed? Am I misquoting you or misphrasing your position on that?

A. Well, when you raise Class I prices, you distribute the money to those producers in those markets that are in higher utilization markets or to producers that have access to those markets.

Q. Okay.

A. And so, you know, there is a disproportionate distribution of the revenues.

Q. Is there a correlation between a Class I market or the size of the Class I market and the amount of money that a producer

Dr. Knutson - Cross by Mr. Yale

loses or needs the extra income? Is there a connection between the two?

A. Well, the answer is yes, but that's why you need a spatial study such as that used in the 1998 decision by the USDA because you need to know where the needs are the greatest in terms of the distribution of milk supplies and associated differentials in prices.

Q. Kind of following that, you talk about over-order premiums in your testimony. What does the existence of the over-order premiums, what does that tell you as you look at those numbers? Does it give you any kind of signal in terms of what's going on in the real marketplace; and, if so, what are those signals?

A. Well, over-order premiums are supply and demand determined.

Q. Okay.

A. So over-order premiums are a very good reflection of supply and demand conditions just like butter prices are, powder prices are, and cheese prices are. They're a reflection of supply and demand conditions.

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As a part of that, over-order premiums serve a couple of functions: One, they are engaged, along with hauling charges, as a method of moving milk to where it's needed, and I think most economists would argue -- in fact, certainly I would -- that over-order premiums are more effective in moving milk toward where it's needed than the Class I price per se is.

Now, if the Class I price was highly effective, then transportation credits would really not be necessary. So over-order premiums is a -- what's the statement by the guy in Iowa? He said, "Money moves milk." That's where I heard it from was from a coop manager in Iowa I think it was, and that's associated with the use of over-order premiums.

Q. Were you in the hearing yesterday when the representative of Smith Dairy testified?

A. No, I was not.

Q. So you're saying that the premiums are a essential part of this whole system of moving milk? Is that what you're suggesting?

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A. Absolutely.

Q. Now, if the amount of additional -- as proposed, the 77 cents, it becomes part of the regulated price, will that reduce the ability of the plants in the cooperatives or producers supplying those plants to raise up or maintain their current premium structure?

A. That's a very interesting question, and I think the answer is we don't know for sure. There's probably some evidence that when Class I price differentials are increased that premiums might decline some, but there's no consistent evidence with respect to that issue; and, in fact, very little study has been done with respect to that issue. So I would leave it open to further analysis.

Q. Let me go to one final topic, and that is that you have seen the proposals and how they're designed. There's really two things going on in the proposals. One is to change the underlying formula to arrive at a Class I fluid price as opposed to the current level, higher up III or IV, advance III or IV.

A. Right.

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Q. That's one change. Then the other change is to actually enhance the Class I prices in those proposed by as much as 77 cents; right?

A. Right.

Q. Okay. Now, for the moment let's forget that we're going to get any -- that the Department, based on the evidence and it is kind of suggested in the notice that it might adjust it, that it might come out with that formula but adjust it so that its relationship at that time with III and IV is the same as it is today.

All right. Is there a danger to using that formula as opposed to just adding 77 cents to the advanced prices?

A. Well, I must say I haven't thought through the answer to that question because --

My reaction to the proposal was, hey, this is a major change in the policy with respect to the differential and how it's derived. When we thought of $1.60 or, you know, if you go back to the proposal's $1.40 or maybe even $1.20, and now you say there's a

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cost change, and we're automatically going to reflect a cost change even on things that are already in orders in that differential.

Now, my point is that that makes no sense to me. It would make more sense to me to do some add-on of some type or another if you are going to do something like that than it is to change the basic mechanism.

MR. YALE: I have no other questions, Your Honor.

JUDGE PALMER: All right. Any other questions? Yes, Mr. Beshore.

MR. BESHORE: Marvin Beshore for the Association of Dairy Cooperatives in the Northeast and Dairy Farmers of America.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Good morning, Dr. Knutson.

A. Good morning.

Q. I noticed and I was intrigued by the emphasis in your statement by the use of the term "science" or "science-based" and its emphasis, and I just took the concluding two sentences and I circled it I think five times.

I don't recall previous testimony with that sort of emphasis. Is economics a science?

A. Absolutely.

Q. Is political science a science?

A. Yes.

Q. Okay. Is sociology a science?

A. Yes.

Q. Anthropology?

A. Yes.

Q. Psychology?

A. Absolutely.

Q. The same fields? They're in the same --

A. The same fields?

Q. No. I'm sorry. They're in the same realm, science?

A. Yes. The only difference is that we have actual numbers, currency, pounds and so forth to deal with. Most of these -- well, I have got to divide between anthropology I guess, but most of these other fields do not have these sound economic numbers of quantities, prices, and most of them do not operate on the basis of markets. Now, there might be people who argue with that, but that's the difference to me.

Q. Okay. So the sound numbers that economics are dealing with are things like elasticities?

A. Yes.

Q. Okay. And I think you said one of the elasticity numbers that you used in paragraph 16 was based on a rule of thumb; correct?

A. Yes. Yes.

Q. Is that a scientific number, a rule of thumb?

A. Well, understand, I said, you know, I questioned this number and I did it on the basis of the rule of thumb. Obviously sound science reason for doing that would be to conduct a study which allowed you to verify that, but nobody provided us the time in an emergency hearing to do that.

So it is extremely difficult to do anything other in this environment than to question the economic analysis that has been done on the basis of things like rules of thumb.

Q. Okay. So that's what's embedded in these projections that you have discussed in your testimony; correct?

A. No. No.

Q. Well, if you --

A. If you go back to the spread sheet, --

Q. Yes.

A. -- that is based upon USDA analysis and numbers, not rules of thumb.

Q. Okay. Let's take your spread sheet. First of all, the base, the volume and utilization base for your spread sheets are the past production data for Order 30, 2005; correct?

A. Yes.

Q. Okay. So in using the spread sheet, you're assuming that those production and utilization figures would be the same for nine years; correct?

A. Yes. That they would be the same

Dr. Knutson - Cross by Mr. Beshore

percentage, exactly, for nine years. Right.

Q. And the same volumes?

A. No. I assumed the same percentage.

Q. Well, you took volumes times numbers to get dollars. So you're assuming the same volumes, are you not?

A. No. Mr. Beshore, what I did was I took the percentage that the Upper Midwest accounts for national production, and then I multiplied that by the numbers supplied by USDA. So I did assume the same percentage.

Now, I would have used 2006 had we had a full year of data. In fact, I did run the numbers through for the months that we have in 2006 and the numbers -- the results would be higher.

Q. Well, let's --

A. But since I didn't have a full year I decided that's not a good way to do it.

Q. Well, I think the volume numbers on your spread sheet will speak for themselves. We can all look at those.

A. Right.

Q. The milk volume numbers.

Dr. Knutson - Cross by Mr. Beshore

Now, let's look at -- basically your spread sheet is volume times price equals dollars and dollars lost as far as you're concerned?

A. Exactly.

Q. All right. Now, let's look at the price numbers. What price numbers did you use in that spread sheet, the one that has the hard numbers you want us to work with?

A. I used the prices derived -- given by USDA, the changes.

Q. The nine-year average price changes which were the product of the USDA modeling?

A. Exactly. Exactly.

Q. Okay. The model that has the elasticities in it that are based on things like rules of thumb; correct?

A. No. My elasticities are the ones by USDA.

Q. That's what I mean.

A. These are not rules of thumb here. These are the elasticities used by USDA.

Q. Okay. But they used things like the 50 percent farm-to-market elasticity; correct?

Dr. Knutson - Cross by Mr. Beshore

A. I don't have any idea, and I asked the IDFA attorney, Steve, to find that out for me, but unfortunately the AMS economist didn't show up at this hearing. So how can you find out?

Q. Did IDFA ask the AMS economist to come to this hearing?

A. No. I don't know if he did or not, but everybody assumed. I think you assumed he would probably be here.

Q. Do you know whether anyone, any party asked him to be present?

A. No. No, I don't.

Q. If I understand your statements in paragraph 16 about these elasticities, you say USDA uses a demand elasticity at the farm level which is lower than estimated by other prominent dairy economists use?

A. Yes.

Q. Now, do they use a 50 percent difference between a farm level and demand level like everybody else?

A. Roughly, yes.

Q. Now, that 50 percent, you said, is

Dr. Knutson - Cross by Mr. Beshore

based on the assumption that the cost of -- the retail cost of fluid milk products, the farm price of fluid milk is about half the retail cost; correct?

A. Yes. Yes.

Q. Now, if that ratio is not correct today, should you have a different farm elasticity number?

A. Yes. It would be a little different, yes.

Q. And if the retail price today is a third --

I mean, if the farm price is a third of the retail price, should it be a third rather than 50 percent?

A. Roughly.

Q. Okay. What would that do to the results of any of these projections?

A. It would not change the numbers on this chart.

Q. Well, isn't that farm elasticity embedded in those supply projections over that nine-year average?

A. The elasticity by USDA presumably is

Dr. Knutson - Cross by Mr. Beshore

a farm level elasticity.
Q. Right.
A. I mean, I have done enough checking myself to determine that it probably is. Okay?
Q. Okay.
A. That was estimated using, I presume, econometric methods. No rule of thumb involved in that. That's basic econometric methods. I would love to have used econometric methods if I had the time to do it.
Q. Well, here's my question. The numbers that you put into your spread sheet --
A. Yes.
Q. -- were the ones that USDA's econometric model generated?
A. Exactly.
Q. And they were nine-year averages?
A. Yes.
Q. And so they're the product of whatever assumptions went into them?
A. Exactly.
Q. Okay. And if, for instance, as you say, that AMS uses a demand elasticity at the farm level, 0.48, and that's -- that's in the

Dr. Knutson - Cross by Mr. Beshore

model; right?

A. Yes. 0.48, yes.

Q. Minus --

A. Minus 0.048.

Q. Okay. And if that's based on 50 percent farm to retail; right?

A. Understand, when I said that was a rule of thumb that economists use, I don't -- I don't know what that was based upon, but I assume, knowing Howard McDowell, that he used econometric methods to derive that 0.48.

Q. So Mr. McDowell is one of the persons who runs the model?

A. That's my understanding, yes.

Q. Okay. Let me ask you this, Dr. Knutson: Can you tell us how many hundredweight of milk IDFA members that you are speaking on behalf of purchased at the minimum Federal Order price for Class I uses during its --

A. Oh, I have no idea.

Q. Do you know whether there's any?

A. Any milk purchased at the minimum Class I price?

Dr. Knutson - Cross by Mr. Beshore

Q. Yes. For Class I uses.

A. Premiums are extensive throughout the country. I would guess -- I would speculate there probably is none.

Q. Okay. Now, if there is none, is the minimum Federal Order price generating sufficient volumes of milk for that purpose?

A. Absolutely. Absolutely they are.

Q. Because of premiums?

A. Well, because of two things. The fact that you supply a minimum price reduces the downside risk of pricing for farmers, and it has been demonstrated by economists over and over again that policies that reduce farm downside risk increase supply.

So the combination of the minimum price plus the premium plus reducing the downside risk are the factors that induce supply change.

Q. So the fact that there's a program there and that producers are paid premiums allows them to produce enough milk for the system?

A. Yes.

Dr. Knutson - Cross by Mr. Beshore

Q. Do you know whether the organization for which you are speaking, the IDFA, has supported or opposed the MILC program which you have spoken so positively about?

A. I have no idea, and I don't think it is relevant to my role as an economist here to know what their policy position is because I was asked to do an analysis and did the analysis.

Q. Okay. Well, I gather from your comments to Mr. Yale I think about the MILC program, as an economist consulting to them, you would commend them to support that program?

A. No. What I said was this: I said the benefits of MILC, the economic consequences are quite different than increasing the Class I price in that they go to everybody, particularly to small producers.

Admittedly there is a cap in those kind of detail provisions, but they go to everybody; and, as a result, you know, in contrast with this proposal where the benefits go primarily to producers for high utilization markets and disadvantage producers in low

Dr. Knutson - Cross by Mr. Beshore

utilization markets, the MILC goes to everybody.

Q. Okay. Now, have you analyzed the regional impacts of MILC?

A. Well, yes. If you analyze the regional impacts and you consider things like the payment limit on MILC, clearly those markets where you have larger producers like California do not benefit as much as those where you don't have large producers, but on the other hand --

And there's I guess political social reasons for doing that. But this proposal knocks the small producers in the Upper Midwest in the gut.

Q. Okay.

A. And as an economist, I would be concerned about that kind of a proposal.

Q. Well, let's --

A. I don't worry about our farmers in West Texas. I mean, they're big. They're going to survive.

Q. Let's explore the impact, the ostensible impact of the proposal on the

Dr. Knutson - Cross by Mr. Beshore

producers that you're concerned about here.

A. Yes.

Q. Are you familiar with Mailbox, the Mailbox Milk Price series?

A. Yes. Generally, yes.

Q. Can you tell us what the relationship is between Mailbox prices at farms in Wisconsin, Ohio, Pennsylvania? Do you have any idea?

A. No. I have not studied that issue. I have no idea.

Q. Well, if you assume with me for a moment that the Mailbox Milk Price series shows that farmers in those states get close, roughly in the same ballpark mailbox prices, their mailbox price levels are about the same.

A. The same as what?

Q. Equal.

A. For who?

Q. Wisconsin, Ohio, Pennsylvania.

A. Okay.

Q. About the same.

JUDGE PALMER: Just for the record, would you define what that is? That's

Dr. Knutson - Cross by Mr. Beshore

a new term for me. Just put it in the record, mailbox prices. Do you want to do that?

MR. BESHORE: Sure. Can you tell us, Dr. Knutson?

THE WITNESS: In essence, Judge, a mailbox price is what the farmer receives in his check.

JUDGE PALMER: Okay.

THE WITNESS: Divided by the quantity of milk. So that would be, you know, my understanding of what the mailbox price is.

MR. BESHORE: Sort of like his take home pay.

THE WITNESS: Yeah. Yeah. This is sort of --

JUDGE PALMER: You have the reblending by coops and all the rest of it?

THE WITNESS: Exactly. Exactly.

JUDGE PALMER: This is what the independent farmer, the individual farmer gets?

THE WITNESS: Yes. Yes.

JUDGE PALMER: Okay.

Dr. Knutson - Cross by Mr. Beshore

BY MR. BESHORE:

Q. So assume with me that those mailbox prices are of the same order, approximately. You're aware that the utilization in those Federal Order areas is quite -- is different; correct?

A. Uh-huh.

Q. Now, what does that tell you?

A. Well, it probably tells me that's who's been reblending and so forth by cooperatives if that's the case.

Q. Does it tell you anything about the expenses of marketing the milk?

A. It might tell me more cheese is made in the Upper Midwest.

Q. More cheese is made, what would that --

A. Class III, you know. The history is that Class III prices are a little higher.

Q. So there's an advantage to the Upper Midwest in that respect?

A. I wouldn't -- well, there may be, but that doesn't say anything about this proposal in terms of its economic impact. I

Dr. Knutson - Cross by Mr. Beshore

don't understand the relevance of the question to the proposal.

Q. Well, if the mailbox prices in higher Class I utilization orders are the same as that, relatively the same as that in lower Class I utilization orders, might that not say something about the marketing expenses in those areas?

A. Well, it might or it might not. It might also say something about what the coop is doing to receipts during the moving of them around.

Q. You're assuming that what? The coop's moving them from a higher utilization market to a lower utilization market?

A. Could be. Could be. Could be. You don't know.

Q. Do you have any basis for that?

A. Well, I know that there have been -- in the past my original study was of formation of inter-regional coops.

Q. What year was that study?

A. A way long time ago.

Q. Tell us what year so we know what

Dr. Knutson - Cross by Mr. Beshore

you're talking about.

A. Probably 1972.

Q. Okay.

A. And that's when you started to get a feel for, you know, the power of relationships of coops and their ability to move milk around and move money around.

Q. Now, let's assume --

A. Reblending in the judge's terms.

Q. Let's assume that those mailbox price series, of course, include all the price levels to the independent dairy farmers. You understand that?

A. Yes.

Q. That's not going to reflect any coop reblending; right?

A. Oh, yes. But they have to be competitive.

Q. The coops have to be competitive; right?

A. Well, it goes both ways.

Q. Okay. So those mailbox prices are going to reflect the competitive prices in those areas; correct?

Dr. Knutson - Cross by Mr. Beshore

A. With premiums. Yes.

Q. Okay. And one -- I will drop that thought.

Now, your concern about small farmers in the Upper Midwest, were you here when Mr. Crossland testified? I'm sure you weren't.

A. No, I was not.

Q. Well, you're aware, of course, that there are many, many small farms, in particular Amish and Mennonite small farms in Pennsylvania, Ohio, Maryland, in those areas?

A. I am. Yes.

Q. Right. Aren't you concerned about the impact about returning benefits to those small farms?

A. Sure.

Q. And if the testimony of someone speaking on behalf of 800-some of those farms cooperative indicated that they needed more than the proposed increase price in their area, does that play into your thinking at all?

A. It doesn't justify this proposal to me, no. As I have said, there are other ways

Dr. Knutson - Cross by Mr. Beshore

to do this.

Q. Such as MILC payments?

A. Yes.

Q. You make the comment in paragraph 37 I think -- here it is. It is one of the sentences about the middle. "Given that Class I premiums are pooled and shared among producers regardless of whether they are supplying Class I facilities." What do you have reference to there?

A. Well, just exactly what it says, that when a firm -- when a coop collects premiums, those premiums perform a couple of functions. One is they compensate the coop for the function performed and the costs associated with it, and if there's anything net left over, it will go back to the producer. That's typical of coops.

Q. So when you say "Class I premiums are pooled," you are talking about within --

A. Within the whole.

Q. They're assumptions you're making within a cooperative?

A. Yes, yes.

Dr. Knutson - Cross by Mr. Beshore

Q. Of course, Class I premiums paid directly to independent dairy farmers are not pooled; correct?

A. True.

Q. You referred a couple of times to transportation credits and orders. Do you know how many orders have transportation credits?

A. I think there are probably -- well, the answer is no, not exactly, but I think there are three or four that have -- maybe five that have that type of mechanism. They're not all exactly the same.

Q. Now, are you endorsing and espousing transportation credits as a mechanism for servicing Class I markets?

A. It is a way to move milk, yes. Since the Class I price itself does not real effectively move milk, then transportation credits are a way to move milk.

Q. Should the transportation credits be paid out of the pool or be funded by additional charges to the Class I marketplace?

A. I have not studied that issue, and I have no opinion with respect to whether it

Dr. Knutson - Cross by Mr. Carman

comes from one place or the other.

Q. It makes a difference to producer income, doesn't it?

A. It probably does, yes.

MR. BESHORE: I have no other questions at this time. Thank you.

JUDGE PALMER: Any other questions?

MR. CARMAN: Yes.

JUDGE PALMER: All right, sir. Mr. Carman.

MR. CARMAN: Clifford Carman, C-A-R-M-A-N, with USDA Dairy Programs.

CROSS-EXAMINATION

BY MR. CARMAN:

Q. Good morning, Ron.

A. Good morning.

Q. We've had a series of questions on the econometric model used by USDA.

A. Yes.

Q. If the model -- there is some documentation in the model available on the USDA website. Have you seen that

Dr. Knutson - Cross by Mr. Carman

documentation?

A. I have. Yes. I printed out -- that's where I got the elasticity from, to tell you the truth. I went back to check on it. Yes.

Q. Do you have that document with you?

A. No, I do not.

Q. If you had that document to you, could I show you my copy of that documentation?

A. Sure.

MR. CARMAN: Let the record show that I presented to the witness a copy of the documentation of the USDA econometric model.

JUDGE PALMER: Very well. The record will so show it.

Q. Ron, I refer you to a table in that documentation.

A. Yes.

Q. Could you read the title of the table, please.

A. It is Table 3, Per Capita Demand and Related Equations.

Q. So in a sense it is looking at the

Dr. Knutson - Cross by Mr. Carman

retail level of the model; is that correct?

A. Yes.

Q. So the demand elasticity that you were talking about in the model of negative 0.048 would, in your interpretation, be a retail demand level for Class I milk?

A. No. I did not say that. I said that I assumed that it was the farm level. In fact, I didn't talk to Howard McDowell per se, but I talked to an individual at FAPRI who had talked to Howard about the issue. So therefore, based upon that discussion, I assumed it was a farm level elasticity.

Q. With the documentation in front of you, would you change your opinion of what that elasticity is?

A. No, I wouldn't, because, you know, I was told that it was a farm level elasticity. If it's a retail elasticity, then it's bizarre.

Q. But it is a very strong estimated he equation as you can see in the documentation?

A. It's an estimated equation, yes.

Q. So to the extent that it is a retail demand equation and there are other levels of

Dr. Knutson - Cross by Mr. Carman

the model such as the wholesale and farm level, there is no rule of thumb to get to an elasticity used in the model?

A. If this is a retail elasticity, then it is a third, approximately, of that used by Cornell and -- well, a lower percentage. It takes 10 percent of that use by Cornell.

I mean, if that's a retail elasticity, then the impact on farmers in the Upper Midwest is much higher than I had thought it was. But I don't think that elasticity is -- it does not reflect --

It is not an accurate reflection of a retail elasticity. I think that economists in general would agree with that. I mean, clearly it is --

FAPRI has spent years working on this issue of demand elasticities, and they don't come anywhere near that elasticity.

Q. They have an elasticity of minus 0.144 as you purport in paragraph 16 of your statement?

A. Yes. Yes.

Q. Do you know how FAPRI estimated that

Dr. Knutson - Cross by Mr. Carman

elasticity?

A. Well, they used econometric methods and analyzed it, I'm sure. I mean, they don't --

Q. You don't know what durables that they used in their equation?

A. No, I do not. No, I do not.

Q. The Department has put forth their documentation, and to the extent that their variables are put forth in that table, those elasticities could well be the results of the model?

A. They could be the result of this model that they used, yes.

Q. Okay. The model documentation indicates that it is relatively current, that is, it is using updated through 2004. Do you happen to know whether Mr. Cox or the FAPRI model, what their time periods are?

A. The FAPRI model is updated every year. Mr. Cox, Mr. Cox is doing other things these days. So I'm not sure exactly what Cox -- in fact, I don't even quote the Cox estimate because I couldn't get my hands on what the Cox estimate is.

Q. Well, in this case, rather than demand elasticity, I switched to supply elasticities, and I believe you do quote a supply elasticity from Mr. Cox.

A. Yes, I do, because that was a peer-reviewed journal article, 2003.

Q. Do you happen to know the time period of that estimate?

A. No, I do not.

MR. CARMAN: Thank you, Ron.

JUDGE PALMER: All right. Thank you. Mr. Tosi. Mr. Stevens.

MR. STEVENS: Garret Stevens, Office of General Counsel, U. S. Department of Agriculture.

CROSS-EXAMINATION

BY MR. STEVENS:

Q. I think you testified in response to a question from Mr. Beshore that you didn't request the appearance of any individual from the Department of Agriculture to speak to the model?

A. True.

Q. And as far as you know, the organization you're speaking for did not request such an appearance either?

A. I don't know that.

Q. Well, from your knowledge you don't --

A. From my knowledge, no.

MR. STEVENS: Okay. Thank you very much.

JUDGE PALMER: Mr. Tosi.

MR. TOSI: My name is Gino, G-I-N-O, Tosi, T-O-S-I, with Dairy Programs, USDA.

CROSS-EXAMINATION

BY MR. TOSI:

Q. Could you please explain a little more what is it about this national milk proposal that, if adopted, would represent a change in Class I milk pricing policy?

A. Well, it represents an increase in the Class I differential and it implies -- you

Dr. Knutson - Cross by Mr. Tosi

know, if you accept the notion, it implies that the considerations in Option 1A, which USDA rejected twice, were the right considerations in pricing milk. That Option 1A was, in essence, mandated by the Congress, and so, you know --

And, in fact, it changes the differential itself in the process. So that's why I considered it a major change in pricing policy.

Q. Would you agree then that the Class I price level between Option 1A and 1B was a difference in what the Secretary at the time felt should be how much of a role government needed to play in establishing a minimum price but that the components of the Class I differential remained largely unchanged? We're just talking about level, in other words.

A. You know, this issue of market oriented versus regulatory oriented is an interesting issue. I would have a very difficult time saying that a Republican Secretary of Agriculture is less market

Dr. Knutson - Cross by Mr. Tosi

oriented than a Democrat Secretary of Agriculture. I mean, you're talking about Glickman versus Johann. That's a little bit --

I would prefer not to get into that argument, to tell you the truth, as to whether one is more or less market oriented.

Q. So we can stand on what's said in the decision then on the conclusions as to why 1B versus 1A was -- why they were different and why the Department supported one over the other?

A. Well, you mean in the final decision?

Q. Yes, sir.

A. The interesting thing is in the final decision they don't go through those individual reasons, as I recall. I mean, that's rather amazing to me that, you know, they just accept basically what the Congress said.

Q. In economic models do they assume rational behavior by producers?

A. Yes.

Q. Okay. When prices are really high,

Dr. Knutson - Cross by Mr. Tosi

what's the signal that's given to producers with respect to production?

A. Produce more.

Q. When price prices are really low, what does a farmer need to do to lower his per unit cost of production?

A. There are some things that farmers can do to lower costs, but the normal farmer response is to cut back on production.

Q. Okay. Do your --

A. Time to sell cows.

Q. They may do that?

A. Yes.

Q. But would you agree then that even in past history here when we've seen prices go up and down that milk production nevertheless continues to increase?

A. I do not believe those people who say higher prices induce more production. That that is a ludicrous notion. I mean, that farmers -- excuse me.

That lower prices induce more production, that is a ludicrous view. That somehow farmers, in response to lower prices,

Dr. Knutson - Cross by Mr. Tosi

make up the revenue by producing more, I have heard that stated many times, but it is not by good economists that make that statement.

Q. With regard to your analysis on the differing impacts being different in the Upper Midwest versus other places, I take it from your testimony that it is a highly negative impact to producers in the Upper Midwest?

A. Well, it is a negative impact.

Q. What is your opinion then about the -- what's the role of the Class I differential? Why do we have it?

A. To increase revenue to producers. I am an economist. I know that USDA does not use elasticity estimates or price discrimination models as the basis for Federal Orders, but I am convinced that that's the primary function that they serve is as a price discrimination model to increase revenue to producers.

The rhetoric of USDA may be different than that, but that's my view. They don't -- it has been demonstrated, as I said earlier, that they don't really move milk around. You need transportation credits to do

Dr. Knutson - Cross by Mr. Tosi

that or you need premiums to do that.

They aren't really effective in moving milk around. So they increase returns to producers who serve Class I markets.

Q. Are they reflective of the additional value that is attached to Class I milk?

A. That's inherent in the notion of an elasticity, that it has higher value to consumers, that consumers are less likely to substitute.

Q. Do you mean yes then to the question?

A. Yes.

Q. Okay. Do you know what the role of pooling standards play in orders?

A. Yes. Yes. They prevent milk, unneeded milk, from moving into the market.

Q. To the extent that pooling standards provide handlers, Class I handlers, a reasonable assurance that they're going to be supplied with milk, to the extent that condition is met, isn't it producers that decide, producers associated with the market

Dr. Knutson - Cross by Mr. Tosi

that decide to what extent they want to share revenue amongst other producers based on some level of performance?

A. Well, it's cooperatives that decide; and if you are equating producers with cooperatives, the answer is yes.

Q. So if producers or cooperatives in the Upper Midwest decide that they want to pool as much milk as possible and require the least amount of standard to demonstrate its standard -- demonstrated performance in serving the Class I market versus producers in another market that decide they want to share their revenue different, what's your take on that with respect to the differing impacts that are going to happen that's going to be injurious here to the producers in the Upper Midwest?

A. Well, my take goes like this: If you look at northern Indiana where you have had this big new cluster of milk production of moving substantial quantities of milk into the Southeast, they obviously have a comparative advantage in doing that.

If you look at West Texas, which I

haven't looked -- I haven't quantified this on the map, but my observation would be that they're increasing milk production very rapidly. They are looking for markets for milk. They can't build plants fast enough; and, as a result, it is to their advantage -- and when I say "their," the cooperatives' and the producers' advantage -- to move milk to the southeast. It is probably even cost efficient to do it simply because of the highway systems that exist that run east and west which create a great deal of efficiency associated with it. But, again, that's as much speculation as anything else.

Now, the Upper Midwest, cheese plants primarily, high cheese manufacturing utilization, and I think that they probably see a cost associated with moving milk that is greater than the benefit.

Now, that isn't to say that there's no milk that moves from the Upper Midwest to the southeast. It is simply saying that every one of these situations is a little bit different in terms of what you give up, if you

Dr. Knutson - Cross by Mr. Tosi

will, in terms of revenue. That's my take on that.

Q. If producers in the Upper Midwest chose to restrict their pool, wouldn't the impact -- wouldn't your impact on your analysis here be very, very different?

A. If they chose to restrict their pools?

Q. Yes. If they chose to restrict access to the pool, to be much more selective in terms of how far they want to share additional revenue that comes from Class I sales, okay, wouldn't your analysis be very different?

A. Sure. If you're -- sure. If you make a different assumption, you get different results. Yes.

Q. Okay. So your conclusion then about the different impact here of what happens to producers is based on -- is based largely by decisions that producers make themselves on how they want to share revenue?

A. It is based on the decisions that cooperatives make in terms of how they want to

Dr. Knutson - Cross by Mr. Tosi

share revenue.

Q. The producing sector then, sir?

A. Yes.

Q. Okay. Is it the role of Federal Orders to guarantee access to markets for dairy farmers?

A. Well, "to guarantee." Certainly it is a role of Federal Orders not to unduly impede access, and as I said, you know, you increase the Class I price, you're going to increase the need to impede access to high utilization markets, higher level regulation.

Q. Would you say that again, please.

A. If you increase the Class I differential, you are going to create greater need to restrict access to high utilization markets because producers are going to be more inclined to want to be associated with that pool because of the higher Class I price and that --

You know, you asked the question what was the impact of 1A? 1A is an important extent, a reason why you have to have such tight pooling requirements.

Dr. Knutson - Cross by Mr. Tosi

Q. Are you offering any other model for analysis --

A. Sir, I accepted -- in my flow chart here I accepted USDA's analysis. I said, yes, it looks like a lot of weaknesses to me. If indeed that elasticity is a retail elasticity, there are more weaknesses than I thought there was.

But I accepted that in the spread sheet and said even when you accept that, you get negative impacts on Upper Midwest producers.

Q. Okay. I would appreciate it if you will assume for a moment that we appreciate there are different ways to analyze what the impacts are going to be. Is there anything in the impact statement that addresses or challenges the evidence that's been presented on the higher costs that have occurred in producers supplying the Class I market?

A. No, there isn't.

Q. Okay. If this is the same model that was used to analyze the impact on changes to Class III and IV make allowances, did that

Dr. Knutson - Cross by Mr. Tosi

have anything to do with the legitimacy of the higher costs that manufacturers claim that they were incurring?

A. First of all, I have not studied the make allowance decision real carefully.

Q. That's okay.

A. But, you know, generally speaking these models do not -- they deal with macro issues, macro impacts. They don't deal with micro issues of what individual cost items are.

And that's why I said when you make an Order decision, you need the economic information clearly that are provided by models, I am a strong proponent of that, but you need the other information that's provided by hearings that you've got to consider, too. And I recognize that.

But I do say that, you know, if you say the cost of Grade B milk is increased over Grade A, it seems to me, one, that the cost has to be -- that Grade B milk conversion has to be a significant issue, which I don't think it is; but, secondly, you have to have a study of those costs.

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And to say 1977 updated for the costs, well, that makes me roll my eyes. I don't know about that. It's easy enough. You could get a study if you needed it.

Q. So your answer, I take it then, that to the extent that there is nothing in this analysis that was performed by USDA on what we thought the outcome might be, that it has absolutely nothing to do with the increased cost information that the proponents are providing as a rationale for increasing --

A. I see no --

Q. Please let me finish.

A. Okay. Go ahead.

Q. All right. To the extent that there is nothing there regarding that other than to say this is what we think the outcome might be, and to the extent that it is the same thing now for costs on another part of milk orders, that is, manufacturing costs, your answer is, is that it is no here, but you don't know about over there even if the model is the same?

A. If the model is the same, I expect that in general it is going to yield the same type of results applied to the situation that's being analyzed.

Q. No, sir. I was asking about cost information that were contained in the proposals.

A. I have not seen a reference in the model results to, for example, difference in cost between Grade A and Grade B. I see reference in the proposal to it, but I don't see reference to costs per se in there, so --

MR. TOSI: All right. Thank you.

JUDGE PALMER: Any other questions?

MR. ROSENBAUM: I do.

JUDGE PALMER: Yes, I want to get you, Mr. Rosenbaum. I just want to make sure we don't have any other cross.

All right, sir. We will have you back on redirect.

REDIRECT EXAMINATION

BY MR. ROSENBAUM:

Q. Dr. Knutson, you were asked some

questions as to the basis for your statement that you believe adoption of the proposal would represent a change in policy for USDA; correct?

A. Yes.

Q. And in response you identified one example of such a change would be in accepting various cost parameters as the basis for setting a Class I differential when, in fact, USDA rejected that in both 1998 and 1999; correct?

A. Yes.

Q. Now, would a decision by USDA to ignore the adequacy of the milk supply and its ability to serve the Class I market, if USDA were to ignore that, would that represent a change in policy by USDA?

A. Yes, it certainly would. Yes.

Q. In fact, has the adequacy of the milk supply to serve the Class I market been the touchstone for Federal market decisions?

A. It has certainly been very important.

Q. The economic analysis performed by USDA as contained in the hearing notice

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includes a baseline projection as to what USDA believes the milk supply will be if the proposal is not accepted; correct?

A. Exactly.

Q. And it also projects, for example, how much Class I usage would be under that scenario; correct?

A. Yes.

Q. And as you testified, that analysis would indicate a growing milk supply overall, virtually no increase in Class I usage; correct?

A. Yes.

Q. Accordingly, to the extent that USDA were going to look at its historical consideration of the adequacy of milk supply, does the model, in fact, provide highly useful information as to that question?

A. Yes.

Q. And what conclusion do you draw as to whether the milk supply is adequate?

A. As I stated in the testimony, I certainly don't see any evidence that it wouldn't be adequate. It certainly would be

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adequate, yes.

Q. Now, when USDA set about to set Class I differentials in the late 1990s as part of which has been sometimes termed Order reform, they looked at the spatial relationship of Class I differentials; correct?

A. Yes.

Q. Does adding a 77 cent per hundredweight across the board increase to Class I differentials change that spatial relationship?

A. Yes, it does. It certainly does. It changes -- that depends upon how you look at spatial relationship, but it changes the relationship of returns to producers certainly in the higher utilization markets. You look at spatial in that sense, but you can also look at spatial in terms of the difference in, for example, Dallas versus Florida in the level of the Class I price. That's also a dimension of spatial relationship.

Q. And these are things that have not been analyzed for this proposal?

A. No. And beyond that, you know, I

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think that when USDA makes a decision of this type, it is very important that they understand what is the basic equilibrium, the spatial relationship of prices. I think that's extremely important.

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

JUDGE PALMER: Are there any other questions? Thank you very much, Doctor.

THE WITNESS: Thank you.

JUDGE PALMER: I would like to take a short break. Probably what we might do is take a break for ten minutes and start the other witness, then we will take a luncheon break.

(Recess taken.)

ROBERT D. YONKERS, Ph.D.

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

JUDGE PALMER: Do you have a copy of your statement?

DR. YONKERS: Yes.

(Exhibit No. 45 was marked for

identification.)

JUDGE PALMER: Very well, sir. Proceed.

DIRECT EXAMINATION

BY MR. ROSENBAUM:

Q. Dr. Yonkers, you have a prepared statement that's been marked as Exhibit 45. If you could read it, please.

A. Thank you. This testimony is submitted on behalf --

JUDGE PALMER: Give your full name, please. I thought it was somewhere in this statement.

THE WITNESS: It is, Your Honor. Robert Yonkers, Y-O-N-K-E-R-S.

JUDGE PALMER: All right.

A. This testimony is submitted on behalf of the International Dairy Foods Association, or IDFA, a trade association representing manufacturers, marketers, distributors and suppliers of fluid milk and related products, ice cream and frozen dairy desserts, and cheese. IDFA represents the nation's dairy manufacturing and marketing

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industries and their suppliers with a membership of 530 companies representing a $90 billion-a-year industry. IDFA is composed of three constituent organizations: The Milk Industry Foundation, the National Cheese Institute, and the International Ice Cream Association.

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

As buyers and processors of milk, IDFA members have a critical interest in this hearing. Most of the milk bought and handled by IDFA members is regulated under the Federal Milk Marketing Orders, or FMMO, promulgated pursuant to the Agricultural Marketing Agreement Act of 1937, or the AMAA.

I am Dr. Robert D. Yonkers, chief economist and director of policy analysis at the International Dairy Foods Association. I

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have held that position since June 1998. I hold a Ph.D. in Agricultural Economics from Texas A&M University in 1989, a Master's Degree in Dairy Science from Texas A&M in 1981, and a Bachelor of Science degree in Dairy Production from Kansas State University in 1979. I have been a member of the American Agricultural Economics Association since 1984.

Prior to taking my current position at IDFA, I was a tenured faculty member in the Department of Agricultural Economics and Rural Sociology at the Pennsylvania State University, where I was employed for nine years.

At Penn State I conducted research on the impacts of changing marketing conditions, alternative public policies, and emerging technologies on the dairy industry. In addition, I had statewide responsibilities to develop and deliver extension materials and programs on topics related to dairy marketing and policy.

I have written and spoken extensively on economic issues related to the dairy industry, and I have prepared and

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delivered expert witness testimony to state legislatures and to Congress.

These hearings were called to consider proposals contained in a petition from National Milk Producers Federation, the petitioners, to change the Class I and II price formulas used in all Federal Milk Marketing Orders. IDFA opposes all five proposals contained in the hearing notice and, in addition, opposes the consideration --

(Interruption in the proceedings.)

JUDGE PALMER: Going off the record.

(Discussion held off the record.)

JUDGE PALMER: Please continue, sir.

A. IDFA opposes all five proposals contained in the hearing notice and, in addition, opposes their consideration on an emergency basis for the reasons I am about to explain. One, there is no need to make these changes to ensure orderly marketing or a

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sufficient quantity of pure and wholesome milk to meet current or projected needs.

Two, making the proposed changes would lead to disorderly marketing.

Three, data used by proponents of these changes do not address the relevant considerations and are in any case flawed and in many instances self-contradictory.

Before addressing these issues in detail, I would first like to note our strong objection to the short notice provided for this hearing.

Class I pricing is the most fundamental aspect of Federal Order regulation. Past considerations, such as those undertaken during Order reform, have involved detailed and careful analyses, including analyses of the regional impacts of Class I pricing. The hurried nature of these hearings has resulted in superficial presentations and the use of surrogate and, as noted, often flawed data even with respect to those factors that the proponents claim are relevant to this inquiry.

Earlier this year USDA suspended for

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several months its consideration of updating the Class III and IV make allowances to await the development of what it believed would be more reliable and appropriate data than it had received when those make allowance hearings had first been held in January 2006.

We believe that USDA must conclude either that the proposals in this hearing should be denied or that a suspension of consideration of the proposals should occur in order to prevent appropriate data to be developed. There is no need to make these changes to ensure orderly marketing or a sufficient quantity of pure and wholesome milk to meet current or projected needs.

I would have assumed that everyone, including the proponents, would have recognized that the touchstone of the inquiry here is the adequacy of the milk supply to meet Class I needs. This is, of course, a critical factor under the AMAA and was by far the most important factor to USDA when it last held a hearing to consider raising Class I and Class II prices in 1998.

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As I will discuss in more detail below, USDA at that time rejected a proposed price floor that would have had the effect of raising Class I prices by $1.05 per hundredweight principally because there was no evidence of a shortage of milk for Class I needs.

More recently, in a January 23, 2000, letter to Congressman Blunt and a January 21, 2003, letter to Congressman Sherwood explaining why USDA would not call a hearing to consider a drought adjustment surcharge on Class I and Class II prices. Undersecretary Hawks listed the first objective of the FMMO program as "to assure an adequate supply of milk for the fluid market."

THE WITNESS: I would ask that these letters be introduced as exhibits into the hearing record.

JUDGE PALMER: Are they part of the --

MR. ROSENBAUM: No. Your Honor, at this time I would like to mark what would be Exhibits 46 and 47, which are the two

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letters that were referenced by Dr. Yonkers in his testimony. I have copies.

JUDGE PALMER: All right. They're marked for identification as 46 and 47. Thank you.

(Exhibit Nos. 46 and 47 were marked for identification.)

Q. Please continue, Doctor.

A. Remarkably, the proponents do not even attempt to address this factor, claiming it irrelevant. I find that attitude baffling in light of the AMAA standard and past USDA practice.

The facts are clear and telling. The U.S. milk supply has been, and will continue to be, adequate to meet all market needs for milk and is certainly much more than adequate to meet all needs of the fluid market, the touchstone under the AMAA.

Total U.S. milk production has grown dramatically in the past 30 years. In 1975, total U.S. milk production was 115.4 billion pounds. This has grown to 177.0 billion pounds in 2005, and is forecast by USDA to increase

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another 4.9 billion pounds in 2006 to 181.9 billion pounds. See Figure 1. This increase of 57.6 percent over the past 31 years has only been due to increases in consumer demand for farm milk for the processing and manufacture of milk and dairy products.

However, little of this increased farm milk production has been needed to serve the need for fluid milk products. While U.S. milk production grew by 61.6 billion pounds between 1975 and 2005, total U.S. product sales only grew by 800 million pounds.

Q. Fluid.

A. I'm sorry. Total U.S. fluid product sales only grew by 800 million pounds. That would be 0.8 billion pounds. U.S. total fluid product sales were 53.2 billion pounds in 1975 and reached a record high of 55.1 billion pounds in 1991. Since then, total fluid product sales have been on a slight downward trend and were only 54.0 billion pounds in 2005.

As these very different trends in farm milk production and fluid product sales

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demonstrate, there is clearly no lack of farm milk available to serve the declining fluid sales. Indeed, it is more than a little ironic that the proponents would chose to burden with sharply higher prices the one segment of the dairy industry, fluid milk, that has experienced for many years now steady declines on a per capita basis.

The most recent trend in total U.S. fluid product sales can also be seen in the use of monthly data published by USDA's Agricultural Marketing Service. Adjusted to average daily volumes, total fluid sales have trended downward since the implementation of Federal Order reform in 2000. See Figure 3.

Nor can it be argued that, for whatever reason, this increase in milk production has not, nor will continue to be, available to all dairy processors. Several IDFA members representing significant Class I and II processing capacity in many different areas of the country have presented testimony regarding their ability to procure milk for these class uses with ease.

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In addition, USDA itself in recent years has repeatedly and consistently found that the supply of milk in the U.S. is more than adequate to meet the needs of the Class I market and that this dictated that Class I prices not be raised.

In its June 1998 decision resulting from a hearing to consider a proposal to floor the Class I and II prices in all FMMOs, USDA addressed a proposal by NMPF members that in effect would have increased the Class I differential by $1.05 per hundredweight. See 63 Federal Register 32147.

USDA noted, "Despite a 46 percent reduction in the number of U.S. dairy farms from 1988 through 1997, milk production increased 8 percent. The data contained in the record of the public hearing in this proceeding provide no basis to expect that an adequate supply of milk for fluid use will not be available nationwide. Therefore, the record does not support adopting the proposal which would encourage more milk production." Federal Register, Volume 63, No. 113, page 32149.

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And later, "The petition for flooring the BFP is denied because there is no evidence of a national milk shortage, either for all uses or for fluid uses." Federal Register, Volume 63, No. 113, page 32150.

And still later, "The facts clearly demonstrate that the proposed floor is not required by supply and demand conditions." Federal Register, Volume 63, No. 113, page 32150.

The only difference between the facts at the time of that decision and now is that milk production has continued to grow at an even faster rate, and fluid milk product sales have continued to trend downward.

Nor did that emphasis change in Order reform. USDA in both the January 1998 proposed rule and the April 1999 proposed rule following Order reform emphasized the need to assess whether the Class I price will generate -- excuse me -- whether the Class I price will "generate sufficient revenue to bring forth an adequate milk supply." 63 Federal Register 4912, and 64 Federal Register, 16115. That goal clearly does not require raising Class I prices.

It is perhaps understandable that the proponents here choose to act as if the adequacy of the milk supply is an irrelevant consideration given that the facts on this subject point so clearly toward the denial of their proposal.

The NMPF proposal simply ignores the most important criterion for Class I pricing, namely, the adequacy of the milk supply. This is particularly ironic since NMPF is itself engaged in marketplace efforts that seek to achieve the opposite goal. They are operating a program whose very purpose is to reduce the supply of milk in the United States.

NMPF's Cooperatives Working Together, or CWT, effort collects, on a voluntary basis, 10 cents per hundredweight of milk marketed by participating producers and cooperatives. The funds collected are then used in various ways to reduce the supply of farm milk and dairy products available to the U.S. market.

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NMPF claims that its CWT program has reduced the national milk supply by 3.3 billion pounds since 2003, and effective July 1, 2006, doubled the per hundredweight assessment for the CWT program. See Exhibit 8.

IDFA also notes there are currently FMMO regulations other than minimum pricing which address the factors which petitioners claim require changes in the minimum Class I and II prices. In fact, several of these regulations are in the process of being changed in some or all FMMOs as we sit at this hearing.

USDA has announced a tentative final decision to update the factors in the class price formulas which reflect costs of manufacturing Class III and Class IV products, a decision which USDA expects to be implemented in February 2007 or soon thereafter. This change was announced by USDA to do what NMPF is asking for now: update the factor representing the costs of processing for plants manufacturing Class III and IV products. NMPF asserts that the Class I price needs to be changed to address balancing costs, but in its

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January 2005 final decision rejecting a proposal to cover costs of balancing in the Northeast marketing area with the use of marketwide service payments, USDA noted: "Opponents correctly note that the costs of balancing have already been considered and are accounted for in the Class IV product price formula make allowance used in all Federal milk marketing orders for establishing the Class IV milk price." Federal Register, Volume 70, No. 19, page 4951.

In addition, USDA on December 1, 2006, implemented a decision for the Appalachian and Southeast marketing areas to address the costs of moving milk to those markets for Class I use.

Other witnesses discussed the specifics of the changes. I will simply observe that the adoption of the proposals being considered at this hearing would duplicate the adjustments made in those marketing areas. Furthermore, transportation credits are a better way to address the problem, given that the one providing the

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transportation service gets paid for it, as opposed to changing Class I differentials and paying money to those providing no services of any kind. A similar set of regulations exist in the Upper Midwest marketing area to move milk from supply plants to pool plants.

USDA also several times since Federal Order reform has held hearings and adopted changes in some marketing areas to limit the pooling of milk. There have been two hearings to consider such proposals with decisions in each of the following marketing areas: Upper Midwest, Central, and Mideast. The most recent of these final decisions were only implemented on December 1, 2006.

One reason these decisions were implemented was to address problems with depooling, which in some months led to significant volumes not being pooled on the orders due to adverse class price relationships, with the resulting decrease in the volume of milk shipped to Class I plants in order to remain in the pool.

Making the proposed changes would

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lead to disorderly marketing. The preliminary impact analysis conducted by USDA and published as part of the notice for this hearing leads to the conclusion that there is no market problem and that their proposals would create disorderly marketing.

The baseline analysis provided by USDA clearly demonstrates that U.S. milk production will be more than adequate to meet current as well as future demands for milk and dairy products.

Total Federal Order marketings in the baseline increase by over 9.6 billion pounds in the next nine years. The same analysis could not be made for total U.S. marketings due to the lack of detailed year-by-year data like that provided for Federal Order marketings in the "Appendix to Preliminary Analysis for Hearing Concerning Class I and II price formulas."

Meanwhile, the same baseline shows total Federal Order Class I marketings increase by only 147 million pounds, or 0.147 billion pounds, during the same nine-year period.

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Milk production growth thus far exceeds the needs of the Class I market. In fact, the baseline estimate of an increase in Federal Order Class I marketings is an optimistic deviation from the trend since 1991 of a decline in total U.S. fluid product sales as reported by USDA's Economic Research Service, as well as the more recent trend in estimated total U.S. fluid sales published by USDA's Agricultural Marketing Service.

In addition to the baseline analysis clearly demonstrating that milk production will be more than adequate to meet fluid product needs for at least the next nine years, the analysis of the proposals by USDA clearly shows how it promotes disorderly marketing.

Adoption of the proposals would decrease Federal Order Class I use by 616 million pounds over the next nine years, more than wiping out the meager increase forecast by the baseline without adopting the proposals. Total U.S. Class I use would decline even more, losing 747 million pounds.

At the same time, the impact

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analysis also shows that total Federal Order milk marketings would increase by 1,294 million pounds as a result of adopting the proposals. Note this growth is on top of the baseline's forecast growth of 9,600 million pounds.

The impact on total U.S. milk production is even greater, with adoption of the proposals leading to an increase of 2,043 million pounds above the baseline. This means the net impact of adopting the proposals is to reduce total U.S. Class I use by 747 million pounds from the baseline while at the same time increasing total U.S. marketings by 2,043 million pounds. The result is an increase in the use of milk in all manufactured dairy products of the sum of these two figures, or 2,790 million pounds more than the baseline increase.

As USDA's impact analysis clearly shows, the sum of the reduced Class I use and the additional farm milk marketings end up being used in manufactured dairy products. This, in turn, reduces the market prices for butter, nonfat dry milk, cheese, and dry whey

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such that not only are Class III and IV minimum prices lower if the proposals are adopted, but so are Class II prices. The latter is certainly disorderly marketing if, as NMPF claims, the changes are necessary to increase the Class II price to ensure an adequate supply of milk for Class II use.

Looking at this another way, adoption of these proposals will force NMPF to increase the level of activity under the Cooperatives Working Together program to remove an additional 2.79 billion pounds of milk above what they planned to remove over the next nine years in order to meet their target of maintaining the wholesale butter price at $1.30 or above and the wholesale price of cheddar cheese at $1.40 or above, even assuming this is a legitimate effort.

The disparity of regional impact.

JUDGE PALMER: I think this is probably a good time for a break. We will be back at 1:00 in whatever room we will have.

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

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JUDGE PALMER: The witness is still sworn. We had stopped at the very top of page 16, and the next part of your statement is The Disparity of Regional Impact.

THE WITNESS: Thank you, Your Honor.

A. The disparity of regional impact. One notable feature missing from USDA's impact analysis and, presumably, its baseline model period is the ability to analyze the impacts of the NMPF proposals on a marketing area-by-marketing area basis. Certainly, this information is critical for producers who might have to decide whether to vote for or against the orders in a referendum should the proposals be adopted.

USDA has, in fact, consistently noted the disparate regional impacts as justification for rejecting previous calls for a national change in the Class I and II price calculations.

When it acted in 1998 to reject the $1.05 Class I price increase reflected by the floor proposal, USDA looked not only to the

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fact that the milk supply was more than adequate, as discussed above, but the disparity of the regional impact.

"The proposed floor under Class I and II prices would have unequal effects on farm level milk prices unrelated to the financial need of the farmers affected. The benefit of the proposed floor to a producer would depend on the proportion of Class I and II milk used in the order in which the producer's milk is pooled. Thus, a producer whose milk is pooled under a marketing order with a relatively high 80 percent Class I and Class II use would get 80 percent of the projected $1.05 difference between the proposed floored price and the projected BFP for the last half of 1998 and early 1999, or 84 cents per hundredweight. On the other hand, producers in marketing order areas with a relatively low 20 percent Class I and Class II use would receive the benefit of only 21 cents of the $1.05 increase in class prices. Producers in high Class I use areas already receive higher blend prices for their milk than

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producers in areas with lower levels of Class I use, and the effects of the price floor proposal would widen the differences between such areas." It's Federal Register, Volume 63, No. 113, page 32150.

The same point was made by Undersecretary Hawks in the January 2003 letters that I mentioned earlier. "Adding a surcharge to Class I and Class II prices would provide substantially different benefits to farmers depending upon their location. For example, the farmers in the Florida FMMO, which has higher Class I utilization of about 90 percent, would benefit greatly from such a surcharge for milk used in Class I products. However, there would be substantially less benefit to producers marketing in the Upper Midwest FMMO, where only about 20 percent of the milk is used in Class I."

In its 1998 decision rejecting the call for a price floor that would have increased Class I and Class II prices by $1.05 per hundredweight, USDA concluded that dairy producers in marketing areas with low Class I

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and Class II utilization would experience depressed prices for their milk, precisely the concern expressed in this hearing by dairy producers and organizations in the Midwest and Upper Midwest.

"The higher Class I and II prices would also increase milk production and reduce fluid milk consumption, which would lower prices for milk used in manufactured dairy products. Lower prices for these other classes of milk would be even more detrimental to producers in low Class I and II utilization markets." Federal Register, Volume 63, No. 113, page 32150.

The regional impacts are further exacerbated when the impacts of another Federal dairy program, the Milk Income Loss Contract, or MILC program, are accounted for. As USDA's impact analysis notes, MILC payments to dairy producers nationwide decrease by $82 million in 2007 if these proposals are adopted. Producers located in marketing areas with smaller average milk marketings per farm, such as the Upper Midwest, Central, Mideast and Northeast, would

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bear the brunt of lower MILC payments significantly more than marketing areas where average milk marketings per farm are greater like the Southwest and Arizona areas.

While the USDA impact analysis assumes the MILC program payment rate is zero beyond 2007, changes in the majority in both houses of Congress, with the resulting changes in both chamber and committee leadership, could result in the extension of the current payment rate of 34 percent or even higher.

Even without the extension of the MILC program's non-zero payment rate, USDA's impact analysis shows that government costs increase above the baseline in each of the next nine years due to increased purchases of dairy products under the Milk Price Support Program.

How can it not be considered disorderly marketing to adopt changes designed to increase the Class I and II prices which lead to less Class I use, lower Class II milk prices, lower Class III milk prices, lower Class IV milk prices, and greater use of farm milk in manufactured dairy products, at least

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some of which must then be purchased by the government to maintain higher farm prices?

Dr. Brian Gould of the University of Wisconsin has already testified regarding the widely disparate impacts these proposals would have on different regions of the country. Dr. Knutson has quantified the negative impacts of the proposals to Upper Midwest dairy producers, and I will not repeat that testimony here.

And what do the rest of us in the United States get if the NMPF proposals to change the Class I and II prices were adopted? In addition to the increased cost to taxpayers from increased purchases of manufactured dairy products under the Milk Price Support Program, consumers get to pay more for fluid milk products. USDA's impact analysis estimates the increase to be about 5.5 cents per gallon. However, the impact analysis documentation notes that retail fluid milk prices are not projected in the model, so the impact could even be higher.

So the rest of us get to pay more

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for fluid milk and see more of our tax dollars spent on buying manufactured dairy products the marketplace does not want, notwithstanding a baseline analysis of total Federal Order marketings increasing an average of about one billion pounds per year, which drastically exceeds the need for less than 20 million additional pounds of Federal Order Class I marketings per year.

The process followed here is flawed. This hearing was called with less than three weeks' notice and only the NMPF proposal is being considered. Contrast this with the current process underway to consider changes to the Class III and IV price formulas.

On June 28, 2006, USDA announced it was seeking industry proposals for changes to the Class III and IV price formulas and allowed more than 90 days, until September 30, 2006, for industry participants to discuss various alternatives and conduct analysis prior to the submission of proposals.

USDA then for the first time conducted a pre-hearing public information

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workshop to further clarify the intent and specifics of the proposals submitted. This process for Class III and IV price formula changes should have been, at the very least, adopted before any hearing to consider changes to the Class I and II price formulas.

In addition, this short notice did not allow for more deliberate and careful analysis of the supply and demand situation in the dairy markets. The last time USDA considered such changes was during the Federal Order reform process. While Congress did grant USDA the authority to use informal rulemaking for that process, USDA set out on a very public path to ensure that all relevant proposals were considered.

In addition, USDA ensured that all proposals would be carefully and deliberately analyzed. This was accomplished by the creation of several study committees, both within and outside of USDA, plus USDA funding of research specifically designed to provide critical analysis of the full market supply and demand factors relevant to consideration of the class price formulas. None of this is happening here.

The premise of the proponents' request is flawed. Proponents justify their proposals with the premise that costs have increased with respect to three specific cost items in excess of the costs of those items identified by USDA in its January 1998 proposed rule for Federal Order reform, which is Exhibit 9; however, that decision discussed seven options for setting minimum Class I prices.

The cost items upon which proponents purport to rely were only discussed in one of those seven options, and USDA picked only one of the seven options as the preferred option, and it was not the one in which these cost items are discussed. Yet the proponents here purport to use that discussion as the basis for justification for increasing the Class I price.

USDA in 1998 made clear that "At this time Option 1B is preferred for several reasons. First, this option is based on model results that reflects the best available estimates of least cost assembly and shipment

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of milk and dairy products to meet all dairy product demands. By promoting marketing efficiencies, it would be expected to result in the most preferable allocation of resources over time. Option 1B would move the dairy industry into a more market-determined pricing system. By lowering differentials, marketing conditions will have a greater impact on actual Class I prices in the form of higher prices that are provided to those producers who service the Class I market. In this way the revenue necessary to obtain milk for fluid use may be minimized since the Class I value is not shared marketwide with those producers that do not service the fluid market." Federal Register, Volume 63, No. 20, pages 4914-4915.

Rather than look to what USDA actually concluded in 1998, proponents build their case for changed proposed at this hearing on the justification for Option 1A as discussed in that 1998 recommended decision. But as noted, Option 1A was rejected in the 1998 proposed rule in lieu of Option 1B. Nor was that justification later accepted in the 1999

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final decision, which concluded that the Class I differential should not be based upon "the additional value of Class I milk in the most surplus area," but, rather, a level "that will generate sufficient revenue to bring forth an adequate milk supply." Federal Register, Volume 64, page 16115.

As we have seen, that goal is certainly achieved by the current Class I differentials. It was only by an act of Congress, not the careful and deliberate analysis conducted over a three-year period by USDA, that forced the dairy industry to adopt modified Option 1A with a minimum Class I differential of $1.60.

USDA is under no obligation to assess Class I differentials now using an approach that USDA rejected in both 1998 and 1999. Congress certainly has never mandated that it do so. We are not suggesting that USDA at this hearing reverse the higher Class I differentials imposed by that legislation; but Congress never endorsed, much less imposed, a specific methodology for determining Class I

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differentials. USDA must apply AMAA standards in determining whether there is any justification for increasing Class I prices in a manner consistent with its past practice.

I note that several witnesses have testified to the belief that if USDA decided to update the make allowances used in Class III and IV price formulas, then it has the obligation to update the Class I and II price formulas. Nothing could be further from the truth. Manufacturers of Class III and IV products have a noose placed on their ability to cover non-milk costs in the make allowance. The margin between their output price and cost of farm milk is fixed. When costs rise, there is absolutely no recourse for those manufacturers except to process milk at a loss or to exit the industry.

On the other hand, several witnesses have claimed that this conundrum does not exist for Class I and II processors, that they are fully able to pass along higher costs to customers while holding their farm milk suppliers free from harm. This is in and of

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itself a naive and incorrect view, as several others have testified that the harm in higher prices comes in the form of reduced demand for milk and dairy products, something everyone at every stage of the dairy industry should avoid creating incentives for.

But of more direct relevance here, proponents' witnesses fail to recognize that the fact that the pricing of Class I and II products is not controlled by a make allowance formula applies equally to dairy producers. There is no make allowance that fixes the margin between their output price and input costs. In fact, the lower milk prices in 2006 cited by many are a direct result from higher farm margins in 2004 and 2005 due to the highest two-year period of farm milk prices on record.

Clearly, if dairy producers had been subject to a make allowance, forcing their input costs to increase penny for penny with every increase in farm milk prices, there would never have been a surge in milk production leading to the lower prices in 2006.

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The proponents' data is flawed, very flawed. Even if cost data were properly considered, the proponents' data is very flawed. In the recent Class III and IV make allowance decision, USDA rejected the use of its own RBCS survey data, notwithstanding its long pedigree and USDA's prior reliance upon that very data for purposes of setting make allowances. USDA did so because it deemed that data insufficiently reliable. Given the standards set in that hearing, it is very difficult to see how USDA could rely upon the proponents' data as a basis for changing Class I prices.

Proponents conduct no analysis of how the vast structural changes which occurred between the 1996-97 period on which USDA based its analysis of the justification for Option 1A, which it rejected, and today impact the market. Merely updating information which is nearly a decade old, and as I shall show in some cases is 30 years old, ignores industry adjustments to changes in relative costs, changes in technology, and changes in

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underlying economic forces of the marketplace.

Moreover, proponents have conducted no study of any of the actual costs they purport have increased substantially since the time of the 1998 Federal Order decision. They provided no analysis of the difference in costs between actual Grade A farm operations and Grade B farm operations. They provided no analysis of the costs of balancing in the marketplace borne by firms with those costs, nor any analysis of the actual increase in transportation costs due to longer hauls between farms and Class I plants.

Finally, they conduct no analysis of the changes in marketplace premiums for Class I milk which could identify other explanations for increases in some time periods and decreases in others, as well as changes in some marketing areas and the lack of any change in others.

Thus, even if one were to ignore the salient considerations of the adequacy of the milk supply and the regional disparity of the impact of the proposals and accept the

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relevance of the factors upon which the proponents rely, the proposals should be rejected.

Grade A versus Grade B farms. Let's begin with a look at the difference in costs of producing milk on a Grade A versus a Grade B dairy farm operation. First of all, a key justification for Federal Order price regulation was to encourage conversion of Grade B farm operations to Grade A farm operations. That aspect has been wildly successful.

Today, USDA reports that 98 percent of U.S. milk production comes from Grade A farm operations, vastly in excess of the amount needed to service the Class I market. This comes from USDA, NASS, Milk Production, Disposition and Income.

There is no evidence whatsoever of a need to provide any financial incentives or rewards for becoming, or maintaining, Grade A status. In fact, the only actual data related to the cost differences between Grade A and Grade B farm operations was presented by

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Mr. Tonak, which show that difference to be far lower than the 40 cents per hundredweight proponents assume is the beginning point. This would support a significant decrease in the Class I differential.

The proponents provide no basis upon which USDA could reach a conclusion as to the relative cost of being a Grade A versus a Grade B farm. The 1998 USDA Federal Order reform decision did cite an estimate of 40 cents per hundredweight difference, but did not cite a useful source for that estimate.

The most recent publication of research into the actual cost differences between actual Grade A and Grade B dairy farm operations was published almost 30 years ago by Frank, Peterson and Hughes in April 1977 based on actual farm data from 1974 to 1975. That's from Class I Differential: Cost of Production Justification, by Gary G. Frank, G. A. Peterson and Harlan Hughes, in Economic Issues, Department of Agricultural Economics, College of Agricultural and Life Sciences, University of Wisconsin-Madison, No. 8, April 1977.

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Interestingly, while the 1998 USDA decision cites several fixed factors of production expected to contribute to the difference, "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." Frank, et al., actually noted that, "The average producer of fluid eligible milk had $17,892 more invested per farm in 1974 and $18,477 in 1975 than the average manufacturing grade milk producer. On a per hundredweight of milk sold, this difference was not statistically significant."

Therefore, the greatest expenses noted by USDA were found to be not statistically different between fluid eligible and manufacturing grade milk producers.

Of equal importance, the proponents' purported "updating" of the alleged 40 cent spread between the costs of maintaining a Grade A versus a Grade B farm ignores the fact

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that the standards for producing Grade B versus Grade A milk have narrowed over time. There is no basis for anyone to make assertions as to the reported cost difference between a Grade A farm and a Grade B farm without bothering to look at what the current standards are for Grade A and Grade B farms, yet that is what proponents have done.

In addition, the proponents have conducted no study of the actual costs associated with maintaining Grade A status, but purport to apply as a surrogate the changes in some of the on-farm costs of production over an eight-year period. Yet even here the data supplied cannot possibly do the trick.

One set of data supplied by Dr. Cryan and based on ERS figures purports to support a 38 percent increase in the cost of maintaining a Grade A supply between 1998 and 2005, and it is that figure that the proponents use to support a 15 cent increase in the Class I price.

But the other farm cost of production data provided by proponents came

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from Northeast Farm Credit Associations, or NFCA, and unlike the ERS data is a summary of actual data from 539 actual dairy farm operations.

The total cost of producing milk submitted by NFCA show a far smaller increase in total costs of production between 1998 and 2005, with costs rising less than 5.3 percent, from $13.82 to $14.55. This is nearly an order of magnitude lower than that reported by NMPF.

Even using the data presented by NFCA limited to only a few cost categories known as labor, resources and utility, the increase from $6.71 in 1998 to $7.52 cents in 2005 is less than 12.1 percent, more than two-thirds less than the data presented by NMPF. This is a summary of real cost data from actual dairy farms analyzed between two years using the exact same methodology.

I do not see how proponents can expect USDA to take action significantly increasing Class I differentials when their own data is so self-contradictory.

Furthermore, there is every reason

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to question the use of the ERS data upon which NMPF relies. As noted, NMPF uses USDA, ERS data to allege that non-feed costs of production have increased more than 38 percent over the 1998 to 2005 time period; however, the ERS Web site cited by NMPF notes that "Since cost-of-production data for any particular enterprise are only collected about every four to eight years, estimates for non-survey years use the actual survey year as a base and use price indices and other indicators to reflect year-over-year changes. This can cause discontinuities when new survey data replace these nonsurvey estimates. The magnitude of these discontinuities depend upon how much technical and/or structural change occurred in the sector between the survey years, as well as changes in the sampling, questionnaire and other data collection procedures."

For dairy, the 1998 database survey year was 1993, and for the 2005 data the base cost data was 2000. Not only is the 1998 data not comparable to that from 2005, but both of those years are based on five or six years of

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index updates that could bear little resemblance to actual costs of production in those years. Even the updates for changes in output per cow and number of cows per farm as listed by ERS are not consistent with data on those changes reported by USDA, NASS for all of the U.S.

For example, the ERS costs of producing milk data indicate that it was based on a herd with 93 cows for 2000, but only 96 cows in 2005 (no such supporting data on herd size and output per cow were provided prior to 2000) an increase of only 3.2 percent; yet the data reported by NASS shows the average U.S. herd size increased from 87 milk cows in 2000 to 115 milk cows in 2005, an increase of 32 percent, an order of magnitude greater. And, of course, as herd sizes increase, costs per hundredweight generally decrease.

For output per cow, the story is similar. The ERS costs of production data is based on an output per cow of 19,974 pounds in 2000 and increases to only 20,045 pounds in 2005, a total increase of less than 0.4 percent

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for the entire five-year period.

On the other hand, NASS reports that the average milk output per cow in the U.S. increased from 18,197 pounds in 2000 to 19,576 pounds in 2005, an increase of 7.6 percent during those five years. Again, as production per cow increases, costs per hundredweight generally decrease.

Marketing Costs. A second factor cited by proponents requiring an increase in the minimum Class I and II milk prices is marketing costs incurred in supplying the Class I market, including the costs of balancing supply and demand, yet the proponents have provided no evidence regarding actual costs of balancing, instead relying on plant cost of manufacturing data.

This approach ignores salient information regarding balancing, such as the fact that seasonality of milk production has declined over time, including during the period since 1998, thus reducing balancing needs. See Figure 4.

Q. Bob, why don't you just explain

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briefly what that figure shows.

A. Figure 4 was created looking at actual monthly milk production for various three-year time periods. I used three years so that unusual conditions affecting the production of milk in any one year wouldn't affect it to any great degree.

I then put that on an index of 30-day months, and so these three-year time periods are shown here. The 1953 to 1955 time period is at the highest in May and June, and the 2003 to 2005 is the lowest line during May and June.

So an index of one means that you were equal to 100 percent of the average monthly 30-day production in that month for that year, for that three-year period.

Q. So if there had been a line, a year in which it was one all the way across, that would mean that there was no seasonality?

A. It would have indicated equal daily production across that year.

Q. And the amount of variation from the one line, the greater the variation, the more the seasonality; correct?

A. That's correct.

Q. So the bottom line is every decade since the 1950s there has been a steady observable decline in seasonality?

A. That is correct.

Q. In terms of the years chosen, the 2003 to 2005 data, that's the three-year period -- that's the most recent three-year period for which you have data; correct?

A. That's correct.

Q. So you started there and worked backwards?

A. Yes.

Q. That's what causes the particular years here to be what they are?

A. That's correct. I didn't self-select the years. I just took the most recent three-year period and then did every ten years back.

Thus, the need to perform seasonal balance balancing has decreased, not increased, since 1998. As with its discussion of Grade A versus Grade B milk costs, proponents look only

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at increases in secondary factors rather than presenting direct analysis of the balancing costs then and now so a true comparison can be made.

In addition, one must question the logic of how this proposal will address the problem alleged by proponents. Nearly all of these cost factors are post farm gate - seasonal and daily reserve balancing of milk supplies, shrinkage, administrative costs and opportunity or give-up charges at manufacturing milk plants that service the fluid Class I markets.

How does requiring milk processors to pay dairy producers cover this cost? Unless there is some additional proposal that takes that money out of the dairy producers' mailbox and requires that it go to cover the marketing costs outlined above, those costs still must be covered by others in the marketing channel.

And just to repeat a statement from earlier in my testimony, USDA concluded in a January 2005 decision that the make allowances used in the Class IV price formula already

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account for balancing costs.

Proponents also make their case for increases in balancing costs using RBCS data related to general plant manufacturing costs, but USDA determined that this data was not reliable as a source of manufacturing cost data in the recent make allowance decision, and I quote, "In addition, the RBCS survey costs do not conform to reasonable expectations of economic theory that predicts declining average costs where production volume increases directly with plant size." Federal Register, Volume 71, No. 225, page 67484.

And later, "Accordingly, the record does not support concluding that the cost of fuels as reported in the RBCS survey reasonably represents the costs of fuels experienced by manufacturing plants." Federal Register, Volume 71, No. 225, page 67485.

And finally, the tentative final decision resulting from the make allowance hearings this year concluded that the make allowance increases should be far less than that used by proponents to justify a 13 cents

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per hundredweight increase in the Class I price due to increases in balancing costs.

Proponents also allege that average hauling costs are increasing in the marketplace. Data from a recent publication by the Minnesota Department of Agriculture refute that assertion, noting that average hauling rates paid by dairy producers in Minnesota declined fairly steadily between 1982 and 2003.

THE WITNESS: I ask that this be marked as an exhibit.

MR. ROSENBAUM: This will be Exhibit 48.

JUDGE PALMER: Off the record.

(Discussion held off the record.)

JUDGE PALMER: What you were reading, sir, we just talked about Exhibit 48?

MR. ROSENBAUM: Yes, Your Honor. I now would like to have marked as Exhibit 48 the study to which Dr. Yonkers just alluded, milk hauling costs in Minnesota, published by the Minnesota Department of Agriculture.

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JUDGE PALMER: All right. So marked.

(Exhibit No. 48 was marked for identification.)

A. And I quote from this document. "Historical data shows Minnesota producers overall pay a decreasing rate for milk hauling during the past two decades (Table 4). The hauling rate in May 2003 reached a record low of 17 cents per hundredweight." In Milk Hauling Costs in Minnesota, prepared by Sue Ye, Agricultural Marketing Services Division, Minnesota Department of Agriculture, September 2003, and I provide the Web site there, but now that's marked as an exhibit.

While that same report noted that this may be due to subsidization of some of the costs of hauling by the buyer of farm milk, the proposal at issue here would not ensure that the entity bearing the cost receives the benefit of the proposed increase in the Class I milk price.

In addition, that same publication noted a significant and negative relationship

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between average volume shipped per farm and average hauling charges paid by producers. As structural change and the trend of rapidly increasing average herd size continue in the dairy industry, this relationship suggests hauling charges to dairy producers will continue to decline on average in the future, not increase.

Finally, as testified to by others, some marketing areas have specific provisions for covering increased costs associated with transportation to more distant processing plants. In these marketing areas, adoption of the proposals presented at this hearing would result in paying for the same thing twice.

Over-Order Premiums. Finally, proponents also claim that increases in the average level of over-order premiums in one market is sufficient evidence that the level of Class I prices should be raised nationally. Not only is this approach flawed in that relative changes in over-order premiums vary considerably across marketing areas, but also because proponents ignore the fact that the

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result that the Federal Order reform process implemented in January 2000 increased the average level of Class I prices by more than the proponents are claiming is needed now.

The 1999 final decision included two provisions which directly impacted the Class I price level. The first change was to the minimum level of Class I differential, which the USDA proposed to be $1.20; however, subsequent action by Congress forced the dairy industry to adopt modified Option 1A, with a minimum Class I differential of $1.60. In fact, the adoption of a minimum Class I differential was an increase from the $1.20 in place prior to Federal Order reform in Minneapolis.

Therefore, some of the increase in the difference between the fluid grade milk price series in Minnesota and Wisconsin and the Class III price reported by proponents was due to an increase of the minimum Class I differential (and, therefore, an increase in the Class I price) due to order reform itself.

Like the perpetual Class I price

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increase machine proposed by proponents for evaluating changes in the cost differences between Grade A and Grade B farm milk, this also will lead to constant demands to increase the Class I price based upon this flawed analysis.

If USDA adopts proponents' proposal to increase the Class I price by 77 cents per hundredweight, the very next month the NASS fluid grade milk price series will reflect this increase, and proponents or others will come right back to USDA using the new higher difference between that price and the Class III price as a reason for another increase. Talk about circularity.

Even if market conditions in some months lead to a narrowing of the difference between the fluid grade price series and the Class III price, opponents like IDFA or others could demand the same consideration of a decrease in the Class I price.

But this was not the only source of direct impact on the Class I price level. The final rule also required the use of the higher

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of the Class III and Class IV price formulas as the Class I mover. Previously the mover had been the basic formula price, which is equivalent to the Class III price since 2000.

For the six-year period from implementation of Order reform in January 2000 through December 2005, the Class I mover based on the higher of the Class III or IV price formula averaged 48 cents more than had the Class I mover still been based on the Class III price alone.

So there has been on average an increase in the Class I price equal to nine cents more on average than proponents claim is necessary today to address increases in differences between the fluid grade and Class III price and the increase in the over-order premiums.

In addition, comparison of over-order premiums between 2004 and 2005 and most any other two-year period has the problem that significant volumes of milk were depooled in certain months, especially in 2004. A close look at the monthly data for premium levels by

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month show that fluid plants were forced to pay higher premiums to get milk due to that depooling.

As a final point on over-order premiums, they can adjust to rapidly changing marketing conditions both over time and across regions. Class I minimum prices do not have that same luxury, as it can take many months and even years from the time a petition is filed until a final decision is issued by USDA to amend Federal Orders.

Petitioners only looked at competitive factors in the states of Minnesota and Wisconsin and nearby cities. USDA, NASS publishes data on fluid grade milk prices for all states, and USDA, AMS reports monthly differences between the Federal Order Class I price and the announced cooperative Class I prices (used by proponents to represent over-order premiums) for over 30 cities. In some markets, the over-order premium has never even reached the 39 cents proponents claim is the increase since 1998.

One last point on over-order

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premiums, and perhaps the most important point of all. The critical difference between over-order premiums and the Class I minimum price regulated -- I'm sorry -- the Class I minimum regulated price is that over-order premiums actually move milk to the Class I handler while higher Class I minimum regulated prices do not. They do not because all dairy producers receive the blend price and thus have no incentive to provide milk to a fluid handler due to a higher Class I price. Give-up charges, et cetera, in the form of over-order premiums are still the key.

For Class II, USDA should reject the proponents' proposal to increase the Class II price due to the fact that USDA's impact analysis shows it would have just the opposite effect proponents are striving for: higher farm milk prices. Other witnesses will also address the incentive the proposed change would create for the substitution of Class IV products for fresh cream.

For all of these reasons, the proposals should not be adopted. That concludes my testimony.

MR. ROSENBAUM: Your Honor, at this time I would like to ask that Exhibits 45, 46, 47 and 48 be accepted into evidence.

JUDGE PALMER: Yes, sir, Mr. Beshore.

MR. BESHORE: I have one objection to note. Which number is the letter that is supposed to be to Sherwood?

JUDGE PALMER: I have them here. The letters are -- the one to Blunt is 46 and the one to Sherwood is 47.

MR. BESHORE: Okay. With respect to 47, I note that it was faxed in February 1995 from the fax line at the top. Apparently it also was addressed to a John Lincoln.

JUDGE PALMER: Mine says it is from John Vetne.

MR. BESHORE: Yes, that also. But there's a John Lincoln down here at the bottom.

JUDGE PALMER: Oh, okay. In the cc.

MR. BESHORE: That's not the end of the letter. So if it's not a cc, I don't know what it is. But the second page also has Lincoln's name on it. I mean, I don't know what the letter is. I object to it.

JUDGE PALMER: Well, do you want to explain it? Can you explain 47?

MR. ROSENBAUM: Well, I think that, not to cast aspersions on Mr. Vetne, but I don't believe he ever -- my guess is he never set the date on his fax machine.

JUDGE PALMER: It must have been the date he bought the machine.

MR. ROSENBAUM: So, you know --

MR. CARMAN: The letter is dated.

MR. ROSENBAUM: The letter is dated. It is extremely similar in content to Exhibit 46. They are dated roughly a week apart and I think --

MR. BESHORE: Who is John Lincoln? What is that about?

MR. ROSENBAUM: I can't

explain that part of it, but I do know that the letter not only is addressed to The Honorable Don Sherwood but the salutation is "Dear Congressman Sherwood," and I think we can ignore the John Lincoln information.

JUDGE PALMER: Well, I think the point of the letter is to show what the Department of Agriculture's stated policy was January 30th or so, January 23-January 31, 2003, and it does give you that. We will receive it, noting that Mr. Vetne's fax machine should be corrected.

(Exhibit Nos. 45, 46, 47 and 48 were admitted into evidence.)

MR. ROSENBAUM: At this point Dr. Yonkers is available for examination.

JUDGE PALMER: Yes. Who has questions?

CROSS-EXAMINATION

BY MR. SCHAD:

Q. Good afternoon, Bob.

JUDGE PALMER: Give your full name now.

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MR. SCHAD: Dennis Schad, S-C-H-A-D. I work for Land O Lakes, and I am representing the Association of Dairy Cooperatives in the Northeast.

Q. I have a few questions, and they center around pages 33 through 35, if you want to go there. Starting first with your Figure 4.

A. Yes.

Q. I note that it is seasonality of milk production in the United States. Would that include California as well?

A. Yes, it would.

Q. Is there any reason you're including California's numbers in something which purports to talk about seasonality in the Federal Orders?

A. I just took the U.S. total milk production, and I didn't subtract out California, Dennis. It wasn't intentional on my part. I could do that also.

Q. You use indices, and you explained how the index is and it is basically --

Please explain it again.

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A. If I used actual milk production, obviously milk production has been growing over time and it would be much more difficult to see the seasonality. All I did was take annual milk production, looked at each month to a 30-day corrected month. So it is almost like an average daily production for that month compared to the average daily production for the year.

So an index of one means that the average daily production in that month was the same as the average daily production for the entire year. If it's greater than one, it means the average daily production in that month was higher than the average daily production for the year. If it's lower for that month, it means the average daily production in that month was lower than the average daily production for the year.

Q. Thank you. And if you were a balancing plant, for instance, the indices wouldn't have lots to do with the challenges you're faced day to day? Would you agree with that? It is the actual volume of milk?

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A. Well, I think there are two questions there. The actual volume of milk that needs to be balanced is important. I did not look at the change in plant capacity over time because basically I know of no data available that indicates plant capacity. We have some on plant numbers but not plant capacity. So this was my only way to look at the volume of milk in one part of the year compared to another part of the year.

If you are asking me if the fact that we have greater milk production today than we had 10 or 20 years ago, that would imply we need a structural change period, not just seasonal balancing, which is what I was addressing here.

Q. Well, I agree with you that we have more milk production. Would you agree with me when you do an indices on a year that has a lower milk production, the volume of -- when you are comparing indices across one of your years, if one of year has much less milk production than another year, the volume of milk reflected in a change of 1.1 to 1.01 would be more?

A. I think what you're asking me is if a 10 percent change on 100 million pounds is a lot less than a 10 percent change on 200 million pounds. I agree with that.

Q. Thank you. You speak of balancing often. How do you define balancing? You used the word "balancing" in your testimony. I just want to understand your definition of balancing.

A. Well, it can be either day to day or weekly or seasonal. Seasonal balancing would reflect the fact that there's milk supplies and Class I use vary seasonally and, therefore, there is a need for that milk to be processed for something other than Class I milk. So it needs to be balanced.

There needs to be plant capacity when the production exceeds the Class I demands. So there will be times perhaps when the plant is running at lower capacities or perhaps not at all. That would be seasonal.

And the same thing applies to weekly balancing, that if there are some days when

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there's not as great a demand for moving milk to the fluid processors, there needs to be manufacturing capacity available to handle that milk, and it may not run on the days when there is a greater demand in that week for Class I use.

Q. Well, something you said there I would like to highlight. You talked about balancing is a function of demand and supply, it isn't just volume of milk. Would you agree with that statement?

A. Yes.

Q. If you agree with that statement, if you turn to page six, I will read a sentence for you. It is the second sentence underneath your chart. "While U.S. milk production grew by 61.6 billion pounds between 1975 and 2005, total U.S. fluid product sales only grew by 800 million pounds." Would that be a better measure of the need for balancing?

A. Oh, heck, no.

Q. Why not? Isn't it the difference between demand and supply?

A. What that's a measure of is how much

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our higher regulated milk products are attracting more milk than is needed for Class I.

Q. Where does that milk go?

A. Well, as others have testified to, increasingly it is going to demand-driven cheese, which increasingly cheese plants need to be balanced. They have regular demands for milk. So we are almost looking at how do we balance that in addition to balancing Class I.

And even more recently, while I have no direct knowledge of this, I read the same industry trade reports others do, that based on commitments for export sales of skim milk powder, those plants are becoming more reluctant to give up milk for Class I when they have contracts to deliver skim milk powder for export.

So this is not a simple method of, well, we only balance Class I milk; and so we have more milk in the market, it means we need to balance more.

No. All this milk is going into demand-driven uses, and I do state that in my

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testimony. If you give me a minute, I will find it.

Well, I do state that the room for that increased milk production is only coming because of the increased demand for both fluid milk and other dairy products.

Q. Before us today is a balancing chart, which would be a reason for increase in the Class I differential. So under that limited view of the reason of why we're here, if you compare the volume of milk against a Class I demand, would you agree with me that it speaks to the need for increased balancing of the Class I demand given the volume of milk, the growth of milk?

A. I have a very difficult time understanding this whole concept, Dennis, because balancing costs are borne by plants which do the balancing, and they may be cooperatives. They probably often are cooperatives.

I don't see how giving a dairy farmer, including independent dairy farmers, more money shares in the cost of that

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balancing. Just the opposite. It is giving them more money for something that somebody else is bearing a cost for, and I do not understand the rationale for that proposal at all.

Q. In Federal Order 1 there was a hearing which included provisions for balancing payments to the entities in the markets that do the balancing. What was IDFA's position at that time?

A. IDFA's position was in opposition because USDA concluded in the reform process that balancing costs were already accounted for in the make allowance in the Class IV price.

Q. Okay.

A. Not because they weren't being covered, Dennis, but because USDA had already concluded they were being covered.

Q. Before we go to that, I want to finish with this. You make the point that your Figure 4 shows the need for seasonal balancing has decreased since 1998. Can the Secretary draw that conclusion, given that you have 2002 through 2005 and the only other comparison,

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close by comparison, would be '93 through '95? Does he have the information to support your conclusion?

A. I believe he would have the information because he could do the same analysis on the documents that I believe John Vetne wanted official notice taken of before he left yesterday.

But I was concerned with picking particular years and being accused of picking particular years to achieve certain results, and I wanted to take the most recent data and compare ten years by ten years by ten years, and that was my only reason for doing it.

Q. Okay. We will move on to your statement that the 2005 decision in February 1, the Secretary said that balancing costs were covered in the Class IV pricing.

A. What page are you on, Dennis?

Q. I just turned over to 34.

A. Okay. Thank you.

Q. You say it twice. On 34 you say it. The Secretary has just issued thea tentative final decision for make allowances. Can you

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cite anyplace in that tentative final decision where the Secretary in that decision, in that tentative decision, gives any weight to balancing costs for Class IV?

A. It wasn't really at issue at the make allowance hearing; but, no, there is nowhere in the decision that I could find that the Secretary said anything about balancing costs related to the new make allowances.

Q. Thank you. Now I go -- staying on page 34. You talk about the RCBS data, and you cite two quotations from the tentative filings, and you talk about the fact that USDA has determined that RBCS data is not reliable as a source of manufacturing cost data. For what purpose do you cite this?

A. It is the only data proponents have presented.

Q. Thank you. If we look at the first quotation there, it talks about, and I will quote, "In addition, the RCBS surveys costs do not conform to reasonable expectations of economic theory that predicts that declining average costs where production volume increases

Dr. Yonkers - Cross by Mr. Schad

directly with plant size."

Were you as surprised as I that the USDA is a harbor of heretics in the South Building?

A. I am not going to discuss the merits of this because I have not gone through the whole, entire decision to do my comments. They are not due until January 22. But if I determine that that's true, I will put that in my comments to the USDA.

Q. Okay. Just generally speaking, if you had a survey which purported to show the costs of separate plants in a make allowance hearing and it had average costs and it had weighted average costs reported in that survey, would you expect that the average costs would be greater than the weighted average costs if that statement was true?

Said another way, if you don't mind my skipping into it.

A. You're giving me a hypothetical question; is that true, Dennis?

Q. I am.

A. Okay.

Dr. Yonkers - Cross by Mr. Schad

Q. If you have a survey and you are trying to determine whether the economies of scale exist and you are given a weighted average cost --

A. Weighted by what?

Q. Volume of the individual plants.

A. Okay. Plant volume.

Q. And a simple average cost. Okay. Would you agree with me if the weighted average cost was less than the simple average cost, that would give evidence that economies of scale exist?

A. Assuming all other factors constant, and we were not doing a model to look at what other factors could explain that, yes.

Q. Thank you. I go now to page 35. Up at the top, that first paragraph, you make the point that while the proponents use the RCBS data and show a percentage of the increase in the cost of a make allowance for Class IV, cost of production for Class IV, you make the point that the Department came up with a number less than that; right?

A. Yes.

Dr. Yonkers - Cross by Mr. Schad

Q. Did NCI testify at the make allowance hearing?
A. Yes, we did. In January.
Q. Okay. And did NCI in its resource testimony advocate a make allowance higher than what came in through the tentative final decision?
A. For?
Q. Cheese.
A. Cheese, yes; but just the opposite for butter and nonfat dry milk. And the dry whey one was close; I don't remember. But for cheese, yes.
Q. Specifically NCI cheese.
A. You added that late so I was already framing my --
Q. I'm sorry. So given the fact that USDA has given you a number less than what you thought were justified costs, what will be the reaction of NCI? Will you commend the Secretary in finding the right set of costs or does NCI still hold that its higher costs are more justified?
A. I haven't started working on my

Dr. Yonkers - Cross by Mr. Schad

comments because I have been doing this for the last two weeks, Dennis. But when I do that, I will submit -- when I answer that question, and my members, share with my members and they have the consensus on what that answer is, I will share it with the Department before January 22.

Q. Just one last thing. You talk about transportation credits often. Just so the record is clear, there are transportation credits in two Federal Orders, leaving out assembly votes. Would you agree with me?

A. I would agree with you in the Appalachian and the Southeast.

Q. And there are also assembly credits?

A. In the Upper Midwest.

Q. In the Upper Midwest. Isn't it true that those transportation credits, that they only cover a limited volume of milk that goes to market in those two orders?

A. Yes, I would agree with that.

Q. And would you also agree with me that they only are applicable between July and December?

A. I don't know that, Dennis.

Dr. Yonkers - Cross by Dr. Cryan

Q. If the record shows that Orders 5 and 7 are only applicable, that a handler can only draw transportation credits during those months, you would agree with that?

A. You are asking me a question of the detail that I just don't know to that level.

MR. SCHAD: Thank you very much.

DR. CRYAN: I'm Roger Cryan.

CROSS-EXAMINATION

BY DR. CRYAN:

Q. Bob, following up on what Dennis said, does Bob Yonkers and IDFA support an expansion of programs like transportation credits and assembly credits and maybe plant balancing credits in order to cover the kind of -- some of the kind of costs that you discussed?

A. None of those are relevant proposals at this hearing, and the only time that IDFA has taken a position on that was with respect to the specific proposal -- since I have been at IDFA, Roger. I don't know what they were

Dr. Yonkers - Cross by Dr. Cryan

before then; I was with them since 1998. Was for the Northeast hearing, which was, I believe, in 2003, and at that we specifically opposed that specific proposal for dealing with marketwide service payments.

IDFA has not taken a position, been involved, nor even attended the hearings to discuss transportation credits and their updates in the Southeast and Appalachian markets.

Q. Does Bob Yonkers and IDFA support the extension of the MILC program?

A. First of all, I should have said this for your first question. I am not here representing Bob Yonkers. I am here representing IDFA. I am going to give you IDFA's answer now. I apologize. Could you repeat the question?

Q. Does IDFA support the extension of the MILC program?

A. IDFA has not supported the extension of the MILC program in its current form.

Q. Does IDFA support the Federal Orders in general?

Dr. Yonkers - Cross by Dr. Cryan

A. IDFA has no policy position opposing Federal Orders; and, in fact, during Order reform did comment on the various factors, the make allowances, the yield factors, the product prices used in Class III-IV, commented on the Class I differentials. Did not oppose entirely.

Of course, that was also before my time. That final decision came out in April of '98, and I didn't join them until June of '98.

Q. Well, I'm glad you don't oppose them.

You have talked in your testimony about the need for extensive modeling. I mean, obviously it would be ideal if we could have a perfect quantitative economic model. Is there such a thing as a perfect quantitative economic model?

A. A perfect quantitative economic model?

Q. Yes.

A. Well, that's the market. I mean, that's not a model. That's actually -- I mean, everything else is an attempt, because of high

Dr. Yonkers - Cross by Dr. Cryan

transaction costs, of trying to model, in effect, simulate that marketplace and how it operates.

For Order reform USDA relied very heavily on a model at Cornell University, which I understand is still operating and still available for use.

There are other models out there that don't look at it nearly the same way, but instead of having the highly disaggregated production and consumption factors at plant locations and transportation costs, only look at it from a more broad elasticity model regionally, not nationally.

So there are different ways of looking at this in a more detailed manner, and perhaps more than one should be selected, Roger.

DR. CRYAN: Okay. Those are all the questions I have, but, Your Honor, I would ask that Dr. Yonkers identify the publication from 1977 on page 28 of his testimony entitled "Class I Differential: Cost of Production Justification," by Gary G. Frank,

G. A. Peterson and Harlan Hughes.

JUDGE PALMER: What page is it on?

DR. CRYAN: 28. I would ask that notice be given of that publication, official notice.

JUDGE PALMER: Well, is everybody agreed that's -- well, I don't recall the text on the subject or whatever it would be that we would take official notice of. If there is no problem with it, we will take official notice of it.

DR. CRYAN: I would also ask since the last exhibit, Exhibit No. 48, I believe -- is that the number?

JUDGE PALMER: Yes.

DR. CRYAN: Exhibit No. 48 makes reference to some of the USDA milk hauling publications that I referred to in my testimony, that those be also given official notice. They are identified in footnotes 15 and 16 of Exhibit No. 5. They are hauling rate studies --

MR. ROSENBAUM: Hold on.

Could you just let me get that out? What page are you on?

JUDGE PALMER: He is basing it on his own exhibit, Exhibit 5.

DR. CRYAN: I would ask that the hauling rate studies identified in those two footnotes also be given official notice so that a fair comparison can be made between the study that Dr. Yonkers and Mr. Rosenbaum have offered and the studies that the proposal is to some extent based upon.

JUDGE PALMER: The hauling rate studies you are referring to are hauling rate studies by whom? The Department of Agriculture?

DR. CRYAN: By the Department of Agriculture.

JUDGE PALMER: Are they updated? I mean, this study that he gives was based on a paper in September of 2003. Do you have more recent?

DR. CRYAN: Yes, there are more recent. They are updated through 2005.

JUDGE PALMER: And you just

stated them, did you?

DR. CRYAN: I can read it for the record. Footnote No. 15 in my Exhibit No. 5 reads, "Milk Hauling Charges in the Upper Midwest Marketing Area," Staff Paper 06-05, December 2006, and predecessor papers." Now, those include several papers for the consolidated Upper Midwest marketing area data back to 2000.

JUDGE PALMER: All right. We will take official notice of it.

DR. CRYAN: They also include, for the record, several similar papers for 1998 and 1999 for predecessor markets. The other footnote is "Analysis of Hauling Charges and Producer by Location and Size-Range of Production," Pacific Northwest Order, May 2005, Staff Paper 05-0303, November 2005 and predecessor papers.

JUDGE PALMER: All right. We will take official notice.

DR. CRYAN: And in the interest of properly considering the Grade A costs paper we have just taken notice of, I would ask that the -- I have an exhibit. These are -- well, previously Exhibits No. 11 and 12 were offered by Mr. Rosenbaum, I believe by Mr. Rosenbaum and one of his witnesses. They reflect the costs of production data from the Economic Research Service from 1993 through 2005, milk costs and production data.

I have here a extension of those numbers back to 1980. These are for 1980 through 1982, and these complete the sources of cost of production data offered by the Department of Agriculture's Economic Research Service.

JUDGE PALMER: Wait. May I ask this: Why do you want to go back earlier? I thought if you were updating, I could understand that was more current data, but older data --

DR. CRYAN: The paper that has been offered on Grade A costs reflects costs from 1974 to 1975.

JUDGE PALMER: So this is a bit more recent than that?

DR. CRYAN: This is as far

back as the series goes. Just in the interest of having data available for the fair assessment of that research, I wanted it looked at for this, for the record.

JUDGE PALMER: And this is from a USDA publication?

DR. CRYAN: This from the USDA Web site. It was obtained from the same source as Exhibits No. 11 and 12. Certainly it is Exhibit No. 12.

JUDGE PALMER: I will give it a new number. We will call it 49. I don't think we want to confuse whose exhibits are whose. So we will make this 49.

Is there any objection to it? All right. It is received.

(Exhibit No. 49 was marked for identification and received into evidence.)

DR. CRYAN: Finally, I believe the last time I might have to address you all, and I will try to keep my mouth shut after this, because of the questions raised by this witness about transportation costs and hauling rates in the Upper Midwest market, I would like to ask that official notice be given of the various producer price indexes which are data series price indexes published by the Bureau of Labor Statistics and the Department of Commerce. They published a number of -- a series for a number of costs that are costs for inputs into various production processes, including transportation costs and fuel costs and things like that. I would ask that notice be given of that data so that it can be used to assess the information.

JUDGE PALMER: The publication by the government, we will take official notice of it.

DR. CRYAN: Thank you very much. That's all I have. Thank you, Your Honor.

JUDGE PALMER: More questions? Mr. Beshore. Off the record.

(Discussion held off the record.)

MR. BESHORE: Marvin Beshore for the Association of Dairy Cooperatives, Northeast, and Dairy Farmers of America.

Dr. Yonkers - Cross by Mr. Beshore

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Bob, when is the last time that IDFA has supported an increase in regulated minimum milk prices for dairy farmers?

A. Marvin, I wanted to look at this and it was something I didn't get to for this hearing, but IDFA -- and this was before I joined them -- did support Option 1B as proposed by the Secretary in April of 1999, and I believe that included some increases in Class I differentials in some parts of the country.

Their minimum differential in their April '99 was $1.20, and I believe there were some differentials lower than that. So I can't go beyond that because I wasn't at IDFA, and my guess is -- well, no, I'm not going to guess.

Q. Okay. At least in your time and within your knowledge, those possibly limited increases in 1B in '99 is the only instance you can think of?

A. The only one that comes to mind,

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yes.

Q. Okay. What is your percentage on volume of Federal Order Class I milk that IDFA represents? 85 percent, that figure?

A. That's a national figure across all products. I don't know. I don't know that we surveyed. We do by product, and some of those product categories can go into different categories and I --

I don't know for Federal Orders what percent of the milk is marketed by -- I don't have any idea, Marvin.

Q. Okay. But I take it that you're suggesting with your testimony here today that it's a very substantial majority of the Class I milk in the Federal Order system?

A. I have never thought about it, Marvin, so that's why I'm struggling. I would guess in some orders it is very high, in some orders it's lower, but I would expect it's the majority of milk in most Federal milk market orders.

Q. What volumes can you tell us of IDFA purchases for Class I have been at zero premium

Dr. Yonkers - Cross by Mr. Beshore

in any recent time period, zero Class I premium?

A. I don't know what my individual members pay for milk, but I would guess that no fluid plant -- very few fluid plants would get any milk if they didn't pay a premium because every farmer gets the blend price. There is no incentive for a farmer to pick and choose -- choose to ship milk to a fluid plant rather than to any other plant in the market unless they're providing something as an incentive to get them to ship to them.

Q. Well, is that really true? Doesn't every farmer have to ship to a fluid plant a minimum -- in every pool a minimum proportion of the time before he's part of the pool?

A. I don't believe an individual farmer makes that decision. He can choose to ship to a plant if it's a proprietary manufacturing plant that has made that decision, but I don't think individual farmers make those decisions.

Q. Well, don't the pool -- I am not trying to slice this too thinly here, Bob, but I want the record to be clear about this. Do

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not the performance provisions of every Federal Order require that minimum deliveries be made to fluid milk plants, distributing plants, in order for producers to qualify in the pool? Isn't that the way the pools work?

A. Yes. Yes.

Q. Okay. So for those minimum deliveries, it is not a matter of being offered an additional, you know, $1.00, $1.50 or anything else. If you want to be pooled, you've got to deliver. Now, isn't that true?

A. I would agree with that statement.

Q. Okay. Now, given that fact, do not all those producers incur necessary costs --

By the way, those deliveries, those required deliveries must be made, the price, the minimum price that's applicable is FOB that fluid milk plant; correct?

A. I believe that's correct.

Q. Okay. So Federal Order minimum prices, the supplier, producer, cooperative has the obligation to get that product to that plant to qualify for the pool; correct?

A. I would say that that's true for

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producers, independent producers who direct ship and for cooperatives that sell milk to fluid plants, but it is also true for manufacturing plants which may buy from independents that have to ship that milk.

In that case I don't know who -- I would assume it's borne by the plant because it is the plant doing the shipping. It is not the individual producers that are doing it.

Q. Okay. Whoever delivers, the deliverer to that plant has to get it there and it is priced FOB to the plant?

A. Yes, I agree with that.

Q. Are you seriously contending that the costs, because of escalation and fuel and energy prices in recent years, that the costs of delivering milk to fluid milk plants have not increased in recent years?

A. I don't believe that was my testimony. My testimony was that what was charged to producers had not increased, which meant that others were bearing the costs, and it was part of my attempt to show the Department that putting it in the minimum milk

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price does not mean it would go to those entities that are bearing the cost if there's Class III and IV manufacturing plants that are paying subsidized hauling to compete in certain markets.

Q. Well, whoever has to deliver -- you just acknowledged a minute ago that whoever has to deliver that plant has to deliver it FOB. So they're going to bear the cost; correct?

A. I agree. And if USDA determines that that cost should be part of the regulated pricing structure, they need to make sure that the person that's bearing that cost receives the money. Putting it in the producer price I do not believe guarantees that the entity bearing the cost will be reimbursed fully for that cost.

Q. Well, if it's a cooperative or a producer --

What proportion of milk, do you have any idea, in the Federal Order system is supplied to fluid milk plants by cooperatives or producers?

A. I don't recall seeing that for

Dr. Yonkers - Cross by Mr. Beshore

Federal Orders. Nationally I believe about 85, 86 percent of the milk is marketed by cooperatives. Is that -- I think that's ballpark. But I would have no reason to believe it would be different in Federal Order markets than the national average.

Q. Well, if you know cooperatives supply fluid milk plants and independent producers supply the fluid milk plants, wouldn't you agree that you are going to cover a very, very high percentage of deliveries to those plants in the Federal Order system?

A. Well, I think in orders that have a shipping requirement of 10 or 20 or more percent, that's got to come from the manufacturing plant. I don't know who is paying those costs, and I haven't seen anything by proponents that said that cost is paid by individual dairy farmers. I understand that cooperatives, when they're moving the milk, is, but it is not always borne by dairy farmers. Some are there hauling to the first plant of use as subsidized as even indicated in that Minnesota paper that I quoted.

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Q. But what does that have to do with whether there's an increased cost in getting the milk to the plant?

A. It only goes to the proponents' proposal and whether that would get the money to the entity bearing the cost.

Q. Well, no. We're talking about getting milk to the plant, aren't we? Isn't that what FOB plant point price is in the Federal Order system is, attracting milk to the plant?

A. I don't know what that's got to do with the FOB portion.

Q. The FOB meaning that the price is when it hits the plant. It is not priced until it hits the plant and at that point; correct?

A. Correct.

Q. So if Federal Order prices are to attract milk to that plant, in establishing that price to reflect some, you know, increased cost of transportation, what does it matter who pays the trucker?

A. It doesn't matter who pays the trucker. What matters is what the Federal

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Order -- who they give the money to that they think is paying that trucker.

Q. And the plant is required to pay the Federal Order -- the distributing plant is required to pay the minimum price to the producer of the cooperative supplying milk if it is a producer of cooperative milk; correct?

A. Well, they're paying it to the pool, right. They don't pay the Class I price directly to the cooperative. They play it to the pool.

Q. Well, I disagree. That depends on what order you're working with, and it doesn't make any difference.

You're not saying that it makes any difference whether you're in an order where the market administrator requires all distributors to pay through the pool versus paying the classified values to the cooperative? You're not saying that makes any difference, are you?

A. Maybe the problem I'm having with what you're asking is are you talking about what Class I plants pay or what farmers get, and the third area here is what entities

Dr. Yonkers - Cross by Mr. Beshore

providing a service to the Class I are being -- whether they're being paid for the services they are providing?

Q. I'm talking about what Class I plants are required to pay, minimum prices. Isn't that what --

A. Minimum prices to the pool, yes.

Q. Right. That's what the proposal is about. That's what you're objecting to; correct?

A. Yes.

Q. To that being increased?

A. Yes.

Q. Okay. And I'm saying that's a price that they pay because somebody delivered fluid milk to their plant; correct?

A. Yes.

Q. Now, if it costs more for that somebody to get milk to the plant because hauling costs have increased, what's the problem with requiring the minimum price to be higher?

A. Because how does requiring the minimum price that must be paid to farmers ensure that the entity paying the cost is getting the money? In the markets that have transportation --

Q. We're not talking about receiving --

A. Could I finish, please.

Q. Sure.

A. In the markets that have transportation credits, the Class I plants pay money into a pool, and that money goes to that milk that is coming into the market to pay that direct cost.

Q. Right.

A. If a plant is receiving -- and I don't know. When you say the minimum price is at FOB, there could be a hauling subsidy from the fluid plant. I don't know that there are any out there, but it alludes to them for manufacturing plants.

I don't know that putting it in that minimum price means it is going to get to the entity that's bearing the cost of moving that milk to the market.

Q. Well, you shifted from -- I'm asking you what is wrong with requiring the higher

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price to be paid to whoever to being concerned with who gets it? I want to ask you, regardless of who gets it, what is wrong with requiring the increased cost of hauling to be reflected in that minimum price that's required and only required for every hundredweight of Class I milk received and utilized as such at that plant?

A. Now I think I understand your question, Marvin.

Q. Okay.

A. That cost must be covered, no doubt. I think requiring it by regulation does not promote efficiencies because it is going to require it at some average level, whether it is the average level nationwide that's being proposed here or the average in the market.

The only way to make sure that those costs when they need to be, when they absolutely, positively need to be ready we can get done and be covered due to changing market conditions on at least a monthly basis. Supply and demand conditions, increases in costs is through over-order premiums. There is no way a

Dr. Yonkers - Cross by Mr. Beshore

regulated minimum price that requires that it be paid can adjust to those changing factors that change on a daily basis but certainly should be reflected at least on a monthly basis.

Q. Don't you think there's been a minimum because of fuel cost increases and other -- increased labor costs, other increases of just hauling milk, that's all I'm talking about, over the last years, isn't there a minimum value that is embedded in every transaction delivering fluid milk to plants in the Federal Order system?

A. I have not seen any data presented here that would suggest that.

Q. I understand that.

A. I have heard and I can look at some of the indices that -- let me go a little while and I'll get there -- that Dr. Cryan just asked to be introduced into the record on cost of process, cost of transportation, cost of inputs, cost of energy, but firms over time, even in the short run, will adjust to changes in relative prices and they will make changes

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in the scale of their operation. It could even be in the location of their supply of milk.

That's not accounted for if all you look at there are changes in those indexes. You are ignoring changes that economic agents in the marketplace are making in response to those changing market conditions.

Q. Okay.

A. But I would agree with you that the secondary data would suggest that those indices have increased. Some of them have decreased, Marv. Not all of them have increased.

Q. Such as?

A. Well, energy prices have come down from where they were at the peak in late 2005, for instance.

Q. Okay. Now, let me just ask you about a couple of specific things. On page 11, the first full paragraph, I'm not sure I understand what you're talking about. "There are currently FMMO regulations other than minimum pricing which address the factors which petitioners claim require changes in the minimum Class I and II prices. In fact,

Dr. Yonkers - Cross by Mr. Beshore

several of these regulations are in the process of being changed in some or all marketing orders."

A. That's what it says.

Q. What are you referring to?

A. Well, I go on and I talk about the change in the make allowances which are being updated to address changes in costs of processing, which was one of the exhibits introduced by petitioners.

Q. Are you seriously contending that's going to help the costs the proponents are talking about here?

A. They talk about balancing costs. Those are borne by plants, Marv, and, you know, I've got nothing else to go by. Giving it to the farmer --

Again, this is another case where putting something at a minimum price, raising the minimum price that's paid to the farmer, I don't see where that helps a plant that has costs associated with balancing functions.

Q. Okay. So it's your position that reducing the minimum Class III and IV prices is

Dr. Yonkers - Cross by Mr. Beshore

going to help with the cost price squeeze at the farm level that proponents have talked about? That's your testimony?

A. I thought the evidence presented for an increase in the Class I price only related to costs of servicing the Class I market. Now, if you're asking me should USDA set minimum Federal Order prices based on farm costs of production period, I would say that in my opinion USDA has consistently rejected that as a basis for setting minimum class milk prices.

Q. Now, I'm trying to understand how you state on page 11 that there are currently FMMO regulations addressing the factors which petitioners claim require changes in minimum Class I and II prices, those factors being higher costs on the farm and in delivery of Class I and II, how what you have now identified as the changes in make allowances, reducing farm prices, are going to address those factors. Are you seriously contending that the make allowances addressing the concerns that Dr. Cryan raised in his testimony?

Dr. Yonkers - Cross by Mr. Beshore

A. His specific concerns?

Q. Yes.

A. You mentioned in the start of your question would address costs at the farm and cost of delivering to I think you said Class I plants.

Q. Right, I and II.

A. For specific additional milk that's needed in the market, I would say that the transportation credit increases are looking at the cost of delivering milk to Class I plants.

Q. In Orders 5 and 7?

A. Yes.

Q. Okay.

A. Not nationally but at least in those orders that would be duplicative, and there are no proposals here to eliminate those and at the same time we're raising the Class I price.

Costs at the farm, again, I don't think there have been cost increases at the farm.

Q. Since when?

A. Between Grade A and Grade B milk production, you asked me that Dr. Cryan

Dr. Yonkers - Cross by Mr. Beshore

testified to, and I thought those were the costs you were referring to since Federal Order reform was put it. The only actual data I saw introduced into the record here was anecdotal data from Mr. Tonak.

Q. You understood Dr. Cryan to be talking about the cost, only about the cost of converting from Grade A to Grade B? Is that your testimony?

A. I understand that Dr. Cryan was talking about the incremental cost of having a Grade A farm versus having a Grade B farm. Was it more than that? Did I miss something?

Q. I think you did, yes. I will go on. Let me look at page -- go to page 27 of your testimony. What is the basis for your statement that -- the second full sentence in the paragraph Grade A versus Grade B, what's the basis for your statement that "First of all, a key justification for Federal Order price regulation was to encourage conversion of Grade B farm operations to Grade A"? What's the basis for that?

A. Back in the 1930s there was a huge

Dr. Yonkers - Cross by Mr. Beshore

amount of Grade B milk production and not much of Grade A production required to serve the more widely fluctuating seasonal needs that there were in existence back then, and my understanding was that one of the key purchases of Federal Orders was to ensure there was an adequate supply of that fluid quality milk, what we know of today as Grade A, so that it could serve the Class I market.

Q. By encouraging conversion of Grade B farms to Grade A? I have never read this before, Bob, in any text, in any text or history or publication or anything else about the history of the program, and there's probably something I haven't read. I just wonder what you base that on.

A. I have nothing specific because that's common knowledge that I went through in my training as an economist, as an undergraduate or as a graduate student was the understanding that, you know, Federal Orders provided an incentive for milk producers of Grade A milk to get a higher value out of the marketplace, and the purpose in doing that was to get more of them and get more milk in Grade A. Yes, that is my understanding, Marvin.

Q. Okay. On page 20.

A. 20 did you say?

Q. 20, yes. There's a sentence in the middle of the paragraph. It says, "The impact analysis documentation notes that retail fluid milk prices are not projected in the model, so the impact could be even higher."

What I'm wondering here, you're commenting that what? Because the USDA model uses wholesale price changes rather than retail that there could be differences in the results depending upon what's going on at the retail level? Is that it?

A. My understanding of the model is that it uses farm level Class I prices, not even wholesale prices, Marv, and that it specifically says it is a straight pass through.

My documentation I looked through is that that 64 cents that they estimate as to the interdynamic model is a straight pass through

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of 5.5 cents a gallon because on Table 1 -- and I don't have it in front of me, but I believe it is Table 1 in the hearing notices -- the only piece of data that is not provided in the baseline is a retail price for fluid milk. They have prices of other products, but the only thing that's not provided there.

So that's an indication to me that they're not doing anything with retail. They're not modeling the retail. They're not modeling anything beyond the farm increase in Class I prices.

Q. On page 13 at the top you talk about depooling decisions, and the last part of the sentence in the paragraph at the top of the page is what I'm not sure about, what I don't understand. Are you saying that there were decreases in the volume of milk shipped to Class I plants in those orders?

A. No. What I'm saying is that more than the minimum was shipped. I mean, they depooled. If you had 100 percent of your milk and 20 percent of it had to go as a shipping requirement, what you depooled is 80 percent.

I mean, you still ship exactly the same volume as a Class I plant, but now you're shipping 100 percent of that milk you're pooling rather than 20 percent of the milk you're pooling.

So all I'm saying is that there was a decrease in the volume of milk shipped to Class I plants that was required to be shipped to remain in the pool, and perhaps I should have said a decrease -- how do I want to say that. It is an increase in the percentage.

Q. Not the volume?

A. Yes, not the volume. You're right.

MR. BESHORE: Okay. I have no other questions at this time.

JUDGE PALMER: Anybody over here? Mr. Carman.

CROSS-EXAMINATION

BY MR. CARMAN:

Q. I love models, Bob. You know that. Concerning the Cornell model, during cross-examination you were purported to say that the models that we used in Federal Order reform could be used again. As you perhaps

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recall, that's a linear programming model that looks at spatial prices for all of the products and a number of demand points and a number of supply points, and in order to populate the data of that model, it would take a great deal of work to do current progressions rather than using 1995. You don't purport to use 1995 data; right?

A. I would suggest that you use more recent data than 1995, Cliff.

Q. Okay. To the extent that the documentation of the AMS Dairy Programs model that USDA used in the analysis of this proposal, the documentation would seem to indicate that there's a constant from plant-to-retail margin assumed in the model. Would you agree that that may be what you're referring to in terms of not needing to estimate a retail price?

A. I wouldn't say there's a constant. There's just nothing. It is just a straight pass through. It is not a constant extent or anything.

Q. The margins are assumed to be

Dr. Yonkers - Cross by Mr. Stevens

constant from plant to --

A. No, because margin would actually -- if you're talking about percentage margin, actually it is a straight pass through on the dollar volume cents per unit, yes.

MR. CARMAN: Thank you.

JUDGE PALMER: Questions? Mr. Stevens.

CROSS-EXAMINATION

BY MR. STEVENS:

Q. Are you aware, are you aware personally or are you aware that IDFA asked for any person from Washington to come and explain the model to the hearing?

A. Well, Garret, I am glad you have asked me that question because, no, I did not ask that because, quite frankly, I thought -- I thought that the make allowance hearing in January, the hearing notice is the first time you published that, and you did have a USDA -- you collectively did have someone there to testify, and I assumed that was going to be the case now, and that's my fault.

Dr. Yonkers - Cross by Mr. Stevens

But I have been extremely busy the last two weeks getting ready for this since the hearing notice came out, and the workshop last week.

You're right. I did not ask anyone from USDA if they were going to testify on the model.

Q. Did anyone from IDFA, to your knowledge, ask?

A. Any of our members?

Q. Any representatives? Let's put it this way --

A. I know of no one else. I know I did not ask, and I don't believe anybody else would have.

Q. There was one other thing which just caught me on your statement. I think it is the second to the last page.

A. You were still paying attention.

Q. Page 39.

A. Okay.

Q. In the second full paragraph you start that out with the word "Petitioner." Who is the petitioner? You used the word

Dr. Yonkers - Cross by Mr. Stevens

"proponent" in this thing a lot. Do you use the word "petitioner" more than once in the statement?

A. Well, on page two I specifically referred, at the very bottom there, the National Milk Producers Federation, and in parens I said "petitioners," so --

Q. So that's you?

A. No. The --

Q. Okay. I just want to make sure. So it's National Milk --

A. Yes.

Q. -- is the petitioner. Would also be the proponent, I assume?

A. Yes. Yes.

Q. Okay. I didn't --

A. Yes. Yes.

Q. It's the first place I saw "petitioner," and I guess because of something we can refer to as the hat incident, I did not hear you say that.

A. Okay.

Q. Thank you very much.

JUDGE PALMER: Let's go off

Dr. Yonkers - Cross by Mr. Tosi

the record for just a second.

(Discussion held off the record.)

JUDGE PALMER: Questions? Mr. Tosi, do you have some questions?

MR. TOSI: Yes.

CROSS-EXAMINATION

BY MR. TOSI:

Q. In the reform final decision where the Department expressed its preference for 1B --

A. Well, its preference was in the January '98 one. It actually said 1B in the April '99 one. Does it make a difference which one you're referring to?

Q. Well, it is my recollection -- I am not wanting to testify here.

A. Okay.

Q. It is my recollection that before we wrote the final decision we referred two options for consideration. They were Options 1A and 1B.

A. Yes.

Dr. Yonkers - Cross by Mr. Tosi

Q. And at the end of the day the Department chose Option 1B for the reasons that it said.

A. Yes.

Q. Okay.

A. Well, I assume you did them for the reasons that you said and not any other reasons. So I will make that assumption.

Q. I will leave that one alone.

A. Okay. Thank you.

Q. Okay. And to the extent then that Congress subsequently comes in and says now you should adopt the 1A, you are of the opinion then that all the thinking that went along with the construction of what 1A meant, how the differential levels were arrived at and so on and so forth doesn't carry into what the existing rationale is or that explains what the construction is of the Class I differential?

A. My testimony was that the imposition of 1A by Congress was obviously political. It was not based on the economic justification, which was what USDA used, to determine modified 1B in April of 1999, and I don't believe you

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can throw out the economic justification under the AMAA because I don't think Congress said you have to throw out looking at it based on the criteria of the AMAA. We're just telling you to use 1A now.

I don't think they said you can never look at them again, and when you look at them again, you have to use the same economic-based justification that you used in your '99 decision.

I'm not saying the same stuff you had in the '99 decision necessarily, but you have to -- I don't believe Congress said the reason I want you to use 1A is because it is economically justified based on what you said in the April 1998 decision. I mean the January 1998 decision. I don't think there was anything from Congress that said that.

Q. So unless Congress specifically says all the arguments that explain 1A as an option, don't carry them?

A. I would put it in a different way.

Q. Into their mandate that says these are he differentials that you need to have,

Dr. Yonkers - Cross by Mr. Tosi

A. I would say it a different way, Gino. I would say that unless Congress changes something about, in the AMAA, that you use to derive Option 1B, modified 1B, unless they're saying there's something that changes there that would cause you to only do 1A, that would be another way of looking at it. But I don't think there was anything.

Q. That's your opinion, and you're not speaking for the Secretary on that point?

JUDGE PALMER: You're not speaking for whom? I missed the --

MR. TOSI: The Secretary.

A. I don't purport to speak for the Secretary unless it is my secretary. But, no, I don't. And then I don't speak for her. She speaks for me, tells me what to do.

No, I don't speak for the Secretary, Gino.

Q. Do you think it would be unreasonable to adopt something that Congress had directed?

I think it would be reasonable to know that they understood what the differences

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were between 1A and 1B and then concluding that Option 1A should be the option that should actually be implemented. Why would a reasonable person think that the arguments that go along with 1A don't carry with them, carry into its implementation?

A. You know, the last time I looked there's only a couple of official economists at USDA and none of them are the members of Congress who vote, unless there happens to be one I don't know about who has a degree in economics, and I would apologize then.

USDA under the '37 Act was given the directive to determine the justifications for changes -- for making Federal Orders and then a procedure for changing them. Nothing Congress did by saying you're going to use 1A for this decision at this point in time changed that, in my opinion.

Q. Okay. I understand that that's your opinion.

JUDGE PALMER: Do you want do ask him one question, Mr. Carman?

MR. CARMAN: I tried to

whisper it to him. I tried to pass the question off but I got stuck with it.

JUDGE PALMER: All right, sir. You have yielded the floor to Mr. Carman as they say in Congress.

CROSS-EXAMINATION

BY MR. CARMAN:

Q. Bob, in the Exhibit No. 10, which is the April 2, 1999, decision, which is the modified 1B decision as put forth as approved and supported by the Department --

A. Yes.

Q. -- and would be reasons for that minimum level of $1.60 in Wisconsin set forth in the recommended decision that was back in January?

A. Could you say that again just so I get the --

Q. The final decision issued in April of 1999 --

A. Okay.

Q. -- in which the Secretary suggested that the spatial price structure should start

Dr. Yonkers - Cross by Mr. Carman

at $1.60 in Wisconsin using the 1B option as modified.

A. You say starting in Wisconsin?

Q. Well, the minimum was $1.60.

A. No. It was $1.20. It was $1.60 in Wisconsin, but the minimum was $1.20, as I recall, in the April '99 decision. It was even below $1.20 I think in Seattle.

JUDGE PALMER: Let's not have a group talk here.

A. Okay. Yes. Is that what -- you're asking in my statement that it was increased in the Upper Midwest?

Q. It was increased and it was set at $1.60 under the --

A. Okay. Okay.

Q. And to the extent that Congress then suggested that we use modified 1A which also had $1.60 level for the same locations in that Wisconsin area, that, if you will, the base of establishing that $1.60 would be contained as presented in the recommended decision of January of 1998?

A. I think I get your question, but

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the -- there was an increase in the Class I differential in the Upper Midwest as a result of the Federal Order reform, whether it was 1B or 1A, and that was my point. So that's going to be reflected in the fluid milk price series that NASS puts out. That was my point for pointing that out.

Right. And we developed, if you will, the Department developed the $1.60 as being needed to service the Class I market under the final decision for Wisconsin.

A. Okay.

MR. CARMAN: Okay. Thank you.

JUDGE PALMER: Mr. Tosi.

CROSS-EXAMINATION

BY MR. TOSI:

Q. Bob, I'm a little confused when you make the statement that our Class I differential levels, they're not what causes milk to move to Class I plants. Is that an accurate representation?

A. Yes, it is.

Q. Okay. If that's the case and to the

Dr. Yonkers - Cross by Mr. Tosi

extent that the Department has articulated in the past that one of the purposes of the Class I differential is to get milk to move to attract an adequate supply of milk for Class I use at those locations, wouldn't it be reasonable to conclude that the level of the Class I differential is inadequate?

A. I would say, Gino, because of the higher Class I price being pooled with everyone in the order -- now we're talking about marketwide pools.

Q. Marketwide pools.

A. And I don't know if this developed, the statement you made about the Class I price, one of its purposes was to attract milk to Class I was when we had individual handler pools. That would be very different.

But just talking about it from this perspective, for an individual farmer in a large pool, certainly, he can have almost no impact on the blend price in the market by moving from a manufacturing milk plant to a Class I plant. I don't see how that provides an incentive.

Dr. Yonkers - Cross by Mr. Tosi

Q. Well, I mean, if that were the case, then it is totally irrational -- I mean, would it be reasonable to conclude that it is irrational then to, one, have a differential at all or that the differentials would be different depending on, you know, what location Class I milk is delivered to?

A. Well, if you don't have a Class I differential, there's no need to have a pool because I assume that means all the prices are going to be the same. I assume you wouldn't keep Class II higher, but --

Q. No, no. Please, let's just focus on this for one.

A. Okay. Can you ask your question again? Because I didn't understand it.

Q. Sure. If the price isn't doing -- if the Class I differential which leads to Class I prices, which are the only prices that vary from month to month in an order, to the extent that they're not causing milk to move, wouldn't it be reasonable -- you know, why would it be rational to have different Class I differential levels at different locations

Dr. Yonkers - Cross by Mr. Tosi

around the country? I mean, you're supporting on one hand some of the things that Cornell say here about the location value of milk. Okay?

A. Yes.

Q. But now we're saying but that's not really -- now that doesn't really matter, and it's sort of confusing.

A. Within an order everybody gets the same blend price.

Q. True.

A. If all the plants are in the same pricing zone.

Q. Sure.

A. All right. And you move them around there's -- you know, within an order there could be some location adjustments, and to the extent that that's going to attract some milk to move farther than it would otherwise to go to a plant, you're going to get 10, 20, 30 cent higher Class I price in the pool, but the farmer doesn't get that. So the only --

My members who are fluid plants, Gino, have to pay an over-order premium because otherwise everyone is indifferent about who

Dr. Yonkers - Cross by Mr. Tosi

they ship to. I mean, everybody is indifferent who they ship to unless they pay an over-order premium or they do something else after the shipping requirements are met.

Q. All right.

A. Now, across orders, higher differentials in orders, first of all, just the utilization alone -- let's say all the differentials are the same across the country. Then just the utilization alone would pool milk, although that may not be enough to get it to move that distance. So higher differentials add to that to move milk into deficit areas.

Q. You just got done saying that that's not what causes it to move.

A. Within the order -- I mean, I understood your question to be why are there over-order premiums. There have to be over-order premiums within the market.

Q. I was trying to -- you know, why are Class I differentials different than if it's only over-order premiums that are moving milk?

A. Right. Okay. They do move milk, and when they're set too high, they move too

Dr. Yonkers - Cross by Mr. Tosi

much milk.

JUDGE PALMER: What does? The differentials?

THE WITNESS: The higher the differentials.

A. When they are set too high, they are generating a higher price, and this is what Dr. Knutson's testimony was. One of the reasons we have to limit the amount of milk coming into an order is because they're getting too much and it is diluting that fact.

Now, you can change that two different ways, Gino. You could lower the Class I differential and/or Class I price in order to correct setting it too high, or you can build a trade barrier, and that trade barrier is limiting pooling.

We can raise pooling requirements. We can say we can't move milk long distances if you get those. You know, I would argue that it is not, from an economic efficiency standpoint of supplying the market at the lowest cost, option one of lowering the differentials is better than option two of actually creating a

Dr. Yonkers - Cross by Mr. Tosi

trade barrier.

Q. To the extent that the orders have provisions in them that provide a very reasonable assurance that Class I plants are going to be adequately supplied, why then would members like of your organization that you're here representing, why would they care how far and amongst however many dairy farmers they decide they want to share that additional money that comes from Class I sales? I mean, it's coming across here like there's a wedge here that --

A. My members are not having any trouble getting Class I milk, and they don't see why that price should go up. That's what most of them testified to here. I think maybe all of them who were Class I shippers may have done that.

So they don't see any reason that more money should go into the pool, whether it is being shared with the same farmers that are in the pool or whether it should be shared with more farmers that are in the pool.

I think it is your job at USDA, the

Dr. Yonkers - Cross by Mr. Tosi

royal you at USDA, to determine are these regulations, whether they are pricing or pooling or shipping requirements or transportation credits or assembly credits or anything else, are necessary to ensure there's an adequate supply of milk for fluid needs.

My members don't get to vote on that after you have decided whether that's right or not. Only the producers do. And the producers can decide that, yeah, I don't like the way you're sharing in and decide to vote against it and vote out the order or they can say I like the way you're sharing it.

But it's your job. It's not the producers to get to decide what those rules are. They get to decide whether to accept them or not. They could accept them or no rules at all, but it's USDA's job to set those rules, all of those regulations, consistent with the mandate in the Act.

Q. So you're saying producers really don't get much of a say then in terms of what the provisions -- how the money should be shared amongst themselves, and from time to

Dr. Yonkers - Cross by Mr. Tosi

time they come and propose different standards because they're asking USDA to sort of referee disputes that they may have amongst themselves about how to share that money?

A. And in a way you're being asked to help set up a trade barrier to keep some milk out and some milk in. You're deciding -- which if it is economical for my members to move milk into an order or for a farmer to get more money in his pocket by moving milk from a more distant place into an order and you want to limit his right to do that, you're only doing that to protect a higher price for those farmers that are already in that market. That's all you're doing.

MR. STEVENS: I object to that. He can make testimony. He can certainly testify.

MR. ROSENBAUM: He's answering a question. I have never seen this before, you object to an answer.

MR. STEVENS: Well, then that's fine. I will withdraw my objection, but then I will ask the question of the witness,

Dr. Yonkers - Cross by Mr. Stevens

Your Honor.

JUDGE PALMER: That's fine. Are you finished?

MR. TOSI: That's all I have.

CROSS-EXAMINATION

BY MR. STEVENS:

Q. I am very interested in what you just said. You say the Secretary, in providing marketing orders, is creating trade barriers to prevent milk from moving outside marketing areas into marketing areas? Is that your testimony?

A. They can be asked to do that. The Secretary has to decide whether that --

Q. I didn't ask whether they can be asked to do that.

MR. ROSENBAUM: Finish your answer.

JUDGE PALMER: Let him answer.

A. I believe that the Secretary has the requirement to determine if that's necessary to ensure an adequate supply of fluid milk.

Q. He does that in every marketing

Dr. Yonkers - Cross by Mr. Stevens

order decision that I've read. Are you saying that he doesn't do that?

A. I'm saying that when you raise the Class I price for whatever justification, whether it is cost base, like the proponents are alleging that there's costs that will raise it here, you may be faced with setting a price that is going to attract more milk than is needed by the market, and those that are in the existing market may ask you to increase the shipping requirements or do something else in order to maintain that price in the market.

And I think it is the Secretary's job, and I think I even quoted from the '98 or '99 decision, that you want milk to move so that it is at the least cost and the most efficient for the market, and if the most efficient way to do that is to not have a local supply of milk production anymore to serve a local market, if it can come from more distance and do it cheaper on a regular basis, I think that's very important for the Secretary to look at.

Q. Well, I assume that you would agree

Dr. Yonkers - Cross by Mr. Stevens

that under the Act that has to be on the base of rule making that establishes a rational basis for doing that?

A. Yes.

Q. All right. And I don't hear your testimony, I assume you're not testifying that the orders are not doing that at the present time?

A. My members are not having any trouble getting an adequate supply of fluid milk.

Q. I understand that. You've certainly testified to that. There may be other people here who have testified that that's not the case. You have a difference of opinion on that with other people that have testified in this hearing.

A. I didn't hear anyone who is getting Class I milk testify that they're having trouble getting Class I milk. So I don't think there were others that testified that they were having trouble getting an adequate supply.

Q. But you heard testimony by producer groups concerning this issue?

A. Yes, I did.

Q. Okay. So there may be a difference of opinion?

A. Often is.

Q. And that's what the Secretary has to get through, doesn't he, to make a decision? He has to look at the record evidence and look at --

A. I don't think --

Q. Let me finish the question. He has to look at the record evidence and has to decide on what's presented before him based on the record evidence what is appropriate to do under the Act?

A. I would agree with that.

MR. STEVENS: Thank you very much.

JUDGE PALMER: Any other questions? Yes, Mr. Rosenbaum.

REDIRECT EXAMINATION

BY MR. ROSENBAUM:

Q. A few issues of clarification. You were asked a question as to the context in

Dr. Yonkers - Redirect by Mr. Rosenbaum

which the proponents had made argument regarding the increased costs they allege they are incurring at the farm level; correct.

A. Yes.

Q. Isn't it, in fact, the case that the only context in which the proponents presented that evidence was in the context of attempting to use that data as a basis for increasing a portion of the Class I differential that allegedly reflects the cost of being a Grade A farm versus being a Grade B farm?

A. Yes.

Q. And your answer to that question a few minutes ago accurately reflected that fact; isn't that right?

A. Yes.

Q. The other factors upon which the proponents purport to allege don't have anything to do with farm costs; correct? They are the costs of balancing being the cost of operating a processing plant; correct?

A. Yes.

Q. Transportation costs, which are not a farm cost; correct?

Dr. Yonkers - Redirect by Mr. Rosenbaum

A. Not necessarily a farm cost, correct.

Q. And over-order premium, which is not a farm cost; correct?

A. That's correct.

Q. Now, on the most perhaps minor clarification point, could you confirm that, in the context of your testimony, the term "petitioner" and the term "proponent" in both cases reference the National Milk Producers Federation?

A. Yes.

Q. In terms of whether a request had been made that USDA's economist appear here at the hearing, were you present when Mr. Vetne stated in the record that he himself contacted the Secretary?

MR. STEVENS: I object to the form of the question. There's no testimony in this record by anybody, no testimony that anybody contacted the Secretary and asked for an economist or anybody from the Department to appear, and I did not hear that from Mr. Vetne.

JUDGE PALMER: I don't

remember, so we're at a loss here. The record will show whatever it shows. If Mr. Vetne said it, it is on the record.

MR. ROSENBAUM: He certainly made that statement.

JUDGE PALMER: You will point it out, I'm certain. Let's leave it go. We don't need him to affirm it.

MR. STEVENS: If we have a statement that he said that, I will let the record reflect whether he said it or not. I am here to tell you that no one contacted the Department and asked that an economist come to that hearing. No one asked for Mr. McDowell or anyone else to appear at this hearing to explain the model.

MR. ROSENBAUM: We will let Mr. Vetne's statement speak for itself.

MR. STEVENS: Fine.

JUDGE PALMER: Your statement will be on the record too, Mr. Stevens. Any other questions?

MR. ROSENBAUM: That's all I have.

Dr. Yonkers - Recross by Mr. Beshore

JUDGE PALMER: Yes, Mr. Beshore.

MR. BESHORE: Just one follow-up question to Mr. Rosenbaum, one of Mr. Rosenbaum's questions.

RECROSS-EXAMINATION

BY MR. BESHORE:

Q. Is it your understanding, Bob, that the only cost reflected in balance of fluid milk markets is operating manufacturing plants?

A. I wouldn't say operating manufacturing plants. It is not in the entire operation of the manufacturing plants because they actually have demand-driven uses, needs to operate also.

Q. But is the cost of plant operations the only cost in your view in balancing fluid milk markets?

A. I think it is.

MR. BESHORE: That's all I want to know. Thank you.

JUDGE PALMER: Any other questions at all? I had some thoughts, and I will keep them all to myself so I will leave it at that. Thank you, sir.

I think our next effort is to talk about filing the transcript. Oh, and you probably got a pro forma -- let's go off the record a moment.

(Discussion held off the record.)

JUDGE PALMER: It has been decided that the filing of briefs --

MR. STEVENS: Your Honor, might I interrupt for just a second?

JUDGE PALMER: Yes. You first.

MR. STEVENS: Garret Stevens, Office of General Counsel. Proposal 6, the proposal that is included in most every Federal Order hearing, it provides the opportunity for the Agricultural Marketing Service and the employees of the Department of Agriculture to make conforming changes, changes that are necessary as stated in the proposal, to conform the order to anything that results from this hearing.

JUDGE PALMER: Fine. So no evidence is needed on that.

Then the other issue was when briefs will be filed. It has been decided that inasmuch as the Department puts the transcript itself on the Internet usually a day after receiving it, what we're going to do for briefing, the deadline is going to be January 30, which is a Tuesday, or 30 days from the date that the Department actually puts the transcript on the Internet, whichever comes later. So whichever is later, that's your due date. That means the date -- you can do it by e-mail, don't you? Do they e-mail it to the Department. E-mail or fax? Because nobody wants to go through the regular mail anymore. So it would be e-mailed or faxed.

MR. BESHORE: If that's not officially reflected in the regulations of the department, however, it has been recognized routinely.

JUDGE PALMER: We're doing it all the time in adjudicatory cases, e-mail and fax, and you will exchange with each other on that same date. The parties will exchange the materials with each other. Anything else?

MR. STEVENS: But certainly under the rules of practice that apply to these proceedings, a copy of this document by whatever form you are sending it needs to go the Hearing Clerk's Office, U.S. Department of Agriculture, Washington, D.C.

MR. ROSENBAUM: So it is an e-mail to Mr. Tosi and mailed to the hearing officer.

(Discussion held off the record.)

JUDGE PALMER: Do what I have just said. By January 30 or 30 days from the time it is posted on the Internet, whichever comes first.

MR. ROSENBAUM: Whichever comes later.

JUDGE PALMER: Whichever comes later. I'm sorry. You will e-mail to each other, you will e-mail to Mr. Tosi, and you will send by Overnight Express to the hearing Clerk's office one copy of it. Then that one is in the Hearing Clerk's office.

I think we've got everything covered now. Thank you very much.

MR. ROSENBAUM: And I think we normally have made proposed corrections to the record due the same day.

JUDGE PALMER: Yes. I have to certify it as being correct. So if you have got any corrections, put those on.

(Whereupon, the above-entitled matter was concluded at 3:27 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/SANDRA J. MASTAY

____